DOCKET SECTION

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

POSTAL RATE AND FEE CHANGES, 1997	Docket No. R97-1

RECEIVED
APR 1 4 33 PM '98

INITIAL BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Anthony F. Alverno
Richard T. Cooper
Susan M. Duchek
Kenneth N. Hollies
Eric P. Koetting
Scott L. Reiter
Anne B. Reynolds
David H. Rubin
Michael T. Tidwell

United States Postal Service
475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
April 1, 1998

TABLE OF CONTENTS

PROCEDURAL HISTORY i

I. THE REVENUE REQUIREMENT DEVELOPED BY THE POSTAL SERVICE, WHICH REFLECTS AND SUPPORTS ITS FINANCIAL AND POLICY GOALS, SHOULD BE USED AS THE BASIS FOR THE COMMISSION'S RECOMMENDATIONS IN THIS DOCKET I-1
- A. The Postal Service's Request Seeks to Build on Its Strong Financial Performance in Recent Years I-1
- B. The Postal Service's Financial and Other Policy Goals and Objectives Create the Framework for Its Proposals in this Case I-4
- C. The Postal Service's Revenue Requirement Is Adequately Supported on the Record I-7

II. THE COMMISSION SHOULD ONCE AGAIN RELY ON THE VOLUME ESTIMATES AND FORECASTING METHODOLOGIES PRESENTED BY THE POSTAL SERVICE II-1
- A. OCA Witness O'Bannon's Analysis Of Imputed "Own Price" Elasticities Is Fundamentally Flawed II-3
- B. Witness Clifton Demonstrates That Substantial Care Must Be Taken In The Interpretation Of Witness Thress' First-Class Letter Workshare and Non-workshare Models II-5
- C. NNA's Criticism Of The Postal Service's Volume Estimates Is Tenuously Based II-7

III. THE POSTAL SERVICE'S ESTIMATES OF THE COSTS CAUSED BY EACH SUBCLASS AND SERVICE HAVE BEEN DEVELOPED BASED ON A SOLID AND COMPREHENSIVE COSTING FRAMEWORK, PROVIDE SUPERIOR RESULTS COMPARED TO ALL PROPOSED ALTERNATIVES, AND SHOULD BE ADOPTED BY THE COMMISSION . . III-1
- A. Professor Panzar Presents The Appropriate Economic Framework For The Costing Exercise III-2
- B. For The First Time, The Postal Service In This Case Presents Comprehensive Incremental Costs III-6
- C. The Postal Service Has Employed A Coherent Analytic Framework To Improve The Treatment Of Mail Processing Costs And To Address Concerns Raised In Previous Cases III-10
  - 1. All credible evidence of record in this proceeding clearly demonstrates that mail processing labor costs are not fully variable with volume. III-13
    - a. The Postal Service's new analysis of the volume variability/distribution key methodology for mail

processing labor costs was well-conceived, carefully implemented and thoroughly documented. III-14
b. The prior, untested assumption of 100 percent volume variability of mail processing labor costs must be set aside. III-18
c. The fixed-effects model presented in Professor Bradley's direct testimony is the most reliable econometric evidence of the true variabilities of mail processing labor cost pools. III-27
i. Professor Bradley's variabilities are derived from a properly specified cost equation and use of that cost equation is appropriate III-27
ii. Use of labor hours as the dependent variable has strong precedent and reflects actual resource consumption. III-28
iii. Use of a cost driver such as TPH is both proper and supported by precedent. III-35
iv. Dr. Bradley properly controlled for factors that could confound the measurement of variability. III-40
v. Dr. Bradley's analysis is appropriately short-run. III-44
vi. Dr. Bradley correctly used a cost equation in which a capital variable was unnecessary and, if added, has no significant impact on the results. III-47
d. The data used by Dr. Bradley are appropriate for estimating the variability of mail processing labor costs. III-49
i. The panel data used by Dr. Bradley are comprehensive and hold advantages over other types of data. III-49
ii. The MODS and PIRS data are reliable and are suitable for estimating variabilities for mail processing labor costs. III-50
iii. Dr. Bradley's data scrubs were objective and appropriate. III-60
e. Dr. Bradley followed proper procedure in choosing his econometric method which results in the best measure of variability. III-64
f. Dr. Bradley's econometric results are robust. III-71
g. All issues raised by the Presiding Officer and the Commission concerning Dr. Bradley's variability analysis have been fully addressed and resolved In favor of his approach. III-76

2. The Postal Service has provided the correct distributions of volume-variable cost pool costs to complete the estimation process for subclass mail processing marginal costs III-89
a. Witness Degen properly uses direct and mixed-mail tallies to distribute the volume-variable costs in each cost pool to the subclasses handled in that cost pool III-89
b. None of the Suggested Alternative Distribution Methods Rely on a Coherent Economic Framework of Causality, Or Result in Reliable Estimates of Marginal Costs III-94
i. All methodologies under discussion use some type of cost pools, and make certain assumptions about those cost pools. III-97
ii. Witness Stralberg's belief that the Postal Service's cost distributions are biased against presorted mail is unfounded III-100
iii. By Actually Calculating Coefficients of Variation for His Distributed Costs, Mr. Degen Has Proven That Allegations of "Sample Thinness" Provide No Legitimate Grounds to Reject His Methodology III-104
iv. The new Postal Service methodology accurately reflects the causality of "migrated" mail processing costs III-105
v. Illusory "Automation Refugees" and Other Unfounded Allegations of Inefficiency Provide No Legitimate Basis to Reject the Postal Service's Proposed Allocation of Mail Processing Costs III-108
(a) These types of allegations were made long before the Postal Service proposed the new methodology III-109
(b) There is No Corps of "Automation Refugees" III-109
(c) Neither The Growth of Not-Handling Tallies Nor Cited Extrinsic Evidence Support the Claim That the Postal Service is Inefficient III-112
(d) The increase in the mail processing costs of Periodicals is being exaggerated, and the actual increase in recent years appears to be explained by changes in mail makeup III-115
(e) Intervenor Witnesses Making Allegations of Inefficiency, Excess Capacity, and Slack Time Appear to

Not Appreciate Fully the Significance of the Variability Analysis In the Overall Economic Framework III-117
vi. UPS witness Sellick's proposed application of the new distribution methodology is inappropriate without a consistent theory of cost causality III-121
3. ANM's theories on Nonprofit Standard (A) costs are not compelling III-126
a. Dr. Haldi's commentary on anomalous IOCS weights does not stand up to alternative explanations. III-127
b. Dr. Haldi's alleges discord between the Postal Service's data collection systems. III-129
i. The bases for Dr. Haldi's conclusions are an ill-founded survey and speculative volume assessments. III-132
(a) The ANM survey methodology virtually guarantees biased results. III-133
ii. The ANM survey responses cannot be used to make inferences on the degree to which inconsistencies between volume and cost data systems affect nonprofit costs. III-135
iii. Witness Haldi's volume estimation methodology is flawed, and overestimates the volumes of mail affected by "mismatching." . . III-136
iv. The Postal Service's investigation of the inconsistency between volumes and costs for nonprofit Standard (A) mail found that the true rate of inconsistency was much lower than opined by ANM. III-137
(a) PERMIT and accounting data show that the incidence of mail entered at nonprofit rates, but later assessed regular Standard (A) rates, is infrequent, and does not necessarily lead to inconsistency between volume and cost data systems. III-138
(b) The Postal Service's survey results show that the incidence of mail with nonprofit indicia paying regular rates at acceptance is minimal. III-139
(c) PERMIT data show that there are volumes initially paying regular rates which later are assessed nonprofit rates. III-141

v. The Postal Service's investigation shows that witness Haldi's theory is not supportable, and therefore that it does not support his claim that nonprofit costs are overestimated. III-142
D. Witness Brehm Provides Updated Window Service Variabilities . . III-143
E. Improvements To City And Rural Carrier And Special Delivery Messenger Costing III-144
1. The evidence of record confirms witness Baron's conclusion that prior treatments of coverage-related load time have overstated volume variable costs. III-144
2. The Hume methodology to estimate reclassified test-year unit delivery costs should again be used by the Commission. III-156
3. Witness Nelson's Costing Refinements and Data Collections Are Uncontested and Should Be Accepted . . . III-157
F. The Commission Should Adopt Dr. Wade's New Estimate Of The Variability Of Vehicle Service Driver Costs III-158
G. The Postal Service Makes Use Of The Two Step Volume Variability/Distribution Key Method for Purchased Transportation Costs. III-159
1. Dr. Bradley presents a new variability study of purchased highway transportation costs. III-161
a. Dr. Bradley's variability study fulfills a Commission request raised in Docket No. R94-1. . . . . III-161
b. Cubic foot-miles is a good cost driver. III-162
c. The Docket No. R87-1 approach is still applicable. . III-164
d. The new database used for Dr. Bradley's study has allowed variabilities to be estimated based on a census rather than a sample of contracts. III-165
i. The HCSS data are accurate and reliable for use in estimating variabilities. III-165
e. A cross-sectional rather than a time series analysis is appropriate in this instance. III-167
f. Dr. Bradley's analysis makes a number of methodological refinements representing a significant improvement over the Docket No. R87-1 analysis. III-167
2. The TRACS system generates distribution keys for application to the pools of volume variable costs. III-168
a. The Postal Service has expanded documentation and provided all electronic data for TRACS. III-169
b. Claims that TRACS has never been scrutinized in Postal Rate Commission proceedings are unfounded. III-170
c. Sampling "imbalances" in TRACS do not result in over-attribution of costs to mail on the inbound legs. III-170

d. ANM witness Haldi's characterization of TRACS' treatment of route-trip-segments is incorrect, and the selection of route-trip-destination days is logical. . . . III-171
e. Dissatisfaction with the highway transportation cost distribution is not evidence of problems with TRACS. III-172
i. The empty space allocation in TRACS does not have a material effect on the distribution of costs. III-173
ii. The expansion to container size and space above the container is defensible and correct. III-174
f. FGFSA's reliance on Dr. Merewitz's Standard (A) to Standard (B) ratio is flawed and is not evidence of problems in TRACS. III-175
g. Recent increases in purchased transportation costs reflect a variety of operational factors, not flaws in TRACS or in the variability analysis. III-176
h. The allegation that the Postal Service's transportation is inefficient is both incorrect and irrelevant. III-180
H. The Postal Service's Cost Model Must Be Used. Criticisms Of It Are Baseless, And Alternatives Are Either Unsponsored Or Flawed. III-185
1. The Postal Service's compliance with revised Rule 54(a)(1) and intervenor use of the alternative cost presentation does not obviate the need for Commission sponsorship of its own cost model. III-185
2. DMA witness Buc's proposal concerning the cost reductions in Cost Segment 2 is based on misinterpretation and speculation, and must be disregarded. III-188
3. Witness Sellick's simplified rollforward is insufficient. III-190
4. Witness Thompson's cost model does not replicate Postal Service costs nor is it easy to use. III-192

IV. THE RATE LEVELS PROPOSED BY THE POSTAL SERVICE FOR EACH SUBCLASS AND SPECIAL SERVICE REFLECT A REFINED APPLICATION OF THE RELEVANT RATEMAKING CRITERIA OF THE ACT IV-1
A. The Preservation Of Economic Efficiency Is One Important Ratemaking Policy Of The Act IV-3
B. Professor Panzar Has Presented the Economic Framework in Which Efficiency Concerns Must Be Addressed IV-5
C. The Postal Service in This Case Has Provided the Commission With All Information Necessary to Implement the Appropriate Economic Framework for Pricing IV-11
D. The Proposed New Economic Framework for Pricing is Fully Consistent With the Requirements of the Act IV-13

E. The Proposed New Economic Framework for Pricing Makes Sense IV-19
F. The Postal Service and the OCA Have Provided Information on Economically Efficient (Ramsey) Prices To Assist in the Ratemaking Process IV-21
G. "Efficient Discounts" Do Not Necessarily Yield "Efficient Rates" IV-27
H. Dr. O'Hara's Comprehensive Approach Is Consistent With The Postal Reorganization Act And Improves Upon Past Commission Practice IV-31
I. The Cost Coverages Proposed By The Postal Service Reflect A Fair and Equitable Allocation Of Institutional Costs and Give Proper Consideration to All of the Applicable Ratemaking Criteria . IV-37
1. First-Class Mail -- Letters and Sealed Parcels IV-38
2. First-Class Mail -- Cards IV-39
3. Priority Mail IV-40
4. Express Mail IV-42
5. Periodicals IV-43
a. Regular IV-43
b. Preferred Rate IV-44
6. Standard A Mail IV-44
a. Regular IV-44
b. Nonprofit IV-45
c. Enhanced Carrier Route IV-45
d. NECR IV-47
7. Standard B Mail IV-47
a. Parcel Post IV-47
b. Bound Printed Matter IV-48
c. Special IV-49
d. Library IV-49
J. Witness Chown's New Cost-Allocation Metric, Like Her Previous Commission-Rejected Proposal, Would Inject An Unnecessary And Unreasonable Additional Level Of Complexity In Postal Ratemaking, And Would Foster Irrational And Uneconomic Decisionmaking. IV-50
1. Old Wine in New Wineskins - The Current Chown Proposal IV-51
2. Ms. Chown's characterization of the ratemaking problem is based upon invalid and incoherent inferences of subclass responsibility for institutional cost causation. IV-53
3. The Chown Metric is an unnecessary solution to a misperceived problem. IV-57
4. The Chown Metric is not merely unnecessary; it is also counterproductive IV-59
5. The Current Chown Method Introduces a Mechanistic Middle Step Into the Ratemaking Process, in Conflict With Commission Policy and Supreme Court Precedent. IV-62

6. The Chown Metric Must Be Rejected. IV-64
K. The Costing And Pricing Approach Suggested By Witness Henderson Is Economically Unsound, Would Lead To The Loss Of Essential Cost Information, And Fails To Consistently Apply Commission Precedent. IV-65
L. Conclusion IV-71

V. THE RATES PROPOSED BY THE POSTAL SERVICE WILL RECOVER THE NECESSARY AMOUNT OF REVENUE FROM EACH SUBCLASS IN A FAIR AND EQUITABLE MANNER V-1
A. First-Class Mail V-2
1. Proposals V-2
2. Discussion V-5
a. The Postal Service's First-Class Mail rate design for existing automation- and presort-based categories builds upon the Commission's Docket No. MC95-1 recommendations. V-6
b. The Postal Service's automation- and presort-based discount proposals for the existing categories of letters and cards are based upon improved cost avoidance estimates. V-7
c. The Postal Service's use of the improved cost estimates is consistent with sound ratemaking practice. V-10
d. The Commission should recommend the First-Class Mail basic single-piece rate proposed by the Postal Service. V-12
e. The Commission's rate recommendations for the remaining First-Class Mail single-piece and nonautomation presort rate categories should conform to the Postal Service's proposals as closely as possible. V-13
i. Nonautomated Presort Rate V-13
ii. Additional-ounce rate V-15
iii. Nonstandard Surcharge V-16
iv. Heavy-Piece Discount V-18
v. Basic Card Rate V-20
vi. Nonautomated Presort Card Rate V-21
f. The Commission's recommendations should conform as closely as possible to the Postal Service's proposals for existing automated First-Class Mail categories. V-21
i. The Automation Letter Rate Categories V-23
ii. Automation Rate Category Flats V-26
iii. Nonstandard Surcharge V-26
iv. Heavy-Piece Deduction V-26

v. Additional-Ounce V-27
vi. Automated Card Rate Categories V-27
g. The Commission should recommend the adoption of the proposed Prepaid Reply Mail and Qualified Business Reply Mail classifications and rates. V-28
3. *Intervenors' proposals* V-37
a. The Commission should reject the alternative intervenor First-Class Mail basic rate proposals. V-37
i. MMA witness Bentley refrains from proposing his own preference V-37
ii. Greeting Card Association witness Erickson provides no basis for a re-evaluation of ECSI value V-38
b. The Commission should reject the intervenor alternative First-Class Mail presort and automation letter proposals. V-39
i. ABA/EEI/NAPM witness Clifton's result-oriented cost analysis wilts under the slightest scrutiny V-39
ii. Dr. Clifton prefers his own personal rollforward model V-42
iii. Dr. Clifton's estimate of the impact of the Move Update requirements has no foundation . V-45
iv. Dr. Clifton is in denial concerning the bulk metered benchmark V-47
c. Witness Bentley's proposed basic automation letter rate has merit, but the remainder of his automated letter proposals should be rejected. V-50
d. NAPM witness MacHarg uses the wrong benchmark for flats. V-52
e. Witness MacHarg fails to acknowledge that the heavy piece discount has become obsolete. V-53
f. Relaxation of the sortation requirement for 3/5-Digit presort flats should not be recommended without the attendant rate consequences. V-54
g. The intervenor additional-ounce proposals should be rejected. V-55
i. Dr. Clifton set out in a different direction, but ends up where the Postal Service started V-55
ii. MMA witness Bentley's modification of his previously rejected proposal gets him nowhere V-59
h. NDMS witness Haldi's nonstandard surcharge proposals should be rejected. V-61
i. The APPA postcard proposal should be rejected. . . . V-66

j. Douglas F. Carlson's proposal for a lower stamped card rate is based on a flawed approach to classification policy and an inadequate cost basis. . . V-70
k. The OCA CEM proposal should not be recommended. V-76
i. The Commission should not recommend a two-stamp system that the mailing public decidedly does not want V-80
ii. CEM would complicate the nation's mail system for all parties involved. V-83
iii. That CEM would be voluntary does not alleviate the confusion it would generate. V-85
iv. CEM would require an extensive public education program. V-86
v. CEM short paid enforcement would require a step backwards in postal operations. V-87
vi. CEM enforcement would generate other costs. V-90
vii. The cost of administering CEM would outstrip the benefit it would be designed to redistribute. V-90
viii. The administrative burdens overwhelm the benefits of de-averaging a mailstream whose costs are converging. V-91
ix. The revenue loss associated with CEM would have to be recovered. V-93
x. The CEM proposal is patently inequitable V-93
xi. The record lacks substantial evidence that the statutory classification criteria justify CEM V-94
l. Niagara Telephone Company's "local" mail proposal is deficient. V-97
m. The Brooklyn Union Gas Company modifications to PRM are not welcomed. V-100
B. Priority Mail V-102
1. Proposals V-102
2. Intervenor proposals V-105
a. Witness Haldi's proposed increase in the breakpoint between Priority and First-Class Mail should be rejected. V-105
b. The Commission should again reject Witness Haldi's alternative procedure to project test year after rates volumes and revenues by applying the estimated own-price elasticity to individual rate cells, in favor of the standard method used by the Postal Service. . . V-107
c. The Commission should again reject witness Haldi's proposal to eliminate the mark-up on the distance-related component of transportation costs. V-109

d. Uniform incremental rates are not justified in this case. V-111
e. UPS witness Luciani's proposed surcharge for Priority Mail parcels should be rejected. V-113
f. The precipitous Priority Mail rate increase proposed by witness Henderson should be rejected as conceptually unsound and obviously self-serving. . . V-114

C. *The Express Mail Rates Proposed By Witness Sharkey Should* Be Recommended As Sound, Fair, Cost-Based And Amply-Supported. V-115
1. The Postal Service's proposed Express Mail rates are reasonable and consistent with prior Commission recommendations V-116
2. Although UPS witness Henderson essentially supports Mr. Sharkey's proposed rate increases for Express Mail, his slightly higher average rate increase must be rejected as unsound. V-117

D. The Postal Service's Proposed Standard Mail (A) Rates Employ *Comprehensive, Sensible, And Improved Approaches To* Measuring Cost Differences And Designing Rates, And Should Be Recommended. V-119
1. An overview of the proposed Standard Mail (A) rate change. V-119
2. Witness Moeller's rate design fairly balances multiple, sometimes competing, considerations. V-120
3. The Postal Service's letter and non-letter presort discounts in the Regular and Nonprofit subclasses fairly balance the considerations of recognizing the value of worksharing and impact of rate changes on mail. V-122
a. Measurement of the presort- and automation-related cost differences should be adopted by the Commission. V-122
i. Witness Talmo presents the results of two major data collection efforts which are used to better assess the presort-related costs for Standard Mail (A). V-122
ii. Witness Daniel has improved the methodology by which presort and automation cost differentials are estimated for letters. V-124
iii. Witness Seckar has improved the methodology by which presort and automation differentials are estimated for nonletters. V-125
b. The proposed passthroughs for the Regular and Nonprofit presort and automation discounts recognize the calculated cost savings while

tempering the rate increases for individual rate categories. V-128

4. The Postal Service's letter and non-letter density and automation discounts in the ECR and NECR subclasses fairly balance the considerations of degree of mailer preparation, rate incentives, simplicity, and impact of rate changes on mailers. V-130

a. Measurement of the presort- and automation-related cost differences should be adopted by the Commission. V-130

i. Witness Daniel's development of automation cost differentials in ECR and NECR is comprehensive and accurate. V-131

ii. Witnesses McGrane and Daniel present a more advanced and comprehensive measure of ECR and NECR mail processing cost differentials. V-131

b. Witness Moeller's proposed basic tier shape passthrough serves important operational objectives. V-132

c. The proposed passthroughs for the ECR and NECR density and automation discounts recognize the calculated cost savings while remaining sensitive to the rate increases for individual rate categories and relevant rate relationships. V-134

d. NAA witness Donlan presents no justifiable reason for the Commission to reject the Postal Service's carrier route density discounts. V-135

i. Witness Donlan's conclusion that classification reform resulted in a narrowing of the mail processing cost differentials lacks evidentiary support. V-136

ii. Mail processing cost estimates are not unreliable. V-140

iii. Delivery costs account for DPS savings. V-140

iv. Witness Donlan's recommendations result in arbitrary and unreasonable outcomes. V-142

e. Witness Haldi's "bottom up" approach to the ECR rate design should not be adopted. V-143

5. The proposed pound rates better recognize the cost effect of weight and the proposed residual shape surcharge, and witness Moeller's use of the PRC-Recommended rate design formula is appropriate. V-145

a. The proposed modifications to the rate design formula are necessary to incorporate the residual shape surcharge and to allow for a more direct establishment of the pound rate. V-145

b. Mailers support the ECR pound rate proposal. V-150
c. Intervenor criticisms of the proposed pound rates should be rejected. V-151
i. AAPS misunderstands the basis for the proposed ECR pound rate. V-151
ii. NAA's criticisms mischaracterize record evidence and defy common-sense. V-152
(a) NAA's weight study criticisms lack merit. V-153
(b) NAA's rate design criticisms lack merit. V-156
6. The proposed residual shape surcharge addresses concerns expressed by the Commission and is the latest step in the march toward more cost-based rates. V-158
a. The proposed residual shape surcharge satisfies the classification criteria of the Act. V-160
b. Witness Crum provides a conservative estimate of the additional costs due to shape within the non-letter category. V-162
c. The various criticisms of the proposal are without merit. V-163
i. RIAA *et al.* witness Andrew's criticisms of witness Crum's cost analysis are without merit. V-163
(a) Witness Andrew's comparison of the revenue and cost differences between flats and parcels was not properly conducted. V-163
(b) Witness Andrew is not correct that the cost distribution within the non-MODS pool is flawed, leading to incorrect cost estimates. . . V-164
(c) Witness Andrew's criticisms of the parcel density used and his proposal for the use of substitute data are unfounded. V-166
(i) Witness Crum uses the most reliable data available. V-166
(ii) Use of the Docket No. MC95-1 data, as suggested by witness Andrew, is not appropriate. V-167
(iii) Is there a physicist in the house? V-167
(iv) No reliance can be placed on RIAA's informal survey. V-168
ii. NDMS Witness Haldi's doomsday scenario of "mischief" of repackaging is unlikely. V-170
iii. Despite the intervenors' concern that the increase will result in substantial price increases for certain Standard (A) pieces, the resulting rates are still a bargain in comparison to alternatives. V-173

iv. Even the information presented in PSA witness Jellison's testimony implicitly supports the propriety of the surcharge. V-174

7. The proposed destination entry discounts continue to recognize the cost savings due to dropship, while limiting the increase in the basic rates. V-175

a. Witness Smith's development of destination entry cost differences are comprehensive and unchallenged on this record. V-175

b. Witness Moeller proposes passthroughs for destination entry discounts that maintain incentives for dropshipment while limiting the increase in the basic rates. V-176

c. AMMA witness Andrew's proposed entry discounts would result in a substantial rate increase for nondestination entry mail and offer little or no relief to piece-rated dropshipped mail. V-178

d. The record contains alternative passthroughs that would address intervenor concerns regarding the reduction in the DBMC/DSCF differential. V-179

8. The Postal Service's proposed Nonprofit and Nonprofit ECR rates comply with the Revenue Forgone Reform Act. V-179

a. Witness Moeller's proposed nonprofit rates adhere to the requirements of the Revenue Forgone Reform Act. V-179

b. NFN witness Emigh expresses frustration with the proposed Nonprofit rates, but provides no other alternative to the Postal Service's proposal which complies with the RFRA. V-181

c. Witness Emigh seems to misunderstand the implication of RFRA by suggesting that increases in nonprofit rates are being used to fund a "rollback" of commercial rates. V-182

d. Despite NFN's unhappiness with the increase in nonprofit rates, the Commission has little choice but to follow the RFRA as the Postal Service has in formulating its rate proposal and just as it did in Dockets No. MC95-1 and R94-1. . . . . V-183

E. The Postal Service's Proposed Rates for Standard Mail (B) Should Be Recommended By the Commission as Proposed V-184

1. Parcel Post V-185

a. Witness Mayes's proposed rates for Parcel Post should be recommended by the Commission. V-185

i. The testimony of witness Hatfield represents a significant improvement over the previous

methodology for assigning Parcel Post transportation costs to rate category and zone. V-186
ii. Using this information, the Parcel Post rate design is largely traditional. V-186
iii. The Postal Service's treatment of intra-BMC intermediate transportation costs is correct. . . V-188
b. The various Parcel Post discounts, surcharges, and enhancements proposed are well supported and should be recommended by the Commission V-190
i. Destination Bulk Mail Center (DBMC) Discount V-190
(a) UPS witness Luciani's criticisms regarding mail preparation and platform acceptance costs do not support changes in the cost savings estimate. . V-191
(b) Outgoing ASF costs should remain in the pool of costs avoided. V-193
ii. Origin Bulk Mail Center (OBMC) Discount . . V-194
iii. BMC Presort Discount V-195
iv. Destination Sectional Center Facility (SCF) and Destination Delivery Unit (DDU) V-195
(a) Witness Luciani's criticisms are based only on speculation and are minor compared to the extremely conservative approach taken by witness Crum V-196
(b) Witness Luciani's criticisms based on the difference between DBMC parcels and other Parcel Post demonstrate the conservative nature of witness Crum's estimates. V-198
(c) Witness Luciani's criticism of the DSCF local transportation costs is based upon a misunderstanding of them. . . V-199
v. Balloon Rate V-201
vi. Increase in Maximum Combined Length and Girth V-201
vii. Witness Daniel's testimony provides detailed, comprehensive, and accurate cost support for the nonmachinable surcharge, intra-BMC cost avoidance, and customer barcoding discounts. V-202
c. Witness Mayes's proposed passthroughs are appropriate. V-205
i. Witness Luciani's criticisms regarding full passthrough of the discounts are unfounded as a matter of rate design. V-206

ii. Witness Luciani's criticisms are countered by the conservative nature of witness Crum's cost estimates. V-208
iii. Several of witness Luciani's arguments for lower worksharing passthroughs ignore witness Hatfield's testimony. V-209
2. Bound Printed Matter V-211
3. Special Standard V-211
4. Library Mail V-212
a. OCA's Treatment of Library Rate Mail V-213
i. Witness Collins's proxy recommendation for Library rate costs. V-213
ii. Library rate is a small subclass with large coefficients of variation. V-214
iii. The c.v.'s for Library rate and Classroom are not comparable. V-215
iv. Witness Collins's tally substitution is inappropriate. V-217
v. The proposed proxy is problematic. V-218
vi. Replacement gives rise to regrettable rate results. V-219
b. The Postal Service's proposed Library rates should be recommended. V-220
F. The Postal Service's Proposed Periodicals Rates Adopt Sensible And Improved Approaches To Measuring Cost Differences And Designing Rates, And Should Be Recommended. V-221
1. Witness Talmo's mail characteristics survey is the most comprehensive survey to date on the characteristics of Periodicals mail. V-221
2. Witness Seckar has developed costs for Periodicals flats using improved methodologies. V-222
3. Witness Taufique's rate design for the Regular and Within County subclasses fairly balances multiple rate and classification considerations. V-225
4. Intervenor criticisms of Periodicals service and rate application are being addressed by the Postal Service, and do not require changes to the Postal Service proposal. . . . V-228
5. Witness Kaneer's rate design fairly balances cost and simplicity considerations. V-234

VI. THE FEES AND CLASSIFICATION THE POSTAL SERVICE PROPOSES FOR SPECIAL SERVICES, AND FOR HAZARDOUS MATERIALS, ARE FAIR AND EQUITABLE, COST-BASED, AND CONSISTENT WITH THE STATUTORY RATE AND CLASSIFICATION CRITERIA. 1

A. Using New Cost Study Results, the Postal Service Proposes Cost-Based Business Reply Mail Fees. 2
1. Witness Schenk's BRM cost study determines the costs for the counting, rating, and billing functions underlying the BRM fee. 3
2. Witness Needham's Qualified BRM Fee Design Applies a Minimal Markup. 6
3. MPA witness Glick's alternative costing approach does not provide an accurate estimate of the cost for counting, rating, and billing Qualified BRM. 7
4. Witness Glick's Fee Proposal Should be Rejected. 11
5. Based on lower cost estimates, witness Needham proposes to lower the fees for other advance-deposit BRM and non-advance-deposit BRM. 11
6. Witness Needham's Proposed Increase in the Accounting Fee Reflects an Increase in Advance Deposit Account Maintenance Costs. 13
B. The Postal Service's Delivery Confirmation Proposal Should Be Recommended, and UPS's Alternative Proposal Should Be Rejected. 13
1. The Postal Service's testimony fully describes and justifies the proposed delivery confirmation service for Priority Mail and the Standard (B) subclasses. 14
2. The alternative delivery confirmation proposals from UPS witness Luciani are consistent with the interests of the party he represents, but they lack merit and should be disregarded. 17
C. The Postal Service's Proposed Insurance Fees and Bulk Insurance Classification Should be Recommended. 21
D. The Postal Service's Post Office Box and Caller Service Proposals Satisfy the Statutory Ratemaking Criteria, and Are Superior to the Office of the Consumer Advocate's Alternative Proposal. 23
1. Postal Service witness Needham's fee proposal reflects the statutory ratemaking criteria and focuses on aligning fees with costs. 24
2. Witness Carlson's criticisms of the Postal Service box fee proposals ignore the low cost coverage for post office box and caller service. 26
3. OCA witness Callow's attempt to allocate post office box labor costs by CAG is seriously flawed. 28
4. OCA witness Callow's cost homogeneity objective is not realized by his proposed CAG-based fee structure. 28
5. Rebuttal witness Kaneer illustrates the Postal Service's fee design intentions. 32

6. Prior proceedings have established in the DMCS a fee structure for post office box service that provides the Postal Service with limited flexibility to apply fees as costs and demand considerations warrant. 33
7. The Postal Service has limited flexibility in applying Fee Groups A through D to its many facilities. 36
E. The Registered Mail Fee and Classification Proposals Are Necessary to Cover Incremental Cost and Simplify the Fee Schedule. 37
F. The Postal Service's Proposal for Return Receipt Service Reflects the High Demand for This Service. 39
G. The Proposed Increase for Special Handling Fees is Required to Set Fees That Cover Costs. 42
H. The Postal Service Proposes a Two-Cent Fee to Fill the Shell Classification for Stamped Cards Resulting From Docket No. MC96-3. 46
I. The Postal Service's Simpler, More Cost-Based Stamped Envelope Fee Structure Should Be Recommended. 48
J. The Commission Should Adopt the Proposed Reorganization of the Special Services Section of the DMCS, But Should Defer Wording Changes Until a Later Proceeding. 49
K. The Commission Should Recommend the Requested Surcharges for Hazardous Medical Materials and Other Hazardous Medical Materials. 50

VII. CLASSIFICATION CHANGES PROPOSED IN THIS DOCKET ARE CONSISTENT WITH THE CRITERIA OF THE ACT AND THE POSTAL SERVICE'S AND COMMISSION'S COMMON GOAL OF IMPROVING CLARITY AND CONSISTENCY OF THE DMCS. VII-1

CONCLUSION

6. Prior proceedings have established in the DMCS a fee structure for post office box service that provides the Postal Service with limited flexibility to apply fees as costs and demand considerations warrant. 33
7. The Postal Service has limited flexibility in applying Fee Groups A through D to its many facilities. 36
E. The Registered Mail Fee and Classification Proposals Are Necessary to Cover Incremental Cost and Simplify the Fee Schedule. 37
F. The Postal Service's Proposal for Return Receipt Service Reflects the High Demand for This Service. 39
G. The Proposed Increase for Special Handling Fees is Required to Set Fees That Cover Costs. 42
H. The Postal Service Proposes a Two-Cent Fee to Fill the Shell Classification for Stamped Cards Resulting From Docket No. MC96-3. 46
I. The Postal Service's Simpler, More Cost-Based Stamped Envelope Fee Structure Should Be Recommended. 48
J. The Commission Should Adopt the Proposed Reorganization of the Special Services Section of the DMCS, But Should Defer Wording Changes Until a Later Proceeding. 49
K. The Commission Should Recommend the Requested Surcharges for Hazardous Medical Materials and Other Hazardous Medical Materials. 50

VII. CLASSIFICATION CHANGES PROPOSED IN THIS DOCKET ARE CONSISTENT WITH THE CRITERIA OF THE ACT AND THE POSTAL SERVICE'S AND COMMISSION'S COMMON GOAL OF IMPROVING CLARITY AND CONSISTENCY OF THE DMCS. VII-1

CONCLUSION

PROCEDURAL HISTORY

On July 10, 1997, the United States Postal Service filed with the Postal Rate Commission (hereinafter "Commission") the Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services (hereinafter "Request"). This Request was filed in accordance with 39 U.S.C. §§ 3622 and 3623 and the Commission's Rules of Practice and Procedure. 39 C.F.R. §§ 3001.1 *et seq.*

The Request, based on a test year of Fiscal Year 1998, states that, without increases in rates and fees, the Postal Service will incur a substantial revenue deficiency in the test year, in contravention of 39 U.S.C. § 3621. The Postal Service has estimated that at current rates, its total test year revenues will approximate $59,403 million, and its total costs $61,846 million, creating a test-year deficiency of some $2,442 million. Included among the proposed rates is a rate of 33 cents for the first ounce of First-Class Mail. In addition to requested rate changes, the Postal Service proposed a number of new classification initiatives, including new presort, origin and destination entry discounts for Parcel Post; customer barcode discounts for Standard (B) subclasses; new reply mail rate categories in First-Class Mail; a new delivery confirmation service for Standard (B) and Priority Mail; elimination of the Single-Piece subclass in Standard (A); modest hazardous materials surcharges for selected single-piece and bulk categories; a new discount for bulk insurance; and separate 3- and 5-digit rate categories in Periodicals. In response to the Notice of Inquiry on classification matters issued in Docket No. MC96-3, this docket provided the Postal Service with an opportunity to propose the reorganization and renumbering

of the special service sections. In addition, the Postal Service proposed a series of nonsubstantive revisions to the text of the DMCS to promote consistency and clarity.

The Request was accompanied by 42 pieces of direct testimony sponsored by 40 witnesses, with exhibits and workpapers related to these testimonies, as well as other material responsive to the Commission's rule 54. The Postal Service's Request was set down for hearing by the Commission as Docket No. R97-1. By Order No. 1186, issued on July 11, 1997, the Commission elected to sit *en banc*, and designated W. Gail Willette, Acting Director of the Commission's Office of the Consumer Advocate, to represent the general public in the proceeding. By separate order, Commission Chairman Edward J. Gleiman designated himself to serve as Presiding Officer in the proceeding. Eighty two parties filed notices of intervention.

The Commission scheduled an initial prehearing conference for July 30, 1997. Following an opportunity to comment at the Prehearing Conference, the Presiding Officer set down special rules for the proceeding and a procedural schedule in P.O. Ruling No. R97-1/4.

Postal Service witnesses and the Postal Service itself responded to numerous written interrogatories, consisting of thousands of individual questions. Most of these were filed during the regular discovery period on the witnesses' testimonies, which ended on September 17, 1997. A special discovery period for obtaining "information (such as operating procedures and data) available only from the Postal Service" ran through February 17, 1998. Responses to discovery requests to the Postal Service and its witnesses were generally provided within 14 days, as prescribed by the

special rules for this proceeding. Evidentiary hearings on the Postal Service's case began on October 6, 1997, and continued through October 22, 1997.

One significant controversy that arose during the course of the proceeding concerned the evidentiary status of library reference materials. In pleadings and in response to Notice of Inquiry No. 1, several participants challenged the longstanding practice of designating certain studies and data as library references without formally moving these materials in their entirety into the evidentiary record. The Commission resolved this controversy by establishing a procedure for acceptance into the evidentiary record of specified materials filed by the Postal Service as library references that were sponsored by witnesses. Order No. 1201. The Postal Service submitted ten pieces of supplemental testimony from Postal Service witnesses in support of previously filed library reference materials. The Commission granted participants an additional opportunity for written discovery and oral cross-examination on these materials. Order No. 1201. The Presiding Officer accordingly issued a revised schedule "so as to continue these proceedings with the utmost expedition consistent with procedural fairness for the participants." Order No. 1201; P.O. Ruling No. 1/54, as revised by P.O. Ruling No. 1/55. The Presiding Officer shortened the time for filing responses to discovery on these materials to seven days, and permitted discovery on Postal Service library reference materials to continue through November 14. At the participants' request, a technical conference on Postal Service witnesses' supplemental testimony was held at Postal Service Headquarters on November 28, 1997. Counsel and consultants for ANM and NFN attended. Hearings on Postal

Service witnesses' supplemental testimony on library reference materials were held during the week of December 1. In order to accommodate discovery and hearings on the supplemental testimony on library reference materials, the deadline for filing participants' cases-in-chief was moved six weeks forward, to December 30, 1997.

Other controversies were also addressed during the course of the proceeding. On February 2, 1998, the Commission received an excepitionally late Notice of Intervention by LabOne, Inc., Osborn Laboratories Inc., and Clinical Reference Laboratory, Inc. (LabOne), seeking to intervene and present testimony on the proposed surcharges for Hazardous Medical Materials and Other Mailable Hazardous Materials. The Commission granted intervention "subject to compliance with rulings *and orders already issued and to timely objections" and setting February 20, 1998 as* the date on which to present testimony. Order 1206, at 2.[1] While the Postal Service appreciates the Commission's interest in having available the broadest possible scope of materials in the evidentiary record, the procedures followed in this instances effectively deprived the Postal Service of any real opportunity to conduct discovery on or develop rebuttal to LabOne's evidence.

This proceeding marked the first time that the Postal Service presented an alternative cost presentation under Revised Rule 54(a)(1), intended to show what its

---

[1] Since the opportunity to present evidence was expressly made subject to prior rulings and orders, one of which set December 30, 1997 as the date for filing testimony rebutting the Postal Service Request, the Postal Service considered but rejected filing a motion to strike the LabOne testimony as late. That would have made a farce of Order No. 1206, and the Commission has consistently stated its preference that evidence be obtained from all sectors of the mailing public, so the Postal Service determined not to avail itself of this opportunity.

costs in this case would look like under the Commission's costing methodology from Docket R94-1. *See* Rule 54(1)(1). The Postal Service met the new requirement of the revised rule by filing USPS LR-H-196 covering the base year and USPS LR-H-215 covering the interim and test years. Revisions to those library references were subsequently filed as a result of several Presiding Officer Ruling's which found discrepancies between the alternative costs presented by the Postal Service and the Commission's Docket R94-1 methodology. *See* Presiding Officer's Ruling No. R97-1/2, July 23, 1997; Presiding Officer's Ruling No. R97-1/7, August 13, 1997, at 2. The Commission indicated that the Postal Service had complied with the requirements of revised Rule 54(a)(1) once it had filed the required interim and test year presentations and had corrected its presentation as specified in the Presiding Officer's Rulings. *See* Order No. 1197, October 1, 1997, at 4.

In addition to complying with the revised Rule, the Postal Service also was directed to furnish a table of markup and markup indices for the various mail subclasses and special services, although it was later concluded that "the table of relative mark-ups while not specifically required by the actual language of rule 54(s), would be a very helpful indication of the effect of variations from established attribution methodologies." Presiding Officer's Ruling No. R97-1/8, August 25, 1997, at 5. Additional burdens were imposed on the Postal Service when the Commission ordered the Postal Service to respond to discovery directed by the parties requesting information above and beyond what the language of Rule 54(a)(1) required. The Postal Service, for example ordered to respond to interrogatories requesting

calculation of certain unit benchmark processing costs underlying worksharing discounts under the Commission's costing methodology and to show the impact of various "final adjustments" to its costs. *See* Order No. 1197, October 1, 1997.

The necessity of doing revisions, providing mark-ups and responding to discovery requests for rate category information are all matters clearly beyond the scope of what the Rule 54(a)(1) requires and beyond what the Postal Service believes is fair and proper. There was an initial burden associated with complying with the clear requirements of Rule 54(a)(1). The further obligations imposed on the Postal Service in connection with its alternative cost presentation became burdensome and clearly detracted from the Postal Service's presentation of its own proposals.

The Presiding Officer issued a total of seventeen Information Requests directed at the Postal Service and selected intervenors, which contained dozens of separate questions on a variety of issues. The Commission issued five Notices of Inquiry. The first Notice of Inquiry concerned the evidentiary status of library references. The second Notice of Inquiry solicited comments on classification policy and DMCS improvements. The third Notice of Inquiry invited participants to submit comments on Postal Service witness Baron's testimony concerning load and access time. In the fourth Notice of Inquiry, the Commission requested participants to evaluate statistical support for Postal Service witness Bradley's model of mail processing labor cost variability. The fifth Notice of Inquiry asked participants

whether the Commission should recognize FY 97 net income in developing rate recommendations in this proceeding.

Pursuant to the revised procedural schedule, the direct cases of participants other than the Postal Service were filed on December 30, 1997. In accordance with the special rules for this proceeding, intervenors responded to interrogatories within 14 days. The period for conducting discovery on participants' direct cases ended on January 28, 1998. Evidentiary hearings on these cases began on February 16, and continued through March 3, 1998. Hearings on testimony submitted in response to Notices of Inquiry were held on March 2 and 3.

Rebuttal testimony was filed by the parties and the Postal Service on March 9, 1998. Evidentiary hearings began on March 16, 1998 and continued through March 20, 1998. An hearing was held on March 30 to give ANM an opportunity to cross-examine Postal Service witness Schenk regarding certain materials underlying her rebuttal testimony. The Postal Service presented testimony from twenty-three rebuttal witnesses and the parties twelve. The complete evidentiary record currently consists of more than 19,000 transcribed pages plus the direct case of the Postal Service, and various materials incorporated by reference.

The date for filing of briefs was set for April 1, 1998, with April 10 set for filing reply briefs. The opportunity for oral argument is available upon request of any participant for the purpose of "providing information that could not be included within an initial or reply brief." P.O. Ruling No. R97-1/55; P.O. Ruling No. R97-1/107.

I. THE REVENUE REQUIREMENT DEVELOPED BY THE POSTAL SERVICE, WHICH REFLECTS AND SUPPORTS ITS FINANCIAL AND POLICY GOALS, SHOULD BE USED AS THE BASIS FOR THE COMMISSION'S RECOMMENDATIONS IN THIS DOCKET

A. The Postal Service's Request Seeks to Build on Its Strong Financial Performance in Recent Years

The Request filed with the Commission in this docket arises in the context of an unprecedented set of circumstances in postal ratemaking. For the first time since Postal Reorganization, the Postal Service has had three straight years with net incomes greater than $1 billion. These net incomes have made a significant contribution to restoring Postal Service equity by greatly reducing the cumulative net loss incurred since Reorganization. For the first time in recent years, in fact, there is a good prospect for complete restoration of equity in the relatively near future. This will relieve current and future mailers of the burden of substantial past deficits, including those resulting from billions of dollars of costs imposed by several Omnibus Reconciliation Acts which transferred responsibility for the cost of Postal annuitants to the Postal Service. See Testimony of William P. Tayman, USPS-T-9, at 2; Rebuttal Testimony of Richard Porras, Tr. 35/18594.

This strong financial performance has already provided substantial benefits to postal customers. When the Request for the last general rate proceeding was filed, the expectation was that the rates requested would not last substantially beyond two years. Now, more than three years later, the Postal Service has asked for general increases in rates that overall, for the second rate case in succession, are significantly below the rate of inflation for the period since the last general increases.

That has never happened before. By the time the rates can be implemented, it will have been three and one-half years since the last general increases, one of the longest periods of rate stability in Postal Service history.

As both a cause and effect of its recent successes, postal management has modified its historic approach to ratemaking in the context of a progressive reorientation of its financial and other policy goals. One product of these goals is the filing of this rate case, which will allow new rates to become effective as early as the last four months of FY 1998. Partly as a result of its approach, the Postal Service has been able to ask for a moderate overall set of increases, well below inflation in the economy. Had the Postal Service deferred this case, or used the more prospective of the two test years that would conform to the Commission's rules (FY 1999), the amount of the overall increase would have been greater. The old pattern of large jumps in rates punctuating periods of rate stability obtained through experiencing large deficits might have been perpetuated. Mailers, many of whom would prefer smaller, more predictable rate changes that allow them to better manage changes in their postal costs, might once again be faced with dramatic increases that would be difficult to absorb consistent with their own business and other objectives.

The current case, however, is not solely a function of timing and impact on mailers. It also reflects fundamental choices made by the Board of Governors and postal management for the future of the Postal Service and its ability to meet its public policy and business responsibilities to its customers and the nation. In this respect, the current rate and revenue proposals reflect decisions regarding

expenditures deemed to be critical to the future viability, growth, and continued financial success of the Postal Service. These choices, oriented around various critical programs, in large part drive the Postal Service's revenue needs as embodied in the current Request. Rather than being nullified by continued growth and favorable financial performance, however, these important future objectives are amplified by them, as the Postal Service seeks to build on its favorable financial performance, while maintaining and improving service.

In this context, it is ironic that the unique circumstances of this case stand to jeopardize the Postal Service's policy goals. While the Postal Service continues to experience more favorable results than originally estimated, the conventions of a ratemaking approach oriented around predicting costs for a future test period threaten to undermine policy. By choosing a financial foundation for its rate proposals which best favors mailers' interests generally, the Postal Service has made itself vulnerable to regulatory lag, and the claim, based on largely hypothetical test year finances, that it has a lower revenue need than warranted by its program objectives. The value of those objectives and their eventual cost, however, are not diminished by the hypothetical nature of the instant ratemaking exercise. Moreover, the circumstances facing the Postal Service and the Commission are neither new, nor unusual. The fact is that during the course of a protracted regulatory proceeding, estimates will always tend to vary in one direction or another.

In this context, it is important for the Commission to keep sight of its broader responsibilities as a partner with the Postal Service in fulfilling the nation's needs for

a progressive postal system. The Postal Service submits that it can do this by relying on the record established by the Postal Service's case, and by following the Commission's practice in previous cases in which it was faced with a different set of financial circumstances. This can be done, furthermore, within the requirements of the statute, without abandoning either established ratemaking principles or the Commission's own responsibilities.

B. The Postal Service's Financial and Other Policy Goals and Objectives Create the Framework for Its Proposals in this Case

A number of factors have contributed to the Postal Service's current financial condition. Service improvements and the relatively low increase in rates in the last general rate case stimulated volume growth. In this regard, the Commission's recommendation of rates in Docket No. R94-1 based on essentially the same revenue requirement as that estimated by the Postal Service played a significant role. Favorable economic conditions, including strong economic growth and low inflation, also contributed to growth in mail volume and revenue. Consistent improvements in service are a factor in this success, as well. USPS-T-9, at 7.

Revenue increases, however, are only part of the story. Equally critical have been cost controls. Effective management and moderate inflation have enabled the Postal Service to keep cost increases consistent with Postal Service objectives. *See id.* at 17. There are also signs that the benefits of classification reform produced by the results of Docket No. MC95-1 are beginning to take hold.

The combination of these factors has contributed to rate stability. As noted above, the Postal Service was able to defer filing this case until well after the interim

that was initially predicted at the time of Docket No. R94-1. An extended rate cycle and improved service tend to enhance the value of postal products; this in turn engenders mailer confidence and further stimulates volume growth.

Most importantly, sound financial and other policies have helped create conditions that have fostered the recent successes. As a result, service has improved, debt has been reduced, and equity has been greatly restored. *See id.* at 3-6; Tr. 35/18688.

In this environment, senior postal management has set a number of financial goals and objectives for the future:

- **Improve Service and Responsiveness to Customers**

As part of its renewed focus on customers and on service improvement, the Postal Service is investing in a number of programs that will benefit postal customers of every stripe. These include the following: Call Centers, which will provide all customers with easy access to postal information of all kinds; the Priority Mail Processing Centers, which will improve service for all Priority Mail customers; Delivery Confirmation service, which adds a feature that many customers seek and expect when they purchase package delivery services; the Point of Service cash register system, which will improve window transactions from the perspective both of the retail customer and the window clerk, and will facilitate internal accounting; Associate Office Infrastructure, which will improve communications between Associate Offices (AOs) and other postal facilities and between AOs and commercial customers; and Year 2000 Software, which will help ensure that critical Postal Service

systems are upgraded in order to function smoothly during the transition to the year 2000. *See, e.g.,* Tr. 35/18616.

- **Aggressive Capital Program**

The Postal Service intends to build the infrastructure for the future necessary to serve customers, to invest in new cost savings opportunities, and to increase automation.

- **Manage Costs**

The Postal Service will endeavor to continue the effective management of expenses and will seek a mutually beneficial set of labor contracts.

- **Restore Equity**

The Postal Service will continue its efforts to recover the remaining $3.4 billion in accumulated losses, in accordance with Board of Governors Resolution No. 95-9, which sets the policy of the Postal Service to "plan for cumulative net income, in the period since implementation of the rates adopted in the most recent omnibus rate proceeding, *to equal* ***or exceed*** *the cumulative prior years' loss recovery target*[1] for the same period." (emphasis in original and added).

- **Debt Restructuring and Cash Management**

The Postal Service will continue to aggressively manage its cash and its debt.

---

[1] "The cumulative prior years' loss recovery target is calculated by multiplying the test year amount for recovery of prior years' losses included in current rates by the number of years that will have elapsed since those rates were implemented." Board of Governors Resolution No. 95-5. It should be noted that the policy states that the prior years' loss recovery should equal *or exceed* the target.

- **Pay for Performance System**

The Postal Service will reward postal managers based on their performance against a number of relevant indicators, providing incentives for the attainment of goals.

C. The Postal Service's Revenue Requirement Is Adequately Supported on the Record

Against this backdrop, the Postal Service has presented revenue requirement estimates for the mostly historical and largely hypothetical test year that are supported by substantial, predominantly uncontradicted evidence. The methodologies and approaches employed consist of those approved by the Commission in numerous previous cases. The financial foundation relied upon, furthermore, is completely consistent with the Commission's rules governing general rate proceedings.

Postal Service witness William Tayman presents this foundation. As always, estimating the revenue requirement begins with identification and estimation of all costs that the Postal Service expects to incur in the test year. USPS-T-9, at 10-37. Then, in accordance with 39 U.S.C. § 3621, a reasonable provision for contingencies is included. In this case, a historically low 1 percent contingency provision was applied. *Id.* at 37-38. As witness Porras explained:

> Faced with balancing the conflicting goals of providing adequate protection against unforeseen events during the test year and beyond, and keeping rate increases below the rate of inflation, the Postal Service chose to emphasize the latter in this case. The Postal Service opted to live with a level of protection below what it normally would have considered adequate in order to accommodate its rate level goals. ... [H]ad the moderately lower expenses I have documented in my testimony been known, I would have recommended a slightly larger contingency to the Board.

Tr. 35/18586-87. Finally, a provision for recovery of prior years' losses is added. As noted above, following adoption by the Board of Governors of Resolution No. 95-9, significant progress toward the restoration of equity has been made in the current rate cycle and the annual amount included in the revenue requirement to recover prior years' losses has been reduced by almost 60 percent from the last omnibus rate case. *See* Tr. 35/18596.[2]

Almost all of the issues which have been raised regarding the revenue requirement revolve around actual operating results for the interim period (FY 1997) and partial results from the test year (FY 1998), and current economic conditions and indicators. These, it has been argued, ultimately invalidate the Postal Service's estimates for the largely historical and hypothetical test year, and impel the Commission to reduce the revenue requirement and make corresponding adjustments to the proposed rates and fees. The Postal Service has addressed these arguments, and placed them in perspective, in its rebuttal testimony. Tr. 35/18574-92. The Postal Service believes that the totality of its presentation shows, as Mr. Porras maintains, that the most responsible course on the record is to recommend rates based on the revenue requirement the Postal Service has presented. Tr. 35/18591-92. Nevertheless, Mr. Porras's testimony provided updates of known changes, in both directions. Tr. 35/18577-86. In addition to the reasons Mr. Porras presents in his written testimony relating to due process, to the technical difficulties inherent in updating, and to the possibility of negative consequences such as those which

[2] (936 - 377) ÷ 936 = .5972.

followed Docket No. R90-1, the Postal Service urges the Commission to refrain from updating, in light of the practical realities that will dictate the true future life of the rates recommended, and the future implementation of the Board of Governors' policy choices for operations, service, and finance.

II. THE COMMISSION SHOULD ONCE AGAIN RELY ON THE VOLUME ESTIMATES AND FORECASTING METHODOLOGIES PRESENTED BY THE POSTAL SERVICE

As the Postal Service's operating environment has evolved, and the classification and rate structures have been refined to allow recognition of new and expanded opportunities for mailer worksharing, the task of forecasting mail volumes has gotten significantly more complicated. The Postal Service has responded with substantial improvements in its forecasting methodologies, relative to the last general rate case, Docket No. R94–1. Many of the new features, however, were developed for classification reform purposes in Docket Nos. MC95–1 and MC96–2, and thus should not be unfamiliar to the Commission.

Forecasts for most subclasses of mail are provided in this case by Dr. Tolley (USPS-T-6), as they have been in every omnibus rate case since Docket No. R80–1. Dr. Tolley uses the same basic approach to forecasting that has been employed in all recent cases. In this case, however, the econometric analysis upon which the forecasts are based is presented by his colleague, Thomas Thress (USPS-T-7). Most prominent among the improvements incorporated by Mr. Thress is a somewhat different approach to modeling demand for Standard A (formerly bulk third-class) mail.[1] Other new features, such as separate equations for workshared and non-

[1] Although witness Thress' improved framework for the analysis of the demand for Standard A bulk mail (USPS-T-7 at 56-83) has not generated any controversy in this proceeding, it represents a substantial body of research. It reflects not only the Postal Service's long-standing desire to pursue opportunities to improve our forecasting ability, but also efforts to be responsive to the concerns raised by the Commission in past proceedings.

workshared First-Class letter mail, are described at pages 22-23 of USPS-T-6.

Forecasts for Express Mail and Priority Mail are once again provided by Dr. Musgrave (USPS-T-8). Dr. Musgrave uses the same basic approach to forecasting that he has used in past omnibus rate cases. Although no fundamental changes were made to either the Priority or Express Mail models, some improvements were incorporated. For example, for Priority Mail, a "mixed estimation" econometric technique was used for the permanent income elasticity. As another example, for Express Mail, the measure of permanent income was changed from the measure of long-run income from expenditures on services to expenditures on nondurables.

The procedures employed by the Postal Service's demand analysis witnesses are fully described in the testimonies and appendices, and are fully documented in numerous workpapers and library references, both hard-copy and machine-readable. Further information was also provided in response to interrogatories and various Presiding Officer's Information Requests. Overall, the forecasts presented by the Postal Service in this case reflect the results of years of objective, systematic research, designed to explore improvements on a continual basis, with the exclusive goal of obtaining the best forecasts possible.

No substantial challenges were made on this record to either the basic forecasting framework proposed once again by the Postal Service, or the econometric demand analysis which supports that framework. There were, however, a few issues that arose which relate to forecasting that merit some discussion.

A. OCA Witness O'Bannon's Analysis Of Imputed "Own Price" Elasticities Is Fundamentally Flawed

OCA witness O'Bannon filed testimony which directly addressed not the forecast of Parcel Post volumes, but instead the related issue of how the aggregate subclass (or rate category) forecast is subsequently distributed among the various weight/zone rate cells. See OCA-T-200, Tr. 25/13472-507. Mr. O'Bannon includes a theoretical discussion of both Marshallian and Hicksian (or compensated) demand analysis. Unfortunately, in seeking to apply this theory to the available empirical data, he overlooked a rather critical feature of the forecast data he was using. Specifically, Mr. O'Bannon attempted to derive implicit "own price" elasticities without realizing that the rate changes which drove the volume changes under examination were a function of both own and cross price effects. Tr. 25/13511-26, 13528-29. Consequently, what he calculated, and then sought to interpret in his testimony, were not true own price elasticities, implicit or otherwise. *Id.* at 13528-29. As Mr. O'Bannon agreed during cross-examination, had he been able to limit his analysis to pure own price effects, the implicit own price elasticities would have been different, the results of his "empirical" tests would have been different (pass versus fail), and his entire testimony would have been different. Tr. 25/13534-35.

At a more fundamental level, Mr. O'Bannon is questioning the proportional distribution method customarily applied by the Commission and the Postal Service to distribute aggregate subclass volumes by rate cell for revenue estimation and rate design purposes. The proportional distribution method assumes that in the absence of any countervailing information (e.g., share models, market research), test year

forecasted volumes are assumed to be distributed within a subclass in the same proportions as in the base year. As both Mr. O'Bannon and Dr. Haldi discuss, this method raises interesting issues when applied to a test year after-rates forecast if different rate cells get substantially different relative price changes.[2]

The complaint of Mr. O'Bannon is that the proportional distribution method does not take into account the fact that some cells may receive rate increases, and some cells rate decreases. Tr. 25/13524. It also does not take into account that even if all cells receive rate increases or receive rate decreases, the magnitude of the changes could be quite different as well. In other words, on a cell-by-cell basis, there is no recognition of own price effects. Instead, what the proportional distribution methodology implicitly assumes is that the cross price effects of the aggregate rate change overwhelm whatever cell-by-cell own price effects there might be. See Tr. 25/13523.[3]

---

[2] Dr. Haldi's discussion of what is theoretically the exact same issue, but applied by him in the context of Priority Mail, is addressed elsewhere in this brief. The principles are the same.

[3] It may be helpful here to be as clear as possible about terminology. Let us assume that our framework for analysis is the volume of an individual cell of DBMC Parcel Post. The own price effect is then any change in the volume of that cell caused exclusively by the change in the rate for that cell. By definition, any change in volume caused by any other price change must be a cross price effect. For purposes of the instant discussion, however, let us further limit the exercise to volume changes caused by rate changes in other cells of DBMC, ignoring for the moment any broader cross price effects (such as those relating to Priority Mail, which confounded Mr. O'Bannon's analysis). Strictly speaking, if we look at the aggregate rate change for all 272 cells of DBMC as causing the volume change in our individual cell, which is implicitly what the proportional distribution methodology does in the absence of inter-category or inter-subclass cross price effects, we are mixing own price and cross price effects, because our cell is one of the 272 cells that constitute the aggregate. As a practical matter, however, it seems reasonable to consider the aggregate as manifesting primarily the combined effect of the other 271 cells, and

As Mr. O'Bannon apparently agrees, whether cell-by-cell own price effects or aggregate cross-price effects dominate is actually an empirical issue. Tr. 25/13518. It is probably the case that the type of effect which dominates can change from situation to situation, and it is even more probably the case that it is quite difficult to predict which type of effect will dominate in any particular situation. As a practical matter, however, the proportional distribution method seems to have worked adequately in the past. In fact, Dr. Haldi's self-rebutting testimony in this case provides strong evidence that the choice of distribution method is not particularly critical in terms of the needs of the ratemaking exercise. Tr. 20/10319.

B. Witness Clifton Demonstrates That Substantial Care Must Be Taken In The Interpretation Of Witness Thress' First-Class Letter Workshare and Non-workshare Models

In ABA/EEI/NAPM-T-1, witness Clifton cites the new workshare elasticity of -0.289 estimated by witness Thress as evidence that "there are competitive alternatives to the Postal Service for this mailstream." Tr. 24/12507. When making this claim, however, Dr. Clifton appears to have failed to come to grips with the fact that in estimating this elasticity, witness Thress held constant not all other prices, but the level of the worksharing discount. Tr. 24/12680, 12774-76.[4] This condition

---

thus to think of the aggregate effect as a cross price effect.

[4] In contrast to Dr. Clifton, Dr. Sherman showed a much keener awareness that Mr. Thress' decision to include a discount term rather than a cross-price term on the right-hand side requires careful interpretation of the results. See OCA-T-300 at 40-45 (Tr. 26/13747-52). The matter was also raised in item 1 of POIR No. 3, to which witness Bernstein responded at Tr. 10/5075-77.

translates into an assumption that the predicted volume response will occur only if any absolute change in the rate for workshared mail is exactly matched by the same absolute change in the rate for nonworkshared mail, which is the only way to hold the discount constant. Tr. 24/12680.

Moreover, if we change our assumption to one that workshared mail and nonworkshared mail receive an identical percentage increase, as opposed to an identical absolute increase, we get a very different picture. As Dr. Clifton agrees, an identical across-the-board 10 percent increase for workshared mail and non-workshared mail, holding all other factors constant, will cause single piece letter volume to decline by 3.5 percent, and workshare volume to decline by 0.7 percent. Tr. 24/12681.[5] These hypotheticals demonstrate that the respective sensitivities to price increases for First-Class single piece and workshared letters are very different depending on whether we anticipate equal absolute increases in the rates for each

[5] Of course, an identical across-the-board increase in workshared mail and nonworkshared mail rates of a given percentage is the same thing as an increase in the total or aggregate First-Class letter rate of the same given percentage. For reasons that are far from clear, Dr. Clifton was uncomfortable with the notion that the ratio of the percentage change in volume of a subset of First-Class letters (either single-piece or workshare) to a given across-the-board change in the price of all First-Class letters (which causes the percentage change in the volume of the subset) could properly be considered the elasticity of the subset with respect to the price of all First-Class letters. Tr. 24/12779-82. (His insistence at 12782 that an elasticity can only be calculated with respect to one price, and "not a whole set of interacting prices" manifests a clear lack of awareness or understanding of the fixed weight index (FWI) measurement of prices, used for many years in the calculation of all postal price elasticities. See USPS-T-7 at 115.) Whatever the semantics, the mathematics of the matter show that a change in subset volume caused by a change in aggregate price can be used to measure an elasticity as that concept is commonly applied in economics.

subset, or equal percentage increases in the rates for each subset. In either event, as even Dr. Clifton ultimately agreed, one consequence of the estimation procedure used by witness Thress (i.e., using the level of the discount as a right-hand side term) is that one has to be very cautious in interpreting differences in elasticities as reflective of differences regarding non-postal alternatives. Tr. 24/12786-87.

C. NNA's Criticism Of The Postal Service's Volume Estimates Is Tenuously Based

The subclass volumes forecasted for the test year are based directly on base period subclass volumes reported by the Postal Service's Revenue, Pieces and Weights (RPW) system. The only negative commentary on the RPW system in this proceeding came from the National Newspaper Association (NNA). Its witness Max Heath, NNA-T-1, criticized the system, claiming to have made an independent assessment of the volumes that he felt should be reported for the within county subclass of Periodicals mail. He uses this criticism to argue that the Postal Service's data systems "may very likely be flawed," Tr. 27/14884, and for the creation of a "*revenue consequence*" *for what he considers to be the Postal Service's recalcitrance* regarding within county mail. Tr. 27/14757. However, the cornerstone of his argument -- his analysis of the Postal Service's base year within county volume estimate -- is hopelessly flawed, biased, and, in the end, demonstrates nothing.

Mr. Heath bases his analysis on a survey conducted of NNA member publications in 1995, which attempts to measure the mail usage characteristics of those publications. Tr. 27/14752, 14850. Mr. Heath's survey suffers from serious

flaws in both its methodology and design, which seriously undermine Mr. Heath's use of its results. First, out of a total NNA membership of 4,000 titles, Tr. 27/14743, he received responses from 868 publications.[6] This is a remarkably low response rate for any survey, particularly given the fact that it was "mailed . . . twice to the universe of NNA members." Tr. 27/14874. Moreover, this level of non-response is of exceptional concern here; despite Mr. Heath's assertion that "[t]here was no attempt made to skew numbers either to the high or low end by soliciting particular newspapers to answer, Tr. 14752, the letter to NNA's membership that accompanied the survey mailout was worded to achieve precisely that effect.

In his letter, Mr. Heath included the following:

> On the reverse is a simple, one-page survey that could help determine the fate of complex proposals by the U.S. Postal Service to "reclassify" the mail structure under which publications have operated for years. A rate case to do this will be filed soon. While it won't raise overall postal revenues, it will create winners and losers by changing the rules for mail acceptance.
>
> The proposals . . . would benefit mostly large publications, more finely sorted and perhaps automatable.
>
> NNA's Postal Committee and staff . . . needs to know how our members distribute and mail. We need to know which work-sharing discounts are must used, both in second and third class, to represent our members better in this and future rate cases.

Tr. 27/14850. It is apparent that this language would tend to induce responses from those NNA members with the greatest reliance on the mail, leading to the inevitable

---

[6] The record is not entirely clear regarding the actual number of responses that NNA received in conducting its survey. Mr. Heath's direct testimony and Exhibit 4 to his testimony refer to 868 responses, Tr. 27/14752, 14777. However, during written cross examination, he numbers his respondents at 836. Tr. 27/14793, 14794.

conclusion that any estimate of within-county mail volume derived from the survey is not truly representative of the "typical" NNA member discussed by Mr. Heath, Tr. 27/14744, much less his broader category of community newspapers. *Id.* Because the lion's share of responses would have come from relatively mail-reliant NNA member publications, it is clear that the estimates of volumes mailed per member would almost certainly be biased upward.

In fact, Mr. Heath admits as much in his testimony:

> If there was a skew, it was probably toward newspapers concerned about the future of postal rates or delivery--but since the motivation for joining NNA may largely stem from the same concerns, I did not feel that this self-selection would alter our results.

Tr. 27/14752-53. In addition, during his appearance before the Postal Rate Commission, Mr. Heath reiterated this point:

> COUNSEL FOR THE POSTAL SERVICE: Still on that page of your testimony, at the very bottom of the page, you talk about a particular skew in your survey, and you say that it would be towards papers concerned about the future of postal rates.
>
> Am I correct in interpreting that as being that NNA members who are concerned about their postal rates would have been more likely to have responded to the survey?
>
> WITNESS HEATH: I think that's probably correct. . . . we can only take a bit of a guess there that perhaps those who are most actively interested in this issue might respond.
>
> However, I would note that we had some daily papers that would not have much dependence on mail that did respond and we had, you know, some free newspapers and things like that that would be carrier delivered.
>
> So it was a distribution survey in that sense, but if we were to guess because we were asked to, I believe we would think that it might be skewed by people who -- a little bit by people who mailed more, but

no way to know for sure.

Tr. 27/14874-75. The resulting imbalance in NNA's survey responses, as described by Mr. Heath, completely undermines the survey's attempted use as a representative account of the mailing profiles of weekly newspapers, or even of NNA members.

Mr. Heath derives from his survey responses a figure of 22 percent, which purports to represent the percentage of "newspapers' total circulation" mailed at within county rates. Tr. 27/14810. He then applies this percentage to the newspaper circulation of *all* weekly newspapers, including those publications within NNA that did not respond to the survey, and to those who are not members of NNA, and which were therefore outside the survey's scope. *Id.* Both of these levels of extrapolation are grossly inappropriate, and inevitably yield upwardly biased estimates. The fact that the survey respondents are "more concerned about the future of postal rates," Tr. 27/14752, makes the application of Mr. Heath's 22 percent within county figure to all NNA member weekly newspapers clearly inappropriate. The fact that the "motivation for joining NNA may largely stem from the same concerns", Tr. 27/14753, rather than *mitigating* the bias acknowledged by Mr. Heath at the first stage of extrapolation, *compounds* the bias, and renders useless his extrapolation of NNA survey results to non-NNA member publications.

Mr. Heath's unreasoning wielding of his survey responses to obtain the 22 percent within county figure, and his insouciant application of that figure to *all* weekly newspapers' circulation, begets his estimate of 848 million copies of within county mailed by weekly newspapers. Tr. 27/14810. He compares this figure to the Postal

Service's FY96 estimate of within county volume of 877 million pieces,[7] and argues that his estimate "allows for only the most minimal use of within county mail by newsletters, city magazines, daily newspapers and other within county users." Tr. 27/14810.[8]

The Postal Service, and the Postal Rate Commission, are left to wonder what results a properly conducted survey would have produced. Since Mr. Heath neither surveyed non-NNA members, nor -- remarkably, given the response rate that plagued the survey -- made *any* attempt to follow up on non-respondents to his own survey, Tr. 27/14796, 14876, we cannot use the survey presented in NNA-T-1 to hazard any guess. It is clear, however, that a properly conducted survey would have yielded an *estimate well below Mr. Heath's 848 million copies of publications traveling in the* within county subclass. Given this inescapable conclusion, Mr. Heath's argument that the Postal Service's FY 1996 within county volume estimate of 877 million pieces is too low is unsupported, and his accompanying disparagement of the Postal Service's volume data should be afforded no credence by the Commission.

---

[7] USPS-T-1 at 11.

[8] Just how much "allowance" need be made is not known, as Mr. Heath was unable to shed any light on the within county mailing profile of these publications. Tr. 27/14803.

III. THE POSTAL SERVICE'S ESTIMATES OF THE COSTS CAUSED BY EACH SUBCLASS AND SERVICE HAVE BEEN DEVELOPED BASED ON A SOLID AND COMPREHENSIVE COSTING FRAMEWORK, PROVIDE SUPERIOR RESULTS COMPARED TO ALL PROPOSED ALTERNATIVES, AND SHOULD BE ADOPTED BY THE COMMISSION

The first tier in the ratemaking process is costing, in which reliable causal links are established between the costs of the Postal Service, and each of the subclasses and services it provides its customers. As in past cases, the general focus of analysis is costs at the cost segment or component level, and a variety of witnesses address cost causation in that context. Also consistent with past cases, cost segment costs by subclass are aggregated by the base year witness (Alexandrovich, USPS-T-5), and projected into the test year by the rollforward witness (Patelunas, USPS-T-15). A new feature in this case, however, is the development and presentation of incremental costs for each subclass and service (Takis, USPS-T-41). To support this new level of analysis, the Postal Service is presenting the testimony of Professor Panzar (USPS-T-11), who explains the proper economic framework for the measurement of both incremental costs and volume-variable (marginal) costs.

All aspects of costing at the subclass level are discussed in this portion of the brief. In addition to the economic framework issues, incremental cost issues, and the issues relating to particular cost segments for which new analyses have been presented, also included within this section of the brief (at the end) are discussion of several rollforward, cost model, and Rule 54 issues. Cost studies used for rate design purposes, which usually relate to costs at the rate category level or below, are discussed in the rate design portion of this brief, which appears in section V.

A. Professor Panzar Presents The Appropriate Economic Framework For The Costing Exercise

In preparing this case, the Postal Service devoted substantial effort to the development of a coherent and consistent framework for the analysis of postal costs. Obviously, this effort was constructed largely on the progress made in costing over the many years since reorganization. Yet previous work, whatever its other merits, was not always conducted in the context of a comprehensive framework. To make the relevant economic framework very clear, the Postal Service has once again sponsored the testimony of Prof. Panzar on this topic, USPS-T-11.

The general principles espoused by Dr. Panzar are relatively simple and, at least in the economics profession, well-understood. Most basically, the costing exercise is an inquiry devoted to the establishment of causation -- what causes the Postal Service's costs? *Id.* at 2. As Prof. Panzar explains, there are two relevant subsets of this inquiry -- the causation of costs at the margin, and the incremental costs caused by provision of the entire volume of a particular subclass or service. *Id.*[1]

Some general guidelines are applicable to both of these inquiries. For example, both marginal and incremental costs should be calculated on a forward-looking basis, yet available operating and accounting data exist only in records of past activities. *Id.* at 3, 13. To get over this hurdle, it is necessary when calculating

[1] Prof. Panzar's explanation of exactly why marginal and incremental costs are the ones which are relevant for any rational ratemaking regime is discussed extensively in the pricing theory section of this brief, which appears as Section IV.

marginal or incremental costs to assume that postal operations are based on some type of operating plan. As Prof. Panzar explains, this does not mean a formal document, but rather a set of reasonably stable practices and procedures which the Postal Service uses in order to serve the mail volume it receives. *Id.* at 3-4, 14-16. The concept of the operating plan is important because it makes it possible to predict the changes in costs required to handle any given level of volume changes.[2] *Id.* Dr. Panzar explains how the Postal Service's operating plan is implicit in its cost measurement system. *Id.* at 18-20.

It is not necessary for the operating plan to be assumed to be cost-minimizing, or perfectly efficient. In fact, as Prof. Panzar emphasizes, as long as it is given that postal services will be produced following established practices and procedures, the relevant marginal and incremental costs are those based on the Postal Service operating plan. *Id.* at 16-17. This has been described as the "actual cost" standard. Tr. 11/5417-18.

The "actual cost" standard is also relevant in another respect. Inevitably, questions arise as to the appropriate length of run over which cost changes in response to volume changes should be examined. Typically, these inquires engender great confusion, and this case is no exception. One of the advantages of a comprehensive costing framework, however, is that it allows such questions to be resolved consistently and coherently.

---

[2] Prof. Sherman in his testimony for the OCA agrees with Prof. Panzar that "cost estimates should be based on a Postal Service operating plan, in order to yield consistent results." Tr. 26/13757.

When economists speak of the long run, they are referring not to a period of calendar time, but a theoretical scenario in which all of the inputs of an economic enterprise are variable, and none of the inputs are fixed. Tr. 34/18243.[3] An on-going firm never finds itself in the "true" theoretical long-run with complete factor variability. Tr. 34/18243. Clearly, measurement of the actual cost response, consistent with an existing operating plan, will never meet the economist's definition of the long run. As Prof. Panzar notes, therefore, by default, the actual costs that are relevant for ratemaking must be some version of short-run costs. Tr. 9/4636.

More specifically, Prof. Panzar explains that the relevant actual costs are those that would be required to serve a sustained change in volume over the time period during which the rates will be in effect, taking into account which productive inputs can and cannot be varied over that time period.[4] *Id.* See also Tr. 11/5417 (Prof. Bradley citing Prof. Baumol). By focusing on any cost consequences that may occur over the entire rate cycle as a result of a sustained change in volume, the proposed framework allows consideration of responsive adjustments that may be made in a broader range of productive inputs over a period of substantial duration, in contrast to an approach with a focus limited to daily, weekly, monthly, or even annual

---

[3] Dr. Christensen equates the concept of the long run as contemplating a postal system that was starting from scratch, or from "a blank slate." Tr. 34/18243-44, 18272-73.

[4] If the sustained change is in marginal volume, the cost changes resulting over the period during which the rates will be in effect would be considered the relevant marginal costs. If the sustained change is the elimination of the entire volume of a subclass or service, the cost changes resulting over the period during which rates will be in effect would be considered the relevant incremental costs.

adjustments. Tr. 11/5417-18.

Specifically with respect to marginal costs, Prof. Panzar also explains why the unit volume variable costs estimated by the Postal Service are economic marginal costs. USPS-T-11 at 21-23. For this explanation, he relies heavily on the Bradley, Colvin, and Smith article cited on page 18 of his testimony, which presents in great detail the specifics of how different varieties of postal costing procedures actually do fit into a coherent economic framework.[5] For example, the concept of a cost driver is an integral part of much of the traditional variability analysis, and it is important to understand the appropriate role of that concept in developing accurate marginal costs (as well as incremental costs). Dr. Panzar summarizes the relevant theory on pages 18-27.

Most of the following discussion in the costing portion of this brief relates primarily to volume variable (marginal) costs within particular cost segments.[6] Before

---

[5] Bradley, Michael, Colvin Jeffrey, and Smith, Marc, "Measuring Product Costs for Rate-making: The United States Postal Service," in Michael Crew and Paul Kleindorfer, eds., Regulation and the Evolving Nature of Postal and Delivery Services: 1992 and Beyond, (Boston, Kluwer Academic Publishers, 1992).

[6] It perhaps should be emphasized that utilization of a comprehensive costing framework based on established economic theory in no way dictates the results of the **empirical** analyses conducted at the individual cost segment level. Each postal costing analyst has conducted objective, impartial research with the sole criterion being to obtain the best possible understanding of postal costs in that segment. The whole (i.e., systemwide variability, aggregate subclass costs) is nothing more than the sum of the parts (i.e., cost segment variability, subclass costs by cost segment). The Postal Service has no "global" objective with regard to costing except to measure the relevant costs as accurately as possible. Baseless comments to the contrary, such as MMA witness Bentley's suggestion that he "cannot regard it as accidental" that improved costing procedures disfavor (at least in his view) certain subclasses (Tr. 21/11209-11, 11290-293), are offensive, unwarranted, and untrue. Each postal cost

proceeding to those matters, the next section will address incremental costs. It must be stressed, however, that matters addressed in the context of the best procedures for estimating volume variable costs for a particular cost segment or component will often have consequences relating to incremental costs, because in most instances, both analyses rely on the same cost equations for the relationship between changes in volume and changes in costs.

B. For The First Time, The Postal Service In This Case Presents Comprehensive Incremental Costs

As a theoretical concept, incremental costs (as that term is currently defined in regulatory economics) are nothing new to the Commission, having been presented in testimony by Prof. William J. Baumol going back several general rate cases. In this case, however, as requested by the Commission, the Postal Service has finally been able to marry theory with practice, and present incremental costs for each subclass, as well as for several larger groups of services. These appear in the testimony of William Takis, USPS-T-41. Although the testimony and exhibits of Mr. Takis constitute a relatively short document, the tremendous effort and substantial body of resources involved in producing this information should not be discounted. A research team of staff economists and consultants worked diligently over the course of several years to examine each cost component individually, and determine how

---

analysis stands on its own merits, and (again contrary to witness Bentley's erroneous views, Tr. 21/11216-18, 11294-11303), objective empirical analysis precludes a priori preferences (for either higher or lower variability) that would bias the result. Nevertheless, the Commission can easily observe that many improved procedures proposed by the Postal Service in this case actually increase variability, in clear contradiction of any contrived "conspiracy theory" of costing. See Tr. 21/11291-93.

such costs are best handled in the context of an incremental cost analysis. Close coordination was required both with postal operations experts, and with costing personnel conducting the more substantive examination of cost relationships at the cost segment level. The result is deliberate, thorough, and well-documented research, designed and executed to fulfill the function for incremental cost analysis laid out in Prof. Panzar's comprehensive economic costing framework.

The testimony of Mr. Takis recounts the theory of incremental costs, and how his work comports with that of Dr. Panzar. He defines incremental cost as "the cost caused by the provision of the entire amount of a product." USPS-T-41 at 3. He discusses both the intuitive and the mathematical context in which incremental costs should be considered. *Id.* at 3-14.[7] He also presents the research path employed, in which he starts with same cost components which are the traditional building blocks of all postal costing analysis. *Id.* at 14-19. He explains his determination to use the "ratio approach" to estimate incremental costs by service for the test year. *Id.* at 19-20. Witness Takis presents his results, and includes a brief discussion of the results by subclass and group. *Id.* at 21-34.

Although there has been relatively little controversy regarding the incremental costs presented by witness Takis, some points do merit attention. One point involves certain terminology that witness Takis inherited but which, in light of more recent

[7] Once again, there is a highly relevant published article on which the witness relies, in this case: Bradley, Michael, Colvin, Jeffrey, and Panzar, John, "Issues in Measuring Incremental Costs in a Multi-Function Enterprise," in Managing Change in the Postal and Delivery Industries, Michael Crew and Paul Kleindorfer, eds. (Boston, Kluwer Academic Publishers, 1997).

developments, creates unnecessary confusion in trying to understand the realities of certain types of costs. In particular, the term "specific fixed" has been applied to categories of costs that do not seem to be "fixed" in any conventional sense of the term. Tr. 9/4733-38, 4765-67. As cited by Mr. Takis on those pages of the transcript, the Commission has itself acknowledged some imprecision in that term. The solution to this difficulty proposed by witness Takis is to move beyond the term "specific fixed" and instead refer to "product specific" costs. Tr. 9/4766-67. Such a change should produce greater clarity for all parties concerned.

Another point that may seem obvious, but nonetheless bears repeating, is that incremental costs for each subclass (as measured by witness Takis) are analytically quite distinct from the sum of the volume variable costs of the subclass (as presented by witnesses Alexandrovich and Patelunes) and what in the past, as discussed above, has been termed the "specific fixed" costs of the subclass. Tr. 34/18241. That sum (volume variable plus "specific fixed") has previously been equated with the statutory term "attributable." As Dr. Panzar and Mr. Takis testify, incremental costs are properly measured as the cost that would be avoided if the entire volume of a subclass were to be eliminated. Mr. Takis has done that analysis, and the results of his analysis are the only evidence on this record of the incremental costs by subclass. Under these circumstances, it would be clearly inappropriate to consider the sum of volume variable and "specific fixed" costs as the full measure of causally related costs, when Mr. Takis' results plainly show that not to be the case.

Questions regarding the appropriate length of run for incremental cost analysis

arose during cross-examination of Prof. Panzar on his rebuttal testimony.[8] Specifically, a number of hypotheticals were posed regarding advertising contracts of particular durations, involving the issue of potential sunk costs. E.g., Tr. 34/18471-72, 18473-75, 18487. The suggestion was that if the duration of the rate cycle got shorter, under the "actual cost" standard, it might be possible that more product specific cost might be considered sunk, and thus excluded from the incremental cost of the service with which they would otherwise be included. Tr. 34/18472. Such hypotheticals are extreme, however, because contract arrangements that result in truly sunk costs require up-front payment to acquire fixed amount of resources that could not be transferred to any other productive activity for the entire length of the contract period. See, e.g., Tr. 34/18475, 18490, 18494. Particularly in the context of government contracting, prolonged contracts of such nature would be expected to be extremely rare, to say the least.[9]

More to the point, however, there has been no showing of any connection of these types of issues to the actual incremental costs presented by Mr. Takis. For

---

[8] In his rebuttal testimony, Prof. Panzar made the point that the Postal Service excludes product specific fixed costs from its marginal costs estimates because such costs do not vary with volume, and not because the Postal Service has chosen to use short run cost instead of long run costs. No matter what length of run is selected, such fixed costs do not vary with volume, and should not be marked up. Tr. 34/18461-62.

[9] On the other hand, at a theoretical level, Prof. Panzar is clearly correct that any fixed costs which are truly sunk (i.e., cannot be avoided by the Postal Service under any set of circumstances) cannot and should not be causally linked to the continued provision of any service. Tr. 34/18475. If the service ceases to exist and the sunk costs remain, the service does not cause those costs.

example, the Postal Service did not identify any product specific costs, but then exclude them from the incremental cost calculation because they were believed to be sunk costs over the expected rate cycle.[10] Instead, all product specific costs have been included in the incremental costs of the subclass or service to which they are specific. As a practical matter, there is no reason to believe any contemplated changes in the frequency of rate filings would have any effect on the treatment of any of the product specific costs identified by Mr. Takis and included as incremental costs. In this context, the notion of sunk costs may provide interesting fodder for discussion, but appears to be devoid of any practical consequences. The incremental costs sponsored by witness Takis have been properly calculated using the appropriate economic framework, and should be accepted by the Commission to be used as Dr. Panzar recommends.

C. The Postal Service Has Employed A Coherent Analytic Framework To Improve The Treatment Of Mail Processing Costs And To Address Concerns Raised In Previous Cases

In response to a variety of criticisms raised in previous cases, and in an effort to better align costing procedures with the appropriate economic framework for the measurement of relevant costs, the Postal Service has substantially improved its allocation of mail processing costs. To achieve this objective, the Postal Service has reviewed the relevant economic theory, has examined that theory to identify the information necessary for actual implementation, and has conducted the analyses

[10] It is not logically possible to provide a transcript cite to "show me exactly where it doesn't say that," but examination of the materials provided by Mr. Takis will reveal no such instances.

necessary to provide the required information. The result is a well-conceived and well-executed integrated body of research which, relative both to the previously employed methodology and to any alternatives proposed in this case, provides superior estimates of mail processing costs by subclass.

The relevant economic framework is identified in the direct testimony of witness Panzar, USPS-T-11. First, Prof. Panzar identifies the actual marginal costs of the Postal Service as the relevant costs (along with actual incremental costs) for postal ratemaking purposes. *Id.* at 5-17. Next, Prof. Panzar demonstrates that properly constructed unit volume variable costs are, in fact, economic marginal costs. *Id.* at 21-23. He also identifies the theoretical basis for the use of cost drivers in estimating marginal costs by subclass. *Id.* Further discussion of how Dr. Panzar's theory is directly applied in the mail processing area appears at USPS-T-14 at 5-6 (Bradley), Tr. 12/6598-6604 (Degen), Tr. 11/5434-35 (Bradley), and USPS-RT-7 at 1-12 (Christensen).

As detailed in the above citations, mail processing costs in this case (like several other postal cost components) are analyzed on the basis of the "volume variability-distribution key" method. This method, as the name suggests, contains two steps -- one step to identify the causal relationship between costs and the cost driver (the "variability" step), and a second step to identify the relationship between the cost driver and subclasses of mail (the "distribution" step). See USPS-LR-H-1, Appendix H.

In this case, Dr. Bradley (USPS-T-14) conducted the first-step analysis and

identified the causal relationship between costs and the cost driver. Dr. Bradley performed this analysis at the activity level, where an activity is a closely related group of mail processing operations, such as those relating to manual letter sorting, manual flat sorting, OCR sorting, platform, etc. Dr. Bradley's analysis relates the number of work hours in the activity to the cost driver, which is generally the total number of pieces handled, or TPH, in the activity. The result of this analysis is the proportionate change in costs caused by the changes in TPH, which is, expressed as a percentage, more commonly known as the variability of the activity.

Mr. Degen (USPS-T-12) conducted the second-step analysis, which relates the cost driver -- pieces handled -- to mail volumes by subclasses. In his work, witness Degen uses tally information from the same data system (IOCS) that has previously been used for many years to distribute mail processing costs. Mr. Degen, however, uses that information in a fundamentally different way. To maintain consistency with Dr. Bradley's application of the economic framework, his analysis is also done at the activity (or "cost pool") level. Dr. Bradley has estimated the portion of each cost pool's total accrued costs that is caused by piece handlings, and Mr. Degen's task is therefore to relate the piece handlings in each cost pool to volumes by subclass of mail. He uses his analysis to distribute to the subclasses the variable portion of the cost pool costs, which is the amount of costs that Dr. Bradley has shown to be caused on the margin by the piece handlings of the mail that passes through the operations that constitute each cost pool. On the other hand, Mr. Degen does <u>not</u> distribute to subclasses those costs in each cost pool that Dr. Bradley has found are

not variable with piece handlings in the activity.

In his rebuttal testimony, Dr. Christensen emphasizes the critical linkage between the variability analysis conducted by Prof. Bradley and the distribution analysis conducted by witness Degen. USPS-RT-7 at 1-12. Because the causal links that have been measured between cost and cost driver are estimated at the activity level, the linkage between the cost driver (which is piece handlings) and subclass responsibility for that cost driver must likewise be made in the context of the activity cost pool. Tr. 34/18288. Each step of the analysis is a necessary part of the ultimate objective of measuring the volume variable costs by subclass that are required, as explained by Prof. Panzar, for rational ratemaking under a breakeven constraint.

This section of the brief on mail processing costs will also be used to discuss one aspect of the criticisms raised by ANM witness Haldi (ANM-T-1) regarding the estimated costs for Standard A Nonprofit mail. Among his other criticisms, Dr. Haldi hypothesizes that there has been a mismatch between costs and volumes for that subclass in the Postal Service's data collection systems. His hypothesis has been shown to be wrong by Postal Service rebuttal witness Schenk. He also calls attention to some unexpected weight observations recorded in the IOCS as Nonprofit Standard mail. Both of these matters will be discussed in detail at the end of this section.

1. All credible evidence of record in this proceeding clearly demonstrates that mail processing labor costs are not fully variable with volume.

In this proceeding, Dr. Bradley presents a comprehensive new analysis of the

variability of mail processing labor costs. In that analysis, Dr. Bradley makes use of nine years of actual operating data to estimate separate variabilities for discrete operational cost pools. Dr. Bradley's overall conclusion is that mail processing labor costs are not fully variable with volume. In addition, he has conclusively demonstrated that different operations exhibit different levels of variability.

Intervenors have lodged various criticisms of Dr. Bradley's database and of his econometric techniques. A variety of alternative variability formulations also have been presented. As will be demonstrated below, the intervenor criticisms are without merit and the great majority of alternative formulations show variabilities of less than 100 percent. Dr. Bradley's study must accordingly be accepted.

a. The Postal Service's new analysis of the volume variability/distribution key methodology for mail processing labor costs was well-conceived, carefully implemented and thoroughly documented.

In this proceeding, Dr. Bradley presents a comprehensive new analysis of the variability of mail processing labor costs. In that analysis, Dr. Bradley makes use of nine years of actual operating data to estimate separate variabilities for discrete operational cost pools. Dr. Bradley's overall conclusion is that mail processing labor costs are not fully variable with volume. In addition, he has conclusively demonstrated that different operations exhibit different levels of variability.

Intervenors have lodged various criticisms of Dr. Bradley's database and his econometric techniques. A variety of alternative variability formulations also have been presented. As will be demonstrated below, the intervenor criticisms are without

merit and the great majority of alternative formulations show variabilities of less than 100 percent. Dr. Bradley's study must accordingly be accepted.

In this docket, the Postal Service presented a new analysis of the volume variability/distribution key methodology for mail processing labor costs. As the record in this proceeding demonstrates, the analysis was well-conceived, carefully implemented and thoroughly documented. It was a multi-year study[11] that required consistency, in every instance, with the essential building blocks of any credible and successful analysis:

- consistency with economic theory
- careful data collection and analysis
- reflection of actual operational practice

How the study addressed each of these items will be discussed in detail below.

Background

The study of the variability of mail processing labor costs began over five years ago. It was given impetus initially by criticisms arising out of Docket No. R90-1 that the advent of automation had caused a sea of changes in postal operations such that the prior method of determining mail processing labor cost variability and the distribution of those costs was no longer serviceable. A more intense focus was engendered by the Commission's Recommended Decision in Docket No. R94-1. In particular, the Commission determined that "[t]he shift to automation has caused a

[11] In fact, as the Postal Service has indicated, a related analysis of the variability of platform operations is ongoing.

number of questions. The effects of this change are complex and have not been analyzed. Some parties argue that the IOCS may no longer be well-suited to a changed operating system." PRC Op., R94-1, at III-8.

Over the course of the last five years, postal consultants, economists, and lawyers, as well as financial, marketing, and operational experts have been consulted continuously for opinions, expertise, and assistance in defining the parameters of the analysis and in reviewing the results. Personnel at all levels of the Postal Service were advised of or involved in the effort. At several points, presentations on the study were made to the Board of Governors. Literally thousands of hours were spent by all involved in reading, writing, collecting data, analyzing data, and reviewing results. Numerous site visits were made and interviews with field personnel were conducted to ensure that the study mirrored operational reality. All aspects of the study were subjected to rigorous scrutiny and debate. As indicated above, the results clearly are consistent with the foundational requirements for any credible analysis.

Consistency with Economic Theory

From it inception, the study was firmly grounded in well-settled economic theory. It embodies the costing structure described by Dr. Panzar and directly implements his prescribed procedures to accurately measure actual marginal cost. It is also entirely consistent with established costing principles and practice. In particular, it uses the two-step volume variability/distribution key methodology used by both the Postal Service and the Commission for determination of volume variable costs of each subclass of mail and the special services that are, expressed per unit

of subclass volume, equal to marginal costs. It represents a marked advancement over the prior untested assumption of 100 percent variability of mail processing labor costs, and further achieves a much finer level of detail in its estimation of variability for and distribution of costs within discrete operational cost pools.

Noted economist, Dr. John Ying, was brought in to conduct an independent review of the variability estimates after the conclusion of discovery against the Postal Service's direct case. Dr. Ying had not been involved in the years of study of the issue nor had he previously worked with any of the economists involved. *Tr. 33/18167.* His review verified that both the economic theory and the econometric techniques of the analysis were sound. Further, he concluded that the evidence demonstrated that the 100 percent variabilities should not continue to be used.

Careful Data Collection and Analysis

The data side of the study received great attention and that concentration is reflected in the comprehensive database presented in this proceeding. Data were collected for hundreds of mail processing sites over a nine-year period. The resulting data set contains hundreds of thousands of data points, yielding tens of thousands of observations for estimation of most of the variabilities. The data were thoroughly examined and scrubbed to ensure that, consistent with the Commission's oft-stated desire, only the highest quality data were used. Use of the highest quality data, in this instance, also ensured valid and reliable results.

Sophisticated and well-settled econometric techniques were used to accurately estimate the variabilities. The comprehensive database allowed many alternative

formulations to be investigated.[12] The estimated variabilities are robust across those alternative formulations and produce a striking body of evidence which compellingly demonstrates that mail processing variabilities are below 100 percent.

Reflection of actual operational practice

Experts on postal operations were involved throughout all phases of the study to assure that both the approach adopted and the results generated were consistent with operational realities. The study makes use of actual operating data from the MODS and PIRS systems, and reflects the structure of activities on the workroom floor. The results plainly make sense to all witnesses in this proceeding and others who have experience in or who have substantial exposure to postal operations.

b. The prior, untested assumption of 100 percent volume variability of mail processing labor costs must be set aside.

Both the Postal Service and the Commission have assumed for quite a number of years that mail processing labor costs bear a significant relationship to the volume of mail processed. In fact, it has been assumed that mail processing costs are 100 percent volume variable. This assumption was unchallenged by empirical evidence and may have been reasonable under those circumstances. For the first time, in this proceeding, the assumption of a significant relationship has been demonstrated empirically to be true; however, the assumption that mail processing costs are 100 percent volume variable has been demonstrated empirically to be false. Further, the

[12] It should be noted that these alternative formulations would not have been possible had the analysis not been as thoroughly and clearly documented as it was.

record in this proceeding also demonstrates empirically that variabilities differ across activities within mail processing. For a number of the mail processing activities that have been evaluated, the relationship is close to proportional. Six of the twenty-five variabilities calculated by Professor Bradley are 90 percent or higher, nearly half are 70 percent or higher (seventeen of the twenty-five), and the vast majority are 50 percent or higher (twenty-one of the twenty-five). *USPS-T-14, at 9.*

The Postal Service is not claiming that mail processing labor costs are unrelated to volume. In fact, the data demonstrate a significant relationship. The substantial and credible data, analyzed for the first time in this proceeding, however, allow the relationship between mail processing costs and volumes to be estimated accurately for separate operational activities. This means that both the Postal Service and the Commission are in a much better position than ever before to ensure that the classes and subclasses of mail are bearing the mail processing costs that they actually cause.

The assumption of 100 percent volume variability made at least some sense in the past because it was clear that there was a strong causal relationship between mail processing labor costs and volumes, and because of the dearth of relevant empirical analysis on the issue. Moreover, it was a convenient assumption, particularly given the time and effort needed to comprehensively study the matter. Convenience, however, can no longer suffice in the face of the compelling empirical evidence concerning the true volume variabilities presented for the first time in this docket by Professor Bradley.

Upon careful reflection, it makes sense that the mail processing labor costs of different operational activities would vary with volume in different proportions. It seems eminently logical, for example, to expect that the mail processing labor costs for manual activities would vary with volume less than those for machine-based activities. Professor Bradley has offered a number of reasons why different variability results for different activities are to be expected. He discusses the existence of "relatively fixed functions within the activity" such as "setting up mail processing equipment or tying down a manual case," which "are not sensitive to the amount of volume sorted." *Id. at 56.* Professor Bradley also discusses the "increased specialization of tasks," which, for example, in a manual activity, increases employees' "familiarity with the activity and, as a result, their efficiency." *Id.* As another example, machine-based sortation occurs at a constant speed, resulting in "high variability as any additional volume would always be sorted at the same rate as any preceding volume." *Id. at 57.* Also, Professor Bradley stresses how the nature of certain "gateway" and "backstop" activities exhibit different variabilities. *Id. at 57-59.* For example, the OCR activity is often used to read and barcode mail as it arrives, thus resulting in a lower variability than activities "in which volume is 'massed' prior to starting the activity." *Id. at 57-58.*

It seems counterintuitive to expect that the platform activity and the BCS activity in a MODS office, or that the BMC platform activity and the BMC sack sorting machine, would have the same level of variability. In fact, both the Postal Service and the Commission, even under the prior assumption, have never assumed exact

proportionality. Platform costs, for example, have not been treated as 100 percent variable.[13] The understandable basis for this has been that

> a portion of the time spent by employees assigned to platform acceptance work does not involve actual acceptance activities or other related functions. Such slack time is unavoidable because employees must be available to accept mail when it is delivered to the platform. Costs for
> such platform acceptance time are classified as institutional.

USPS LR-H-1, at 3-3. Postal Service Area Vice-President Steele offered further reasons why platform operations should be expected to have a lower variability, stating:

> If you walked through and took a snapshot of a bulk mail center platform, you might see an open door as we're waiting for a trailer to back in and see two mail handlers waiting for that truck to be backed in.
>
> A snapshot at that point in time might look like they were not fully occupied, but they're assigned to those doors and waiting for the cycle of trucks in and out.

Tr. 33/17863.

Also, an explicit assumption that mail processing labor costs vary in exact proportion with volumes requires an implicit assumption that there are absolutely no

---

[13] *See Order No. 1203, December 9, 1997, p. 10, n.8,* where the Commission stated:

> The established variability analysis assumes that mail processing labor is 100 percent volume variable for most, but not all cost components. See the treatment of platform and "miscellaneous" work at USPS LR-H-1, pages 3-2 to 3-5. The Postal Service is directed to demonstrate the impact of applying the established variability analysis, not a "100 percent variability assumption" per se, to apply to its rate proposals.

economies of scale in any of the mail processing activities. The absence of economies of scale is not logical, either for industry in general or for the Postal Service in particular. As Time Warner witness Stralberg cogently explained:

> To claim that mail processing costs are 100% volume variable is equivalent to claiming that there are no economies of scale in the system, so that it costs the Postal Service as much to process the last 100 million pieces that enter the system as the first 100 million pieces; as much per individual to train ten clerks as a hundred, or a thousand; as much per machine to buy 20 OCR's as 200; and that the additional OCR's and BCR's the Postal Service buys in response to increased volume will have no technological improvements over the ones they bought originally. . . .*It is impossible to think of any manufacturing industry where it is not believed that higher volumes will lead to improved efficiency and lower unit costs.*

Tr. 36/19290 (emphasis added). Postal operations expert Moden also explained that "[a] sustained increase in volume at a cost pool in a single facility will generally result in some increase in productivity." *USPS-T-4, at 19.* Witness Moden said the reasons for this include "associated work such as obtaining mail, positioning rolling stock, or changing schemes that does not change proportionately with changes in volume;" staffing plans "only roughly" matching workload on a given night, so that mail volume increases make it easier to avoid "running short of mail in the middle on an operation;" and the phenomenon of people working at a quicker pace "when there is a steady inventory of mail waiting to be processed." *Id.*

In this docket, furthermore, despite use of different models and different estimation techniques, the vast majority of the results plainly show variabilities of less than 100 percent. In his direct testimony, the comprehensive and correctly-specified model recommended by Dr. Bradley shows variabilities of less than 100 percent for

twenty-four of the twenty-five estimates. *USPS-T-14, at 9.* In addition, the variety of alternative econometric analyses performed and presented in Professor Bradley's direct testimony -- the econometric equations without a serial correlation correction (*id. at 71*), the two way panel data model that corrects simultaneously for both site-specific and time-specific effects (*id. at 74*), the econometric equations estimated on annual data (*id. at 76*), the econometric results based on SPLY data (*id. at 79*), and econometric equations containing an errors-in-variables analysis (*id. at 84*) -- generally show similar results, with lower variabilities for manual activities and higher variabilities for machine-based activities. The vast majority of activities exhibit variabilities of less than 100 percent. Also, Dr. Bradley calculated the average of estimated site-specific variabilities requested by POIR No. 7, item 1. These variabilities fell below 100 percent. *Tr. 19E/9735.*

UPS witness Neels, in his direct testimony, obtains results reflecting variabilities of less than 100 percent for the great majority of activities estimated, based on Professor Bradley's model but reflecting "all useable observations." *Tr. 28/15618.* Dr. Neels also obtains variabilities of less than 100 percent for the majority of activities when he applied Professor Bradley's errors-in-variables methodology to all MODS direct activities. *Tr.28/15639.*

The responses to Notice of Inquiry No. 4 on Mail Processing Variability (*NOI #4*) also demonstrated that the site-specific model generally yielded variabilities well below 100 percent. Dr. Bradley's response showed that "the vast majority of sites have a variability *between* zero and 100 percent and the variabilities are massed at a

value far below 100 percent." *Tr. 28/16085 (emphasis in original).* MPA witness Higgins reached a like conclusion, stating, "The analysis I have done for the NOI leads me to conclude that the average mail processing variability is no higher than Professor Bradley's figure of 76.4 percent. *Tr. 29/16126.* Even UPS witness Neels presents numerous site-specific variabilities below 100 percent in his NOI #4 response. In fact, all but one of the means of the site-specific variabilities shown in that response fall below 100 percent. *See Tr. 28/15649.*

The rebuttal testimony of Professor Bradley presented additional alternative analyses, which further corroborate the conclusion that mail processing labor costs do not vary proportionally with volume. Professor Bradley estimates variabilities based upon a less restrictive, 26 accounting period scrub, rather than the 39 accounting period scrub presented in his direct testimony. The variabilities resulting from the 26 accounting period scrub are very consistent in terms of magnitude with those resulting from the 39 accounting period scrub and also are very consistent in that they are below 100 percent. *Tr. 33/17893.* Professor Bradley also calculates variabilities based on an errors-in-variable analysis with one year (13 accounting period) differences that shows variabilities of less than 100 percent. *See id. at 17900.* In addition, Professor Bradley "re-estimated the fixed-effects model at the facility level on the panel data used in USPS-T-14," which resulted in an overall variability of 66.3 percent. *Tr. 33/17909-10.* Finally, in his rebuttal testimony, Professor Bradley presented a cross-sectional analysis for FY 1994 which added the capital variables of facility age, the number of square feet used for mail processing in

the facility, and the number of floors that perform mail processing in the facility, and he again obtained variabilities of less than 100 percent. *Id. at 17911.*

Only a very few of the models discussed in this case show a majority of variabilities at 100 percent or greater. And, for reasons discussed in detail in the following sections of this brief, all of these models are demonstrably biased and so fundamentally flawed that they cannot be relied upon. One example of a biased model is the "between" or cross-sectional model estimated by Dr. Bradley as one of the statistical hypothesis-testing steps in deriving his final fixed-effects model. *Bradley WP-1.* The cross-sectional model reflected variabilities of 100 percent or greater. Dr. Neels derived a modified version of Dr. Bradley's cross-sectional model, and, as might be expected, it showed variabilities well in excess of 100 percent for most activities. *Tr. 28/15593.*[14]

In response to Presiding Officer's Information Request No. 4 (*POIR #4*), item 3, Professor Bradley presented two sets of results for a pooled model, with and without correction for serial correlation. The pooled model is biased because it incorporates restrictions that have been demonstrated to be false. Due to this bias, the majority of results for these models showed variabilities of 100 percent or greater. *Tr. 11/5427-29.* Nonetheless, it should be noted that the variabilities for the pooled model, corrected for serial correlation, still fall below 100 percent for nearly half of the

[14] The counterintuitive nature of these results is clearly revealed by simply looking at the 146 percent variability that Dr. Neels estimated for the MODS Allied Platform activity. Even when the Postal Service and the Commission operated under the prior 100 percent assumption, platform was rightly assumed to be less than 100 percent volume variable.

activities (five of eleven of the variabilities presented). *Id.*

These biased models clearly do not all stand on the same footing as the unbiased models presented by Dr. Bradley. No weight can be accorded to the demonstrably biased models. Nonetheless, even if all of the models were assumed to have equal validity, compelling evidence of record proves that the variability of mail processing labor costs is not 100 percent. Of the 20 different econometric models presented on this record, an overwhelming majority -- 16 of the 20 or 80 percent -- decisively confirm that the prior, untested 100 percent assumption is wrong. Actually, the pooled model, corrected for serial correlation, where five of the eleven variabilities fall below 100 percent, also confirms that the 100 percent variability assumption is incorrect. If that is the case, then 17 of the 20 models presented -- or 85 percent -- support rejection of the prior assumption.

The number of models that yield variabilities of less than 100 percent is substantial and it demonstrates the robustness of Dr. Bradley's results. We do not, however, need to select a model by vote. The operational realities of how a small, sustained increase in volume would be handled, point squarely to models that control for site-specific effects--the kind of model presented by Dr. Bradley in his direct testimony.

In light of both the compelling econometric data and persuasive operational reasons that prove that mail processing labor costs are not directly proportional with volume, the Commission must abandon the prior 100 percent assumption. This is the first time that sound econometric data have been brought to bear on this important

issue. The Commission would fail to ensure that rates are based on the best costing information available if these data are ignored in favor of the prior untested assumption.

c. The fixed-effects model presented in Professor Bradley's direct testimony is the most reliable econometric evidence of the true variabilities of mail processing labor cost pools.

i. Professor Bradley's variabilities are derived from a properly specified cost equation and use of that cost equation is appropriate.

The task facing Dr. Bradley in estimating the variability of mail processing labor cost in each cost pool was to derive an appropriate "econometric cost equation for each individual activity." *USPS-T-14 at 12.*[15] The first step in this process, as indicated by Dr. Bradley, was to select the proper variables. *Id. at 11.* Dr. Bradley estimated his cost equations for three types of activities -- direct activities at MODS offices, allied labor activities at MODS offices, and activities at BMCs. *Id.* For the cost equations for direct activities at MODS offices, Dr. Bradley used recorded MODS hours as the dependent variable, Total Piece Handlings (TPH) from MODS as the cost driver, and time trend control variables. *Id. at 12-17.* For the allied activities at MODS offices, Dr. Bradley used a proxy workload measure as the cost driver, separate TPH measures for each major sorting technology -- manual letter, manual flat, mechanized letter, mechanized flat and automated letter. *Id. at 18-19.* For activities at BMCs, Dr. Bradley used PIRS hours as the dependent variable, total

[15] Professor Bradley used witness Degen's disaggregated activity-specific cost pools. *Id. at 6.*

piece handlings as the cost driver, and time trend control variables. *Id. at 20-21.*[16] Certain intervenors attempted to challenge Dr. Bradley's choice of variables. As demonstrated below, all of those challenges failed.

ii. Use of labor hours as the dependent variable has strong precedent and reflects actual resource consumption.

Professor Bradley chose an activity's recorded work hours as the left-hand-side or dependent variable in these equations, representing actual resource consumption. *Id. at 12.* The use of actual labor time (hours) as the dependent variable is clearly consistent with well-established Commission practice for statistically estimating how changes in mail volume cause changes in cost in other cost segments. For example, city carrier costing methodologies have made use of actual time as the dependent variable. As Professor Bradley explained:

> [T]his is not a new issue and labor time has already been used as a dependent variable in a variability equation by many different cost analysts and the Postal Rate Commission. Empirical studies of load time, the time spend loading pieces of mail into a variety of mail receptacles (which is quite similar to manual mail processing), have already related labor time to the pieces handled.
>
> Studies by UPS witness Michael Nelson, MOAA et al. witness Gary Andrew, ADVO witness Norman Lerner and the Postal Rate Commission itself all used labor time as the dependent variable and pieces handled as the cost driver. This is the same approach that I follow in specifying the mail processing equations. Note that this approach of specifying labor time as [a] function of pieces handled is not just an assumption, but rather it is part of a data analysis examined on

[16] The above is a broad outline of what Dr. Bradley did. Dr. Bradley's direct testimony (USPS-T-14) should be consulted in full for a more detailed discussion of some of the differences in his cost equations -- for example, a "piece" in a BMC sack activity is a sack. *Id. at 20.*

the record in several omnibus rate cases.

Tr. 33/17881 (footnotes omitted). In addition, the IOCS traditionally has made use of time to estimate costs by activity. Witness Degen's supplemental testimony describes the basic role of the IOCS as follows: "The In-Office Cost System uses a probability sample of *work time to estimate costs* for time spent on various activities, including time spent processing each category of mail and several special services." *USPS-ST-47 at 10 (emphasis added).*

Further, the use of labor time (hours) as the dependent variable is eminently logical for purposes of estimating the volume variability of mail processing labor costs, the criticisms of UPS witness Neels notwithstanding.[17] Dr. Neels expressed his opinions that hours should not be used as the dependent variable for several reasons, all of which were shown by Dr. Bradley to have no merit.

First, Dr. Neels believes that because the average wage rates may vary among facilities, use of labor hours as the dependent variable does not account for this and is thus inappropriate. Dr. Neels stated that "the higher these wage rates, the higher the average compensation per hour will be." *Tr. 28/15595.* The issue is not whether wages vary, but whether wages vary with small, sustained changes in volume. Dr. Bradley, however, effectively refuted this concern, pointing out that the

[17] Dr. Bradley also cites some practical advantages in using hours as the dependent variable. Because the MODS and PIRS data systems have a direct record of the hours for each activity at each site by accounting period, "no additional constructions or transformations" are needed. *USPS-T-14, at 13.* Additionally, recorded hours are "real" in the sense that they are not affected by, and thus do not have to be adjusted for, inflation. *Id.*

fundamental purpose of a variability analysis is to measure how costs vary with volume. *Tr. 33/17882.* As Dr. Bradley stated, "Wages are not a function of volume, particularly not small, sustained changes in volume." *Id.* It is specifically this type of volume change which is required to measure variability. *Tr. 33/17950-51.* As everyone is aware, including Dr. Neels, "wages are set through collective bargaining between the Postal Service and the union representing postal workers." *Tr. 28/15696.* Dr. Bradley also pointed out that use of dollar costs as the dependent variable presents some complications "because, in doing so one would have to accurately control for all of the non-volume variation in wages." *Tr. 33/17882.* Dr. Bradley further pointed out that using dollar costs as the dependent variable would require an evaluation of the average wage rate in *each activity* in *each facility*, a daunting if not impossible task. *Id.* For example, this is not even done in IOCS, where costs associated with a unit of time are averaged across all offices in a CAG. Further, the average wage rate in each *activity* in each facility, in particular, would not vary with small, sustained changes in volume. *Id.*

Second, Dr. Neels expressed misgivings about using hours as the dependent variable due to an alleged variation in the mix of hours from facility to facility. *Tr. 28/15595.* As Dr. Bradley explained, however, the mix of hours at the facility level is irrelevant for an econometric equation at the *activity* level because the types of hours within an activity will be similar across facilities. *Tr. 33/17883.*[18] The logic of this

[18] Even to the extent they are not, however, the fixed-effects model estimated by Dr. Bradley controls for this type of site-specific heterogeneity. *Id.*

point was further articulated during oral cross-examination of Dr. Bradley.

> Q Is it your view that the mix of hours at a facility has no relationship with the mix of hours at an activity or at the activities at the facility?
>
> A What I believe is that the mix of hours at the facility would reflect the mix of activities within that facility.
>
> So, for example, in a facility, if we had, say, more allied operations
> -- cross docking or something to that extent -- then the mix of hours may have more mail handling hours relative to clerks based upon the mix of activities within the facility.
>
> * * * *
>
> Q I can equally read your testimony to say that the mix of hours within an activity will be the same from facility to facility?
>
> A . . . . Here, when I'm talking about types, I'm talking about the nature of the hours that are used in any operation. I'm trying to make the point here that within a particular activity, the Postal Service uses a particular type of labor.
>
> ...[W]e would expect across different facilities the same types of labors to be used in the same activity. Same type of labor used in a manual activity in facility A will be used in the manual activity in facility B. That's the point I was trying to make here.

Tr. 33/17940 and 17942-43.

Third, Dr. Neels asserted that "the mix of hours at a facility might vary systematically," thus possibly causing costs to vary. *Tr. 28/15596.* Dr. Neels illustrated this point with possible scenarios of high volume periods resulting in (1) greater use of less expensive casual or temporary labor, (2) greater use of more expensive senior or supervisory personnel, and (3) greater use of overtime. *Id.* As Dr. Bradley testified, Dr. Neels' assertions are incorrect. Dr. Neels again fails to

realize that variations in labor at the facility level are not relevant to an econometric analysis at the activity level. *Tr. 33/17883.*

Also, Dr. Neels is confused about the significance of overtime pay for Dr. Bradley's analysis. As Dr. Bradley illustrated, variations in costs resulting from overtime needed to handle seasonal peaks do *not* result from small, sustained increases in volume. *Id. at 17884.* With respect to sustained increases in volume, Postal Service Area Vice President Steele testified that there is an optimization process that takes place to achieve the appropriate balance between regular time and overtime. In fact, he indicated:

> ...[w]e don't want sustained, steady use of overtime in any work unit or any place. It's not a healthy way for us to manage.

Tr. 33/17870. Furthermore, "including [these seasonal variations in costs] in the dependent variable would cloud, not clarify, the accurate measurement of volume variability." *Id at 17884.*[19] Moreover, Dr. Bradley testified that even overtime costs

---

[19] The proper treatment of seasonal variations in hours is to control for them in an econometric equation as Dr. Bradley has done. *See id.* Dr. Bradley elaborated on this point during his oral cross-examination:

> It's certainly true that, over the course of the postal year, there are seasonal fluctuations in volume, just like in agriculture there's seasonal fluctuations, and it's well known that, to accurately measure marginal cost or unit volume variability cost, one needs to take out those seasonal variations, and they are relevant, because if you don't take them out, you're going to confound your measurement of the marginal costs, you're going to confound the way that costs respond to [a] sustained increase in volume.
>
> So, yes, they are relevant and you need to put seasonal factors in to control for them.

incurred to handle a random, non-seasonal peak in volume, although not captured by his seasonal dummy variable, could turn up in the residual term of his equation. *Tr. 33/17952-53.*

Also, the possible use of a mix of casual, part-time, and full-time labor hours does not make use of hours as the dependent variable improper, as implied during oral cross-examination of Dr. Bradley. *See Tr. 33/17934-35.* In fact, Dr. Bradley previously had responded to an interrogatory from DMA on this issue, stating, "It is my understanding that, on average, part time and casual workers are already working close to a full work week" and directing DMA to another interrogatory response for a "discussion of the average work week for part time and casual workers." *Tr. 11/5295.* That interrogatory response, provided by the Postal Service, showed that for FY 1996, casual employees worked an average of approximately 37.5 hours per week and part-time employees worked an average of approximately 38.1 hours per week. *See Tr. 19B/8690.* Casual and part-time labor, then, is essentially no different from full-time labor and accordingly does not affect use of hours as the dependent variable in Dr. Bradley's analysis.

Fourth, Dr. Neels is concerned that hours cannot be compared through time because "[t]he hours of supervisory personnel and skilled craftsmen are not the same as the hours of unskilled casual workers." *Tr. 28/15597.* Dr. Bradley demonstrated that Dr. Neels' assertion is erroneous. As Dr. Bradley stated: "Over time, supervisors don't start running OCRs and mail handlers do not start sorting mail." *Tr. 33/17884-*

Tr. 33/17951.

85. Dr. Neels seems to overlook the fact that work rules specifically delineate the work activities to be performed by particular crafts. Dr. Bradley further elaborated in his oral cross-examination that, for example, supervisors would not be tasked to manually process mail in response to changes in volume.[20] *Id. at 17943.*

In addition to the above-cited reasons that directly rebut Dr. Neels' belief that labor hours should not be used as the dependent variable, Dr. Bradley illuminates an inherent contradiction in Dr. Neels' arguments. As Dr. Bradley states:

> [Dr. Neels] is arguing that hours should not be used as the dependent variable in an econometric variability equation because it misses the variation in costs caused by the response of wages to small sustained volume increases. In sum, he argues that *[the] variability of wages with respect to volume is not zero.*

Tr. 33/17885 (emphasis added). Dr. Neels asserts both that labor hours vary 100 percent with volume and that costs vary 100 percent with volume. *See Tr. 28/15760 and 15634.* Since costs simply equal wages times hours, Dr. Bradley is able to calculate "the mathematical conditions for both assertions to hold." *Tr. 33/17885.* Dr. Bradley demonstrates that for both of Dr. Neels' assertions to be true, then the elasticity of wages with respect to volume *must* be zero. *Id. at 17885-86.* As Dr. Bradley states, [T]his condition directly contradicts [Dr. Neels'] concerns about using mail processing hours as a dependent variable in a variability equation." *Id. at*

---

[20]In addition, supervisor costs are treated in a separate analysis in Cost Segment 2, which reflects the fact that supervisors are not performing the mail processing work, but rather, supervising it.

17886-87.[21]

iii. Use of a cost driver such as TPH is both proper and supported by precedent.

The cost driver for a piece-distribution activity obviously is the number of pieces handled in that activity. Dr. Bradley thus uses Total Piece Handlings (TPH) at the activity level as the cost driver in MODS offices. *USPS-T-14, at 13.*[22] As with use of hours as the dependent variable, there is a well-established practice of using cost drivers in the estimation of cost variabilities in Commission proceedings. Examples include both city carrier load and access time, rural carriers, window service, purchased highway transportation, and vehicle service drivers. *See Tr. 33/17888.* Moreover, as Dr. Christensen emphasized, this approach is well-established in the mail processing area, "which has regarded handling of 'piece[s] of mail, mail container[s], or unit[s] of mail volume' as the relevant cost drivers in mail processing and distribution operations (USPS-LR-H-1, section 3.1)." *Tr. 34/18221.*

Nonetheless, UPS witness Neels criticized Dr. Bradley's use of TPH, stating that, with one exception (the Registry cost pool), "Bradley's datasets and results are devoid of any measure of the volume of mail actually delivered." *Tr. 28/15598.* Dr. Neels is taking Dr. Bradley's work out of context. The testimonies of Dr. Panzar

---

[21] Dr. Bradley's calculations also clearly show that the prior assumption of 100 percent volume variability of mail processing labor costs also depends upon the necessity of a zero elasticity of wages with respect to volume. *Id. at 17887.*

[22] To make allowance for gradual adjustments in the labor force due to changes in piece handlings, Dr. Bradley actually uses both a current and lagged TPH term in his equations. *Id.*

(USPS-T-11) and Dr. Christensen (USPS-RT-7) are very clear regarding the link between Dr. Bradley's variabilities with respect to TPH and witness Degen's elasticities of TPH with respect to subclass volumes. Dr. Neels' criticism of Dr. Bradley's analysis is meaningless because Dr. Neels overlooked the essential link to witness Degen's results.

Further, Dr. Neels' suggestion that "delivered" volumes are the relevant workload driver is ill-advised on a number of levels. As Dr. Bradley correctly claimed, "Anyone with a basic understanding of mail processing costs knows that there are material volumes of mail that are delivered that essentially bypass mail processing." *Tr. 33/17887.* Dr. Bradley further points out that there are volumes of mail that are picked up by customers at the postal facility, yet receive mail processing. *Id. at n. 13.* As Dr. Bradley explained in oral cross-examination:

> The only point I was trying to make here is that really it works both ways. There are some mail -- some mail volumes which skip processing, that -- like bypass mail, presorted mail -- skip processing and go right to the delivery... -- and in addition there is mail that firms will pick up at the facility. And certainly by the traditional definition of working say with carrier street time or rural street time that mail's not delivered. There's no delivery cost incurred.

Tr. 33/17959-60. In other words, the volume of mail delivered -- under whatever definition of delivery one wants to use -- does not necessarily correspond to the volume of mail processed in the various mail processing activities, and thus is inappropriate as a cost driver.

Dr. Neels, in a surprising argument, implies that TPH is a poor cost driver because,

> [o]n its route toward final delivery, a particular item of mail will generate *an additional piece handling every time it passes [through] a processing* step. Thus, the more complex an item's routing, the more piece handlings it will require.

Tr. 28/15598. But the very point of the cost driver for mail processing costs is to reflect the number of pieces sorted in an activity! As Dr. Bradley maintained, Dr. Neels complaint is actually "an argument in favor of using a cost driver, like piece handlings, for determining variability." *Tr. 33/17888.* The fact that different classes of mail make use of different proportions of each mail processing activity only emphasizes that use of pure volume data -- such as raw, originating volumes -- are clearly unsuitable as cost drivers. *See id.*

Dr. Neels also expressed dissatisfaction with an alleged lack of information concerning the relationship between piece handlings and volumes. *See Tr. 28/15599-60.* First, this reflects a fundamental misunderstanding of the role of TPH in the variability analysis. TPH is not a proxy for volume. It is critical to understand that demonstrating the relationship between piece handlings and volumes is completely irrelevant to Dr. Bradley's analysis of the variability of mail processing labor costs with respect to TPH. As Dr. Bradley made quite clear, his analysis does *not* depend upon any assumptions concerning proportionality between TPH and volumes. Dr. Bradley stated, "My analysis provides the first elasticity, the elasticity of cost with respect to the cost driver [TPH]. This does not depend upon any assumptions about the second elasticity, the elasticity of the driver [TPH] with respect to volume." *Tr. 11/5435.* Dr. Bradley reiterated this point in his rebuttal testimony, declaring:

> [T]here was no reason for me to present such information because, as I explained in my testimony, I investigated the "attribution step," which determines the variability of cost with respect to the cost driver. The "distribution step," in which the relationship between the cost drive and mail volume is addressed by witness Degen.

Tr. 33/17889. Thus, Dr. Neels criticism is a total red herring. Even if it were true that there was no information on the relationship between TPH and volume, this provides absolutely no basis for quarreling with Dr. Bradley's analysis. Dr. Neels either has a fundamental misunderstanding of the Postal Service's and the Commission's established costing methodologies or, it would appear, he is deliberately misinterpreting what Dr. Bradley has done by ignoring the clear link to witness Degen's analysis.

In any event, information on the relationship between piece handlings and volume is not absent from this record. Dr. Bradley indicated that Mr. Degen's testimony "deals with the issue of proportionality between TPH and volume."[23] *Id. at 17965.* Moreover, even though this issue is irrelevant for Dr. Bradley's part of the analysis, he did express his opinion that:

> Again, one needs to be careful to qualify the answer to the statement, but certainly I think for example at a point in time there is a proportionality there.
>
> I mean roughly speaking I would expect the more volume you have, using the economist's term ceteris paribus, the more piece handlings you have.

---

[23]Mr. Degen's assumptions regarding the relationship between TPH and volume are fully discussed in his response to Item 5 of the POIR No. 4. *Tr. 12/6598-6604.* What he refers to therein as the "proportionaltity assumption" is that "the number of TPH a typical piece of subclass j receives <u>in cost pool i</u> does not vary with the volume of subclass j, holding factors such as mail preparation and operation mix constant." *Tr. 12/6602-03 (emphasis in original).*

More than that I couldn't specify.

Tr. 33/17964.[24] Also, Dr. Bradley stated that Dr. Neels' apprehension about possible changes over time in the relationship between TPH and volume was unwarranted, making reference to the testimonies of Mr. Degen and Dr. Christensen, where they explain that the Postal Service's approach explicitly allows for variation in the relationship between TPH and volume over time using only data for the most recent year for the distribution key. *Id. at 17888.*[25]

Dr. Neels' criticism of Dr. Bradley's alleged failure to account for the relationship between TPH and subclass volumes is ironic. This is precisely the criticism that would be leveled at any attempt to model the relationship between originating volumes and hours over time. Over time, it is possible the relationship between originating volumes and work hours by cost pool could vary as technology changed. Thus, for any meaningful sample period, the relationship between volumes and work hours could be changing, which would have to be incorporated into such an analysis. Dr. Bradley makes the much more reasonable assumption for his analysis, i.e., that the relationship between TPH and hours by cost pool has been stable over time. Witness Degen provides the current-year snapshot of the relationship between TPH and subclass volumes for calculation of volume variability to feed the rollforward

---

[24] *Motion of the United States Postal Service to Adopt Transcript Corrections To Volume 23 (Bradley) March 27, 1998.*

[25] *See* Dr. Christensen's discussion of this issue at *Tr. 34/18222-23.*

model.[26]

Furthermore, Dr. Neels argument does not lend any support to the assumption that mail processing labor costs are 100 percent variable with volume. As noted by Dr. Bradley, even had his analysis supported the prior assumption of 100 percent cost elasticity, "[t]he Commission would still have to 'worry' about the relationship between piece handlings and volume." *Tr. 33/17890.*

iv. Dr. Bradley properly controlled for factors that could confound the measurement of variability.

It is quite clear that the other variables used by Dr. Bradley in his equations are there simply to control for things that could cloud the very objective of the exercise -- the measurement of cost variability. For example, Dr. Bradley included variables to account for the impact of technological change on volume variable costs. *USPS-T-14, at 13.* As indicated by Dr. Bradley, if such variables are not included, "it is possible to mistakenly ascribe changes in hours to changes that come from technological change to variations in volume." *Id. at 13-14.* To account for technological change, Dr. Bradley adopts the standard econometric approach of using an autonomous time trend, with certain refinements.[27] Dr. Bradley described those

---

[26]The relationship between TPH and subclass volumes varies between the base year and the test year due to subclass-specific program savings in the rollforward model.

[27] Dr. Bradley also indicated that the time trend variable could capture other effects such as the "autonomous changes in the quality of the workforce, improved efficiency of the machinery, or more effective integration of the machine into the operating system, if such things are taking place." *Tr. 11/5277.*

refinements as follows:

> First, I allow for a nonlinear time trend by including a second order trend term in the equation. This more general specification is less restrictive and lets the actual historical performance in hours dictate the nature of the autonomous trend in hours. Next, because of the fundamental restructuring of Postal Service operations in FY 1993, I allow for a segmented trend. In a segmented trend, the trend is "broken" in the sense that it has one shape before the critical period and another after. . . .
>
> The third refinement that I make is done because of the nature of the technological change in mail processing. The Postal Service has worked to automate the mail stream and it is the advent of automation that embodies technological change. As automation expands on the workroom floor, the Postal Service diverts mail from manual activities and this diversion could have an impact on the nature of manual activities.
>
> In particular, the amount of the mail stream that the Postal Service has diverted to automation may influence the hours required in a manual activity. For example, only machinable mail can be diverted to automated activities, suggesting that increasing the degree of automation will cause a decline in the average quality of the mail remaining in the manual activities.
>
> To account for this possibility, I include a variable that is an indicator of the degree to which the Postal Service has diverted the mail stream from manual activities.

Id. at 15-16.

Despite the unassailable logic of this standard econometric approach, both OCA witness Smith and UPS witness Neels make confusing and, at times, contradictory statements concerning Dr. Bradley's use of time trends. The record evidence in this case unquestionably demonstrates that the issues they raise are devoid of substance.

In his initial testimony, OCA witness Smith indicated that Dr. Bradley's use of

time trends is flawed because his study was conducted at the microeconomic level, making a sweeping pronouncement that "[i]n the context of macroeconomic analysis, the time trend can measure productivity changes; however, such *a time trend is inappropriate on the microeconomic analysis level.*" *Tr. 28/15832 (emphasis added).* In response to a later interrogatory, Dr. Smith was forced to acknowledge that it is standard econometric practice to use time trends in both macroeconomic and microeconomic analyses. *Id. at 15904-06.* As Dr. Ying concluded, Dr. Smith's

> original comment is somewhat disturbing and indicates an unfamiliarity with cost estimations, which commonly employ time trends. They are justified if there is a lack of data on specific technological or other dynamic variables, as in this case.

Tr. 33/18143.

Dr. Smith also alleged that because some time trend coefficients are positive and some are negative, he is "unable to conclude what the external effects [time trends coefficients] measure of how or why they affect an activity." *Tr. 28/15835.*[28] Dr. Neels also expressed discomfort with the time trend coefficients, apparently because he expected "that the effects of such [technological] change would be manifested in a steady and gradual improvement in productivity." *Tr. 28/15620-21.*

First, as discussed previously, Dr. Bradley made it quite clear that his time trends were meant to control for other time-varying effects in addition to technological

---

[28] It is instructive to contrast Dr. Smith's alleged inability to interpret the time trend coefficients with his vaunted ability to visually inspect data plots for approximately two minutes each and conclude that "they suggest a variability approaching 100 percent for many of the activities." *See Tr. 28/15842 and 15920.* Dr. Smith could not demonstrate these powers during cross-examination because his powers surprisingly do not extend to plots that exclude the origin. *Tr. 28/15939.*

change. *See Tr. 11/5277.* Moreover, the signs of the coefficients were clearly explained by Dr. Bradley. Dr. Bradley said:

> The differentials in the signs would reflect different autonomous trends in time, and what I mean by that is in any activity there's going to be nonvolume effects which are causing that activity's productivity or hours to go up and down through time. . . . So the reasons that these would be different would be that different individual operations are subject to different external events through time.

Tr. 11/5554. Dr. Bradley further explained that the likely reason the coefficients vary between Time Trend 1 and Time Trend 2 was that "the external characteristics in use of that operation were different in the '88 to '92 period than they were in the '93 to '96 period." *Id.* Dr. Ying also admonished that the purpose of including time trend variables is not to explain, but rather to control for time-varying factors and concluded that "[g]iven the possible time-varying factors captured by a time trend, it would be difficult to describe any coefficients as questionable." *Tr. 33/18143.*

In addition, it seems to have escaped the attention of both Dr. Smith and Dr. Neels that Dr. Bradley presented an alternative analysis in his direct testimony that included a simple time trend and time-period-specific effects. *USPS-T-14, at 72.* Dr. Bradley summarized the results of that analysis:

> The results. . .produce variabilities well below 100 percent and generally lower than my recommended variabilities. This proves that my econometric results are not dependent on the specific time trend employed.

Tr. 33/17902.

The contrived criticisms of Dr. Smith and Dr. Neels should not be allowed to obscure the simple fact that the Gauss Newton Regression tests calculated in Dr.

Bradley's direct testimony suggested rejection of the null hypothesis of no time-period-specific effects. That is precisely why Dr. Bradley included time trends in the analysis he recommends and why he presented the alternative analysis which included a simple time trend and time-period-specific effects. *See Tr. 33/17903.* As a final point, it should be noted that Dr. Bradley's fixed-effects models clearly include time-indexed coefficients because the interactive time trend modeling he used allows the response in hours to changes in TPH to vary over time. *Id.*

v. Dr. Bradley's analysis is appropriately short-run.

Both Dr. Neels and Dr. Smith incorrectly conclude that Dr. Bradley's analysis is flawed because he has not measured long-run volume variability. Dr. Neels hypothesized that because Dr. Bradley uses AP data, his models "look back only a single accounting period" and thus "are not capable of detecting or accounting for changes that take place over longer periods of time." *Tr. 28/15625.* Dr. Smith likewise surmised that "most of witness Bradley's comments and analysis suggest that he is looking at essentially 'monthly' or, more precisely, four-week periods," and concludes that "[c]onsideration of longer-run costs, over the time period that the rates will be in effect, is necessary." *Tr. 28/15835-36 and 15838.* These comments indicate that Dr. Neels and Dr. Smith understand neither the basic economic definitions of "short-run" and "long-run" nor how these concepts are applied in postal ratemaking.

Dr. Bradley succinctly explained both the textbook economics definition of "long run" and its inapplicability, at least for now, to the Postal Service. Dr. Bradley

stated:

> Economists define the "long run" as the ideal state in which all inputs are perfectly optimized and the firm is producing along at its minimum possible cost level. Given the nature of the enterprise and given the collective bargaining structure, it is fair to say that the Postal Service is not yet in this idealized state. Thus, any economist would have to agree that, by the strict economists' definition, Postal Service costs are not "long run."

Tr. 33/17904. Dr. Bradley had also quoted Dr. Baumol's Docket No. R87-1 testimony:

> "A final matter to be touched on briefly here is the choice of marginal costs upon which the rates should properly be based. Should these marginal costs be short run or long run in nature? As I will show, the answer is that they should be the *actual* marginal costs, whichever of those that may be. When an output of a service is increased (or decreased), there is only one amount of cost actually added (or saved), not two or three. The actual marginal costs are normally closest to what economists call short run marginal costs (SRMC). But is must be emphasized that these actual marginal costs do include costs consequences of a current volume changes that may occur in future periods."

Tr. 11/5417 (emphasis in original). Dr. Panzar in the instant docket also said:

> One should attempt to base prices on the marginal costs that will actually be incurred by the firm to serve a sustained increase in volume over the time period during which the prices will be in effect. Taken literally, this would require that some version of short-run marginal costs should be used.

Tr. 9/4636. Similarly, Dr. Christensen affirmed:

> The true difference between short-run and long-run costs is that, in a short-run situation (which could be equivalent to any calendar period of time), not all options are available to the firm, while in the long-run, the firm faces fewer constraints on it decisions. Therefore, the key difference between the long-run and the short-run is the ability to have greater degrees of freedom in making decisions and deploying resources.

Tr. 34/18245. Dr. Ying likewise stated:

> The "actual cost" concept applied by the Postal Service is intended to reflect changes possible over the rate cycle, a period of only a few years, and is therefore closer to the short-run and not the long-run all-inputs-variable definition used by economists.

Tr. 33/18143. Dow Jones witness Shew also concluded:

> For long-run marginal costs to be relevant, the Postal Service must be expected to attain long-run equilibrium within the period during which the new rates will be in effect. Otherwise, short-run marginal costs are relevant.
>
> * * * *
>
> Rates based on long-run costs would give the wrong price signals in the short run. If some of the Postal Service's inputs cannot be altered during the period the rates now being set are in effect, then short-run costs are relevant to ratemaking.

Tr. 28/15546. In a similar vein, MPA witness Higgins said:

> From a theoretical standpoint, there is no reason for confusion concerning long-run and short-run costs. Both concepts are well understood, and are included as part of the common curriculum in economics at the introductory undergraduate level. In economics, calendar time is *not* what determines length of run. Rather, length of run has to do with which inputs are variable and which are fixed. "Long-run" refers to a period of time that is sufficiently long that all factors of production -- including structures as well as machinery -- are freely variable. "Short-run" refers to any length of time shorter than that, so that at least one factor is fixed.
>
> * * * *
>
> In the context of Postal rate-making, the appropriate length of run to consider is not a mystery: it is the period of time during which the proposed rates are expected to be in effect.

Tr. 33/18007-08 (emphasis in original; footnote omitted).

It is thus obvious that the frequency of the data used by Dr. Bradley has nothing whatsoever to do with whether his analysis is short-run or long-run. It is also

clear that Dr. Bradley's analysis has measured exactly what it should have measured for purposes of postal ratemaking -- *actual marginal costs.* This point is confirmed by Dr. Ying, who stated, "Clearly, in an economic sense, Dr. Bradley is estimating a short-run cost equation, consistent with the Postal Service's desire to measure "actual costs." *Tr. 33/18144.* MPA witness Higgins also determined that Dr. Bradley's variability estimates measure the marginal costs that actually will be incurred as a result of a sustained increase in volume over the period the rates will be in place. *See Tr. 33/18008.*

It is also worth noting that, once again, both Drs. Neels and Smith seem oblivious to the fact that Dr. Bradley presented an alternative fixed-effects model on annual data in his direct testimony to address the sensitivity of the results to data frequency. The results of this model showed a majority of variabilities of less than 100 percent. *USPS-T-14, at 76.* Dr. Ying concluded, "The unimportance of the frequency of the data on the results is confirmed in Dr. Bradley's re-estimation using annualized data." *Tr. 33/18144.*

vi. Dr. Bradley correctly used a cost equation in which a capital variable was unnecessary and, if added, has no significant impact on the results.

OCA witness Smith argued that Dr. Bradley's cost equation was deficient. Dr. Smith asserts that Dr. Bradley should have used a production or cost function, which explicitly includes capital. *See Tr. 28/15826-28.* Dr. Smith's claim is without merit.

As Dr. Smith himself pointed out, the type of translog cost form used by Dr. Bradley has been endorsed by both the Commission and in the economics literature.

Id. at 15827. Furthermore, as Dr. Ying pointed out, a cost equation is not intended or supposed to be the same as a cost function. *See Tr. 33/18142.* Dr. Ying also stated that even assuming Dr. Bradley had estimated a cost function, "the explicit specification of production function (or analysis) is not necessary" because the basic principle of "duality in production" means that all of the relevant aspects of a firm's technology are captured in a cost function. *Id.*

Moreover, as amply demonstrated on this record, there is no reason to explicitly include capital. MPA witness Higgins explained that a proper cost function does not have to include direct measures of capital, but can, essentially, take account of such through including time trends to reflect the effects of technological change. *See Tr. 33/18002.*

Dr. Bradley, nonetheless, in his rebuttal testimony estimated a cross-sectional model at the facility level, based on FY 1994 data, which added three control variables for capital--the age of the facility, the square feet in the facility devoted to mail processing, and the number of floors in the facility devoted to mail processing. The results of this alternative analysis show a variability "significantly less than one." *Tr. 33/17912.* The variability results are not appreciably different from Dr. Bradley's original results. Dr. Smith's contention that Dr. Bradley's cost equation was not correctly specified was not theoretically correct, and, as the above analysis demonstrates is of no consequence from a practical standpoint.

Finally, it should be remembered that the volume variability of capital costs has consistently been treated separately from mail processing costs by both the Postal

Service and the Commission. For example, Cost Segment 15 contains building occupancy costs, including rents, and Cost Segment 20 includes equipment, vehicle, and building and leasehold depreciation. Thus, omitting capital variables from a cost equation to determine the variability of mail processing labor costs does not mean that the Postal Service's capital costs are ignored.

d. The data used by Dr. Bradley are appropriate for estimating the variability of mail processing labor costs.

i. The panel data used by Dr. Bradley are comprehensive and hold advantages over other types of data.

The MODS and PIRS data used by Dr. Bradley in estimating his variability equations likely constitute one of the most comprehensive data sets ever introduced in postal ratemaking proceedings. This panel data set "includes both a cross-sectional dimension and a time series dimension" and has distinct advantages over either of those types of data individually. *USPS-T-14, at 23.*[29]

As should be obvious from Dr. Bradley's data set, it includes many more observations than either a cross-sectional or time series data set would. Dr. Bradley's data set contains literally hundreds of thousands of data points, permitting most of the regressions to be estimated on tens of thousands of observations. *See USPS LR-H-148.* Panel data also reduce multicollinearity problems. As Dr. Bradley

[29] MPA witness Higgins characterized Dr. Bradley's data as "an unusually rich panel data set that captures both the cross-sectional variation in the productivity relationship among individual facilities, as well as the time-varying components." *Tr. 33/18020.*

explained, "Because the explanatory variables vary over two dimensions in a panel, they are less likely to be highly correlated with one another." *USPS-T-14, at 24.* More importantly, panel data can alleviate or even eliminate estimation bias. Dr. Bradley quotes Cheng Hsiao's authoritative work, Analysis of Panel Data, to illustrate this point:

> Besides the advantage that panel data allows us to construct and test more complicated behavioral models than purely cross-sectional or time-series data, the use of panel data also provides a means of resolving or reducing the magnitude of a key econometric problem that often arises in empirical studies, namely the often-heard assertion that the real reason one finds (or does not find) certain effects is because of omitted (mismeasured, not observed) variables that are correlated with explanatory variables. By utilizing information on both the intertemporal dynamics and the individuality of the entities being investigated, one is better able to control in a more natural way for the effects of missing or unobserved variables.

USPS-T-14, at 24, quoting C. Hsiao, Analysis of Panel Data, Cambridge University Press, New York, 1986, at page 3.

ii. The MODS and PIRS data are reliable and are suitable for estimating variabilities for mail processing labor costs.

One of the primary advantages of using the MODS and PIRS data for estimating the volume variability of mail processing labor costs is that they are real, operational data used to plan and manage mail processing operations. *See USPS LR-H-147.* As Dr. Bradley said, "These data reflect the actual generation of hours from the handling of actual pieces. This means they are an excellent empirical basis for identifying the causality between work done and the cost required to accomplish

that work." *Tr. 33/17890.*[30]

Certain issues have been raised concerning the reliability of the MODS data based upon several Postal Inspection Service Audits. A careful reading of the audit reports, however, as well as witness Degen's investigation concerning the purposes and conduct of the audits, clearly reveals that the audit conclusions are irrelevant for purposes of both Dr. Bradley's and witness Degen's analyses.

One issue concerns allegations of employees clocked into the wrong MODS operation. These concerns arose as a result of an Inspection Service Audit, the National Coordination Audit: Allied Workhours, filed as USPS LR-H-236.[31] In particular, that audit contained a statement indicating that 31 percent of the opening

---

[30] Witness Degen elaborated on the purposes for which MODS data are used within the Postal Service, stating:

> My understanding is that capital deployment in the Postal Service is *contingent [on] the development of a DAR, A Decision Analysis Report,* and I don't think I have ever seen one of those that didn't involve the use of MODS data.
>
> * * * *
>
> I think MODS, even though it was originally deployed as a local management tool, with a certain amount of local discretion, has evolved over the years into something that has caused accountability at every level, all the way up to the national level.

Tr. 18/8340-41.

[31] Witness Degen and several of his associates undertook a detailed investigation of this audit, which included two meetings with Inspector Yuen, the Team Leader for the audit, and two reviews of the actual audit files, which included "hard copy documents that had the handwritten notations of the inspectors who did the site visits." *Tr. 18/8248-49.*

unit employees checked were clocked into a different MODS operation from the one they were working in. Witness Degen, however, clearly demonstrated that the 31 percent figure had been misinterpreted.[32]

First, it is important to note that the allied workhours audit was neither designed nor considered by the Inspection Service to be a statistically reliable sample. Postal Service operations expert Moden stated that he believed that the "sites chosen by the Inspection Service were not chosen randomly but rather were chosen because they were likely to exhibit the conditions found in the report." *Tr. 11/5998.* First, as is clear from the audit itself and as witness Degen confirmed, the audit "applies to opening units only, not all of LDC 17 or all of MODS." *Tr. 12/6555.* Moreover, upon investigation, witness Degen concluded that "the audit was not undertaken as a statistically unbiased sample of the misstatement of MODS hours." *Id.* Witness Degen reached this conclusion for two reasons: 1) some of the sites were specifically chosen due to LDC 17 workhour issues being addressed at those sites, and 2) the results of the audit were not weighted in any fashion to take account of the mix of sites by size or other pertinent factors. *Id.* As witness Degen revealed, nearly 30 percent of the total errors found by the audit were from one of the twenty-five sites. *Id.* Witness Degen further elaborated:

> I think there is a definite bias in the way the sites were chosen, inasmuch as I think size is correlated with errors with respect to opening

[32] Interestingly, as pointed out by witness Degen, the Inspection Service frequently makes use of MODS data to estimate various savings and performance measures and, in fact, even in this particular audit, used MODS data to estimate savings. *Tr. 18/8343.*

unit management.

> And let me also point out -- well, within the high, medium and low strata, there was a definite bias toward picking bigger sites within each of those. But, further, the high, medium and low strata were not always represented. A high strata was chosen and then either a small or a medium.

Tr. 18/8260-61. Conversations between Inspector Yuen and witness Degen also corroborated this fact. Witness Degen said the Inspector Yuen made clear that the Inspection Service "definitely wanted to identify problems," and thought that, by uncovering problems in large facilities, they would focus the attention of the Postal Service on the issue. *Id. at 8261.* Postal Service witness Steele also indicated that, in his experience misclocking occurs, "but usually to a very minor extent." *Tr. 33/17864.* It is clear then, that the 31 percent error figure set out in the audit was not intended to be, nor can it be extrapolated to be, any sort of nationwide average. Moreover, there are definite difficulties with the manner in which this 31 percent error rate was calculated. Witness Degen explained that the audit reported two types of errors for each operation reviewed -- "1) an employee clocked into the operation, but working elsewhere; and 2) an employee working in the operation, but clocked elsewhere." *Tr. 12/6556.* As witness Degen correctly pointed out, "[t]he *net* effect of these two error types represents the net misstatement of hours." *Id. (emphasis in original).* In the Inspection Service audit, however, "an employee clocked into operation 111 but working in operation 112 generates two errors. . . .one for operation 111 and one for operation 112, " thus clearly overstating "the total net effect on opening unit hours." *Id. at 6555-56.*

Further, and of crucial importance, in the operation 111 and 112 situation discussed above, there would *no error* at the aggregated cost pool level used by witnesses Bradley and Degen.[33] In addition, available data were not sufficient to determine where misclocked employees were actually working. Operational realities dictate that it is more likely that those employees would still be clocked into another operation within the same Bradley-Degen cost pool. As witness Degen pointed out, if an employee is clocked into one of two different operation codes under the same supervisor, the supervisor will not suffer repercussions. *Tr. 18/8331.* But if an employee is clocked into a totally different overall operation, the situation changes. As witness Degen said:

> On the other hand, if I have got people clocked into my overall operation grouping who are working somewhere else, I am going to be charged for hours and held accountable for hours that weren't worked here and so I would expect that a large proportion of the errors did occur within the opening units as we used them.

Id.

Another issue raised by an Inspection Service audit concerns inaccuracy of MODS First Handling Pieces (FHP) data. This audit is titled, the National Coordination Audit: Mail Volume Measurement and Reporting Systems, filed as USPS LR-H-220.[34] That audit contained statements indicating that, at the audited sites, actual piece counts differed from recorded FHP in MODS, for a number of reasons,

---

[33] "[O]perations 111 and 112 are in the same cost pool (1OpPref)." *Id.*

[34] Witness Degen investigated this audit by meeting with Inspector Algood, the Team Leader for the audit, "to understand why it was done, how it was done, and what conclusions were reached." *Tr. 18/8249.*

including out-of-date conversion factors. This issue is largely a red herring because Dr. Bradley uses TPH, *not* FHP. In fact, the Inspection Service audit recommends that FHP be modified to rely on machine counts wherever possible. This is precisely the method MODS uses for TPH.

It is important to note that the volume audit, like the hours audit, does not constitute a statistically reliable sample, as demonstrated by the criteria on which sites were chosen for inclusion. The Inspection Service selected the two processing and distribution centers for each of the ten postal areas with the highest FHP volume, for a total of twenty sites.[35] *See Tr..18/8249-50.*

The most important point, however, is the fact that witness Bradley's analysis relies on TPH, *not* FHP. As witness Degen explained, the FHP measure in "a particular operation are those pieces that are being handled in that operation and have not been handled in any other piece-based operation within the plant." *Tr. 18/8273.* TPH "counts each time a piece is handled" and is derived in the mechanized and automated operations from actual machine counts. *Id. at 8276; Tr. 11/5369.*[36] Thus, the only places where the criticisms of FHP come into play in Dr. Bradley's analysis are in the manual operations. Even in those operations, however,

---

[35] The sites were not selected randomly, but chosen to represent a large fraction of total FHP; however, only a very small portion of FHP was actually counted by the inspectors. *Notice of the United States Postal Service Regarding Additional Information Relating to Library Reference H-220, January 12, 1998.*

[36] TPH is actually the number of pieces successfully read by the machine. In other words, pieces fed minus rejects. *Id.* Witness Degen indicated that he would not expect a lot of day-to-day variation in machine acceptance rates. *Id. at 8305.*

TPH counts are only based on conversion of weight when the mail has not passed through machine-based operations first. TPH counts for pieces coming to manual operations which are from other machine-based operations will be based on machine counts. *Tr. 18/8278.* In addition, for manual parcel operations, pieces are physically counted. *Id. at 8277.* Accordingly, only *a portion* of the manual letters and flats operations determine TPH based on weight conversion factors.

This fundamental fact seems somehow to have eluded UPS witness Neels. He inexplicably asserts, "even if the MODS counts of downstream handlings are totally free of the measurement problems that infect estimates of First Handling Pieces, all of the problems surrounding the measurement of First Handling Pieces are still passed forward into Bradley's analysis." *Tr. 28/15602.* As explained above, Dr. Neels' assertion is factually inaccurate. Dr. Bradley reiterated in his rebuttal testimony, "The TPH for mechanized and automated operations are *not* downflows from FHP" and "are not subject to potential measurement error." *Tr. 33/17898.* As MPA witness Higgins summarized, "While inaccurate scales and conversion factors remain a concern, they are a problem only in the manual operations, which account for only a small, and declining, fraction of the total mail volume processed by the Postal Service, and increasingly are not problematic there, either." *Id. at 18012.*[37]

---

[37] It also must be kept in mind that the evidence of the record in this proceeding does *not* unequivocally demonstrate that out-of-date conversion factors for FHP are a genuine problem. As discussed previously, the audit certainly is not a statistically valid sample. In addition, issues concerning variation in the average weight by subclass reported in RPW do not automatically equate with out-of-date conversion factors, since the RPW numbers reflect changing mix of types of mail -- letters versus flats, for example -- that would have separate FHP conversion factors. *See Tr.*

Moreover, to the extent that the data used by Dr. Bradley do contain some measurement error in the right-hand side piece handling variable, due to outdated conversion factors, Dr. Bradley has addressed that concern fully with his inclusion of a time trend and with his errors-in-variables analysis. The time trend would capture any systematic error resulting from the use of conversion factors. *See Tr. 18/8291.* Dr. Bradley's results revealed only a slight difference between the errors-in-variables estimator and the fixed-effects estimator, leading him to correctly conclude that any "measurement error in manual letter and flat piece handling volumes is not a critical problem for the estimation of cost elasticities for those activities." *USPS-T-14, at 84.*

As might be expected, UPS witness Neels argues that there are flaws with Dr. Bradley's errors-in-variables analysis, claiming that Dr. Bradley's analysis contained "mathematically impossible" results, and concluding that measurement error in the

---

18/8282-83. The RPW numbers also would be reflective of the fact that RPW is a sampling system which will naturally be subject to a certain amount of variation. *See id. at 8289-90.* Moreover, the effects of systematic inaccurate conversion factors would be accounted for by Dr. Bradley's time trend variables. *See id. at 8291.* In a like fashion, variation from facility to facility of a ratio of TPH to FHP may well be a natural consequence of a host of factors that do not have an impact on the reliability of the data, including that TPH and FHP may have been measured differently; that different FHP measures may indicate different operational practices reflecting where mail in a facility is first sent; and that different TPH measures may reflect the number of sorts based on the status of a facility in the overall postal network. *See id. at 8306-09.* Similarly, variation in a ratio of TPH to FHP within a facility over time may be accounted for by elements other than data error -- for example, changes in operating procedures, including deployment of new sorting technologies and seasonality of the mail, which means differences in mail mix at different times of the year. *See id. at 8310-12.* Finally, the fact that TPH is less than FHP in some operations is not counterintuitive. With regard to the OCR and FSM, normally a piece is not handled more than once, implying that TPH and FHP should be the same. TPH then becomes less than FHP when rejects are taken into account -- they are not recorded in TPH but are in FHP. *See id. at 8316-17.*

piece handling variable (TPH) would cause an understatement in volume variability. *Tr. 28/15608.* As clearly demonstrated by Dr. Bradley and witness Higgins, Dr. Neels' conclusions are false and are based on his less-than-complete understanding of how to conduct an errors-in-variables analysis. Part of Dr. Neels' concern is likely due to his incorrect understanding of when TPH relies on conversion factors and when it does not, as discussed above.

Dr. Neels is also incorrect in assuming that measurement error always results in an understatement of volume variability. As Dr. Bradley pointed out, Dr. Neels' belief is simply not in line with standard econometrics. Dr. Bradley cited to G. S. Madalla's widely-recognized text, Econometrics, which cautions against this very kind of thinking:

> "With economic data where such correlations are more the rule than an exception, it is important not to believe that the slope coefficients are always underestimated in the presence of errors in observations, as is suggested by classical analysis of errors-in-variables models."

Tr. 33/17897, quoting, G.S. Madalla, Econometrics, McGraw Hill, 1977, New York, at 302.

As for Dr. Neels assertion that Dr. Bradley's results are "mathematically impossible," Dr. Bradley explained, "While it is true than an *estimated* variance will not be negative, a *calculated* one certainly can be." *Tr. 33/17898.* Dr. Bradley further explained that, in this case, since the formula for deriving the variance hinges on the difference between the fixed-effects estimator and the first-difference estimator, and since the first-difference estimator is somewhat higher than the fixed-effects estimator, a negative variance quite naturally and not surprisingly results. *Id.*

at 17898-99. Dr. Bradley also indicated that this occurs quite logically in that the relationship between the dimension of the fixed-effects and first-difference estimators is uncertain when there is serial correlation in the measured variable (TPH). *Id. at 17899.*[38]

To demonstrate how to derive a non-negative variance, Dr. Bradley accounts for serial correlation in TPH, by calculating an errors-in-variables analysis over 13 accounting period differences. *Id. at 17899-900.* Those results again illustrate that measurement error is not a critical problem. *Id. at 17900.*

Finally, it is important not to lose sight of the forest for the trees. No set of data will ever be pristine, and complaining that it is not is of little utility. Were the data free from noise and non-volume effects the relationship could be calculated rather than estimated econometrically. The real question for ratemaking purposes is whether the data are of *sufficient* reliability to estimate sound costs upon which rates can be based. As discussed below, Dr. Bradley's results are robust, clearly indicating that the data support an accurate measure of what he set out to measure. This needs to be contrasted with the prior assumption of 100 percent volume variability, which was never tested or based on data at all. The fact that the data underlying Dr. Bradley's analysis are not perfect is really beside the point. His analysis has been demonstrated to be sound and that is what is required for ratemaking purposes.

---

[38] Witness Higgins also pointed out that a negative variance was suggested by the "relative magnitudes of the within and first-difference estimators." *Tr. 33/18017.*

iii. Dr. Bradley's data scrubs were objective and appropriate.

In an effort to ensure the best data upon which to estimate his equations, Dr. Bradley basically performs four "scrubs" on the data. First, Dr. Bradley eliminates observations which reflect data omissions in an AP -- in other words, there are "zero values for work hours or piece handlings." *USPS-T-14, at 30.* Second, data for periods where a site is starting a new activity are eliminated as these periods would not be reflective of a "normal operating environment." *Id. at 30.* Third, Dr. Bradley performs a "continuity" scrub, which eliminates sites lacking "at least thirty-nine continuous observations in any activity." *Id. at 31.*[39] Finally, Dr. Bradley performed the "one percent tails" scrub. Specifically to correct for possible misreporting, the data were scrubbed to eliminate those observations which denoted extremely high or low values for productivity -- those observations which "constitute the one percent tails of the density on both ends of the distribution." *Id. at 32.* Even with these scrubs, the remaining data base was still immense. *See USPS LR-H-148.*

It is ironic that UPS witness Neels, who complained vociferously about potential data contamination, is equally strident in his opposition to Dr. Bradley's use of data scrubs.[40] Dr. Neels' complains that Dr. Bradley's scrubs eliminate too much

---

[39] Dr. Bradley concluded that this scrub would assist in accurate estimation of "seasonal effects, secular non-volume trends, and serial correlation corrections." *Id.*

[40] OCA witness Smith claims that Dr. Bradley's data scrubs need further analysis, as they raise a number of questions. Dr. Smith's testimony on this point is unenlightening, as he merely lists a number of questions he has, but makes no attempt to discuss either their relevance or what evidence in the record has been or could be brought to bear in answering them. *Tr. 28/15853.* In any event, most of the

data, are subjective, and produce results different from those that would have been obtained if all data had been used. *Tr. 28/15609.* Dr. Neels' solution is to perform the analysis on the full, "unscrubbed" dataset. *See Tr. 28/15632.* As will be discussed further below, Dr. Neels' results are very similar to those produced by Dr. Bradley. It must be noted, however, that it is the outliers "that tend to cause the greatest mischief" and special attention must therefore be focused on them. *Tr. 33/18013.*

Dr. Bradley's scrubs did eliminate a fair amount of data. Dr. Bradley, however, indicated that this was a luxury allowed by the comprehensive nature of the data set he had to work with. *Tr. 33/17890.* Further, there can be no doubt that elimination of questionable data only enhances the quality and reliability of the results. As Dr. Bradley stated, "When the analyst has tens of thousands of observations, the balance should be placed on improving the quality of the data relative to increasing the raw quantity." *Id. at 17890-91.* Finally, a sense of perspective must be maintained. Dr. Neels' Table 4 showed a staggering total of 267,141 observations remaining after Dr. Bradley's scrubs. *Tr. 28/15611.* This certainly is an exhaustive dataset by any standards.

Dr. Neels is also critical of the data scrubs because he views them as "subjective." *Tr. 26/15612.* From a broad perspective, even the initial decision to scrub data is "subjective." As Dr. Ying said, "Any scrub might seem subjective, but

---

germane questions are addressed, either directly or indirectly, in the discussion which follows.

should remain as objective and reasonable as possible." *Tr. 33/18149.* Also, as witness Higgins made clear, the accepted practice in applied statistics is to improve the quality of a dataset by eliminating certain observations which likely reflect measurement error. *See Tr. 33/18013.*

The initial elimination of data which have zero values, according to MPA witness Higgins, "is not properly termed a scrub at all, but is rather a computational necessity if econometric estimates are to be obtained." *Tr. 33/18014.* In fact, Dr. Neels does not use these eliminated data in calculating his "all useable observations" variabilities. *See Neels WP IV.*

Dr. Neels also took issue with Dr. Bradley's one percent tails scrub, opining that outliers may "contain the most information about the true relationship between cost and volume." *Tr. 28/15613.* Dr. Bradley had indicated that some of the data points eliminated by this scrub "imply throughput rates on machines that are physically impossible." *Tr. 33/17891.*

How an obviously erroneous data point reveals anything about "the true relationship between cost and volume" is a mystery. Nonetheless, even when Dr. Neels calculates variabilities making use of "all useable observations," his results essentially corroborate Dr. Bradley's. Dr. Neels' results sometimes provide higher and sometimes provide lower variabilities than Dr. Bradley's, but there is a distinctly similar pattern. As Dr. Bradley summarized the comparison, "In those activities in which I estimated high variabilities, Dr. Neels estimates high variabilities. In those activities in which I estimated low variabilities, so does Dr. Neels." *Tr. 33/17894.*

Moreover, Dr. Neels' use of the "unscrubbed" data produces only three of twenty-three variabilities of 100 percent or more. *Tr. 28/15618.* This clearly calls for a rejection of the assumption of 100 percent variability of mail processing labor costs.

Dr. Neels also criticized Dr. Bradley's "continuity" scrub. Dr. Neels said:

> Bradley has chosen to require 39 consecutive observations in order to include a site in his analysis of MODS direct activities. Yet, Bradley himself has indicated that 26 consecutive observations may be sufficient. . . . From an economic and policy perspective, decisions to discard data whose implications are this significant require greater and more objective empirical and conceptual justification than Bradley has provided.

Tr. 28/15619 (footnote omitted). In his rebuttal testimony, Dr. Bradley decided "to investigate the robustness" of his decision to require a minimum of thirty-nine continuous observations or three years of data to be included in his dataset. *Tr. 33/17892.* Dr. Bradley again estimated all equations for MODS direct operations with a less restrictive, twenty-six continuous observations or two year scrub. The results show variabilities which are very close to those estimated with the initial continuity scrub. *See Tr. 33/17893.*[41]

The above discussion plainly demonstrates that Dr. Bradley's scrubs were appropriate and did not result in any questionable or unreliable estimates. As Dr. Ying concluded, "In Dr. Bradley's data scrub. . .there are not obvious selection rules which might skew the results." *Tr. 33/18147.* Dr. Neels cannot have it both ways -- raising questions about potential data contamination while at the same time

---

[41] Witness Higgins believed that the continuity scrub was pertinent to allow adequate estimation of trending or seasonal components. *Tr. 33/18014.*

disparaging data cleaning measures. Where Dr. Neels' criticisms may have been theoretically plausible, the responsive work of Dr. Bradley and Dr. Neels' own results belie them as non-issues. Dr. Bradley took a reasonable approach to these issues and his results establish that this approach was sound.

e. Dr. Bradley followed proper procedure in choosing his econometric method which results in the best measure of variability.

The Postal Service has presented a large operational database for the analysis of mail processing costs. This data base is organized as a panel, meaning that it contains a time series of observations from a cross-section of mail processing facilities. Consequently, the data base has two important sources of information, variations in hours and piece handlings through time and variations in hours and piece handlings across facilities.[42]

The first question to be answered when using a panel data set is how to organize the data. Because a panel data set has two dimensions, along time and across facilities, there are three choices. First, one can ignore the cross-sectional information by collapsing the data set into a single aggregate time series. Second, one can ignore the through-time information by collapsing the data set into a single cross-section. Finally, one can make use of both the cross-sectional and through-time information by structuring the data in its natural form — as a panel.

---

[42] In previous work, Dr. Neels praised the dual dimension of panel data as he described the panel data set he used as "a rich set of data describing both cross-sectional and longitudinal differences in behavior." *Neels' Response to USPS/UPS-T1-49.*

All parties in this proceeding have rejected the first approach because it implies a tremendous reduction in information. Collapsing the panel data set into a single aggregate time series would eliminate over 98 percent of the information in the data set. Instead of having a data set with tens of thousands of observations, the aggregate time series would have just over one hundred. Such a reduction in information is simply not acceptable econometric practice. Not only does it tremendously reduce the efficiency of the estimation, it ignores an important source of information, how hours and piece handlings vary across facilities.

Curiously, a similar sort of reduction has been proposed by UPS witness Neels.[43] He suggests to the Commission is that it reduce the available data set by over 98 percent by constructing a single cross section. *Tr. 33/17894.* Witness Neels would use, for example, only 380 observations to estimate the BCS activity equation instead of the 22,737 observations used by Professor Bradley.[44] *Id. at 17896.* His proposed degeneration of the data set suffers from the same problems as the aggregate time series approach — it greatly reduces the amount and type of

---

[43] This is in direct contradiction to his earlier published works in which when using panel data he did not collapse the panel into a cross section, but rather made use of panel data estimators. *See Neels' Responses to USPS/UPS-T1-49 and USPS/UPS-T1-51.*

[44] Another problem with witness Neels approach is that he fails to recognize that the data set contains only a few observations for some sites and over one hundred for others. In constructing his cross-sectional data set, witness Neels uses a single observation for a site, if that is all that the site has. Thus he assumes that site that has only one accounting period of data provides as much information as a site that has nine years of data. Witness Neels does not properly account for the fact that his averages are based on partial years. *See Tr. 28/15715.*

information available for estimating a variability. It also biases his subsequent econometric analysis based upon the "cross-sectional" data.[45]

The only justification that witness Neels can provide for his extreme approach is that it produces higher variabilities because it is somehow "long run." *Tr.28/15731-32.* This is nonsense. As explained by Professor Bradley, transforming the panel data set does not change the analysis from "short run" to "long run." It simply results in elimination of the majority of the data points. *Tr. 33/17906.* Thus, the only justification remaining to witness Neels is that it produces the outcome he desires--higher variabilities. Dr. Neels offers no reason for his prior belief that variabilities should be higher, so the point is reduced simply to a matter of his preference. The purpose of empirical analysis is to put our prior beliefs to the test, not to simply reinforce them. Even if the Commission shares this preference, it is not a justifiable basis for choosing an erroneous result. But, even Dr. Neels' goal-oriented recommendation is without merit. As discussed above, the cross-sectional results are biased and the high variabilities they produce are artificial. Professor Bradley shows that, when an unbiased cross-sectional analysis is performed, the variabilities from the cross-sectional approach are quite similar to those from the panel data approach. *Id. at 17912.*

In sum, there is overwhelming evidence that only one correct answer exists as to how to organize the data for econometric modelling. That answer is as a panel

---

[45] In fact, Professor Bradley constructed a cross-sectional data base for the sole purpose of testing for this bias. *USPS-T-14, at 45.* His results, which witness Neels conveniently ignores, dramatically show that the cross-sectional results are biased.

data set.

The next decision to be made is to select the number of equations to be estimated. Because the panel data set includes repeated observations from the sites, it is possible to estimate site-specific equations for each activity for each individual site.[46] *Tr. 28/16075.* Yet, it is also possible to estimate a single equation for each activity across all sites. This choice is a bit more complex than the previous one and needs to be made after considering a variety of issues. The estimation of a single equation for each activity amounts to imposing a commonality in some or all of the regression coefficients across the sites. In determining the appropriateness of this approach, several factors must be considered: the goal of the econometric research, the ability of the data to support reliable site-specific equations, the results of statistical tests, and the consistency of the results with operational realities.

The goal of this analysis is to determine the impact of small, sustained increases in volume on Postal Service costs. This is achieved by estimating an elasticity or variability for each of the relevant cost pools. This can be done by estimating a cost equation for the entire panel of offices or for individual sites and aggregating the results. While site-specific results may appear more general, there are many disadvantages associated with using site-specific equations to achieve this goal. As Professor Bradley explained:

> The goal here is not to estimate individual site equations or

[46] This is generally true although there are some sites for which the data are insufficient to estimate an individual site-specific equation.

> aggregate equations to be applied to individual sites for the purpose of, say, evaluating the individual sites. Rather, the goal is to produce an aggregate variability or elasticity for the relevant cost pool.[47] This means that even if site-specific elasticities are calculated, they must be averaged or aggregated in some way. This aggregation, in itself, imposes some implicit restrictions, so in choosing between the models, the validity of these implicit restrictions must be balanced against the validity of the explicit restrictions in the fixed effects model.

Tr. 28/16083.

Further, if the site-specific approach were to be used, some method for accounting for the costs at the sites for which no equation is estimable must be developed:

> In addition, the site-specific variabilities are dependent upon the ability of the data to estimate reliable equations for each site. If, for example, reliable equations cannot be estimated for a number of sites, then the aggregate elasticity derived from this approach will be less representative than the elasticity derived from the fixed effects model. Moreover, given the size and complexity of the mail processing analysis, evaluating the set of site-specific equations for just one activity would be a time-consuming job. Evaluating and defending the site-specific equations for each site, for each activity, is an overwhelming job. This also reduces the attractiveness of the site-by-site approach — it is far more difficult to get a thorough review of the econometric results.

Id. The data cannot support estimation of a site-specific equation for every site for

---

[47] The fact that the site-specific equation approach is not consistent with estimating an aggregate variability does not imply that it is necessarily the best econometric model for estimating site-specific variabilities. As demonstrated by Professor Bradley (Witness Bradley's Response to POIR #7, Question 1, at page 5 of 10 (*Tr. 19E/9675*), the fixed effects model provides a complete set of sensible variabilities for individual sites. In fact, the fixed effects model can provide variabilities for many sites for which the site-specific approach cannot.

each activity.

Given the disadvantages of site-specific equations, the next natural choice would be a single equation for each cost pool that controls for site-specific effects. This choice was tested statistically, and, while the statistical tests, taken by themselves, indicate a preference for the site specific equations, (*Tr. 28/16081; Tr. 29/16123)* a broader view, taking into account the other considerations, suggests that a single equation approach is appropriate. *Tr. 28/16028; Tr. 29/16126.*

In sum, although the statistical tests favor the site specific models, consideration of why the statistical results show those results leads to support for the single equation approach.[48] When this realization is combined with the fact that the goal of the analysis is estimating a single variability for the relevant cost pool, a single equation approach is preferred.

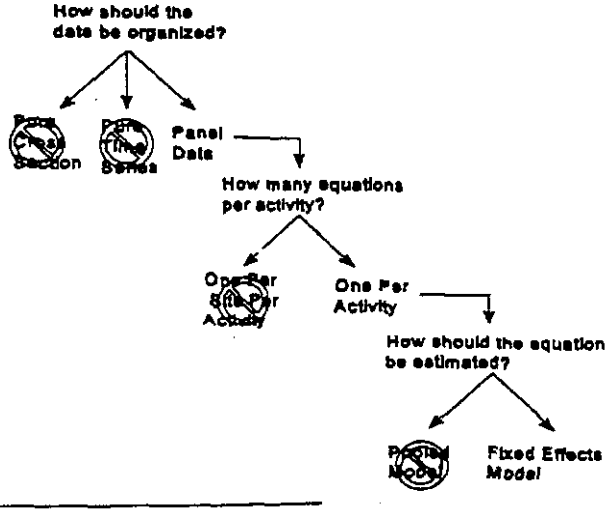
If we do not use an equation that controls for site-specific and time-specific effects we are assuming that there is complete homogeneity of the cost equation across sites and time periods. This is called the "pooled" model. The pooled model assumes that all sites are identical in the characteristics that determine costs, which is a highly unrealistic characterization of the Postal Service's actual facilities. Alternatively, one can control for variations across sites and time periods. This approach recognizes that not all mail processing facilities are identical, nor will they be homogenized as a result of small volume changes. It is called the "fixed-effects"

[48]As Professor Bradley explained in his response to NOI #4, the large number of parameters in the site-specific equation makes it more likely that the null hypothesis of the fixed effects model will be rejected. *Tr. 28/16082.*

model. Both the statistical tests and operational reality strongly reject the pooled model in favor of the fixed-effects model. Many different statistical tests strongly and overwhelmingly reject the pooled modeling approach. *USPS-T-14, at 43; Tr. 28/16081; Tr. 29/16124.*

Rejection of the pooled model means that the fixed-effects model allowing for site specific effects and time-period specific effects is clearly the best econometric approach. This is the approach originally proposed by Professor Bradley in his direct testimony, and the testing that has taken place on the record has only served to confirm, reinforce, and emphasize the correctness of that original approach.

A diagram of the econometric method choice trail may help illustrate the foregoing discussion. This following diagram, unlike PRC/UPS-XE-2, accurately reflects the proper procedure for selecting the econometric model.[49] The procedures discussed above and diagramed below incorporate choices made on broader grounds than mechanistic application of statistical tests.



[49] Not only is PRC/UPS-XE-1 flawed on a conceptual level, it contains various errors about what has and has not been tested. *Tr. 33/17903; Tr. 33/18025 and 18027.*

f. Dr. Bradley's econometric results are robust.

The issues raised by the Commission and the intervenors in this Docket have resulted in analysis of a number of alternative methodologies. Dr. Bradley's initial models are impressive for the stability of the results across all of these changes. The incredible soundness of the results can be attributed to the fact that the analysis is based upon a solid economic model reflecting operational realities estimated on a rich and complete data set.

By any objective standard, the mail processing variability analysis is robust. Indeed, the mail processing variability analysis has shown itself to exceed any historical standard for robustness established by the Commission. This standard was articulated in the instant case by the Presiding Officer:

> In the past the Commission has taken the view that it is desirable for econometric results to be robust and stable. For me this means that minor and plausible changes in econometric models, dataset or estimation methodology do not yield major changes in econometric results.
> *Tr. 28/15786.*

One must be careful not to abuse the Commission's standard for robustness and confuse minor, plausible changes with fundamental changes in data set structure or model choice that would produce different results. Such different results are not an indication of a lack of robustness, but rather are due to answering fundamentally different questions or applying incorrect and inappropriate econometric methods.

A major change, falling outside what would normally be considered a test for

robustness, would be to reorganize the data set into annual data. *USPS-T-14, at 75.* This change is major because it represents a substantial reduction in the amount of data available to estimate the equation. It also requires changes in the econometric model, like the elimination of seasonal variables, to accommodate the change in the frequency of the data. *Id.* Despite the fact that this alternative analysis includes a non-minor change in the data set, the results are quite robust to this change. The manual letter variability, for example, is 0.797 when based upon the accounting period data in Professor Bradley's original analysis and 0.732 when based upon the annual data. *Id., at 54 and 76.* Similarly, the variability for the manual flat activity is 0.866 when based upon the accounting period data and 0.799 when based upon the annual data. *Id.* Thus, even some dramatic changes in the data set do not cause major variations in the estimated variabilities.[50]

Of course, no econometric analysis is, or should be, robust to fundamental mistakes. *See Tr. 28/15807.* There is overwhelming evidence on the record that site-specific characteristics are extremely important and that it is critical for any econometric analysis to control for them. Omitting them is a classic econometric blunder and a whole body of scientific knowledge has been created to avoid this

[50] In fact, as shown in Professor Bradley's rebuttal testimony, the estimated variabilities are quite stable even when erroneous data are included. Dr. Neels' has taken the extreme position that no data scrubs are appropriate despite his alleged concerns about the quality of the data. Thus he presents econometric results on "all usable" observations. As shown in Professor Bradley's rebuttal testimony, although Dr. Neels' results themselves are understandably unstable (they are based upon data errors), they strongly support the same pattern of results found by Professor Bradley. *Tr. 33/17895.*

pitfall. It is because the mistake of omitting site-specific effects can have a large impact by substantially biasing the results, that econometricians have taken it seriously and developed a set of agreed-upon tools to avoid the bias. Quite naturally, when those tools are not used, the econometric results are gravely distorted and the results obtained will be quite different from the correct results.

This is the outcome of Dr. Neels' misguided "cross-sectional" analysis and Dr. Smith's mistaken espousal of the "pooled" model. *Tr. 28/15631; Tr. 28/15861.* Both of these approaches are biased and produce wild and misleading results.

> The results presented below, in combination with the GNR tests presented on page 43 of my testimony, clearly and dramatically demonstrate that the pooled model presents biased estimates. This is not surprising, as the panel data estimator was developed to control for just such a bias:[51] In recent years, researchers in many disciplines, including economics, accounting, finance, and marketing have increasingly relied on panel data to model the behavior of individual firms. They have done so because panel data allows them to control for persistent unobserved differences among individuals or firms that in many instances may bias estimates obtained from the cross-sections.

Moreover, failure to control for site-specific effects can have serious consequences for the results:[52]

> Ignoring such parameter heterogeneity among cross-sectional or time series units could lead to inconsistent or

---

[51] See, Keane and Runkel, "On the Estimation of Panel-Data Models With Serial Correlation when Instruments are not Strictly Exogenous," Journal of Business and Economic Statistics, Vol. 11, No. 1., Jan. 1992.

[52] See, C. Hsiao, Analysis of Panel Data, Cambridge University Press, New York, 1986 at 5.

> meaningless estimates of interesting parameters.
>
> Because these results are demonstrably and materially biased, they are not proper candidates for consideration by the Commission.

Tr. 11/5423 (footnotes in original). For example, Dr. Neels' analysis estimates an improbable elasticity of 146 percent for the platform activity. *Tr. 28/15649*. Such a result serves to highlight the magnitude of the econometric mistake that he makes and illustrates why this mistake must be avoided.

An example of robustness testing is provided by making a minor and plausible change in the data set and examining the consequent variation in econometric results. In his original analysis, Professor Bradley prudently required that each site have at least three years of continuous data. *USPS-T-14, at 31*. A check of robustness is provided by changing that requirement and re-estimating the econometric model, as Professor Bradley did in his rebuttal testimony. In the second analysis, he requires a site to have only two years of continuous data. *Tr. 33/17892*. If the econometric analysis is robust, this sort of change should yield only minor changes in the estimated variabilities. As shown in Professor Bradley's rebuttal testimony, the results are virtually identical across this plausible change in the data set. Several of the variabilities are identical and many have only trivial changes. For example, the variability for the manual letter activity is 0.797 for both data sets, the variability for the bar coding sorting activity changes from 0.945 to 0.944. *Tr. 33/17893*. This incredible stability in results establishes, without question, the robustness of the original econometric analysis.

Along another dimension, robustness can be checked by examining minor and plausible variations in the specification of the model. Such a plausible change was also tested by Professor Bradley. In his original model, Professor Bradley captured time-period specific effects with a segmented-trend formulation. *USPS-T-14, at 15.* As he explained in his direct testimony, an alternative approach to modeling the time-period specific effects is with a "two-way" model.

> To check this decision, I also estimated the panel data model using a correction for time-specific effects in place of the broken trend. Because this model simultaneously accounts for site-specific effects and time-specific effects, it is sometimes called the "two-way" model. *USPS-T-14, at 72.*

The results of this alternative econometric modeling exercise again demonstrate the robustness of the mail processing variability analysis. The manual letter variability in Professor Bradley's original analysis is 0.797 and the manual letter variability from the two-way model is 0.750. *USPS-T-14, at 54 and 74.* Similarly, the manual flats variability in the original model was 0.866 and in the two-way model it is 0.731. *Id.* This comparison shows that the mail processing analysis is robust over plausible changes in the econometric model.

Finally, another plausible, but not minor change in estimation methodology, is to correct for possible measurement error in the explanatory variable. During this proceeding, questions about possible measurement error in the manual operations were raised. To investigate the possibility that this alleged measurement error was influencing his econometric results, Professor Bradley estimated what is known as an "errors-in-variables" model for the manual operations. *Tr. 33/17897.* This

econometric method is substantially different from the original method. It incorporates results from both a fixed-effects model and a "differenced" model and relies upon a simplified model without time trends or seasonal effects. Nevertheless, the results are quite robust. The original manual letter variability was 0.797 and the errors-in-variables manual letter variability is 0.736. *USPS-T-14, at 54 and Tr. 33/17900.* The original manual flats variability is 0.866 and the errors-in-variables manual flats variability is 0.735. *Id.* These results show that, not only are the alleged concerns about measurement error irrelevant for Professor Bradley's analysis, but also that his econometric results are robust over very different econometric techniques.

g. All issues raised by the Presiding Officer and the Commission concerning Dr. Bradley's variability analysis have been fully addressed and resolved In favor of his approach.

As is fitting with any comprehensive new costing analysis, the Presiding Officer and the Commission raised a number of issues relating to Dr. Bradley's mail processing variability analysis. Every issue raised was fully addressed and resolved by Dr. Bradley and others. Resolution of these issues has resulted in a record that is complete and that leads to one and only one conclusion -- compelling evidence of record demonstrates that the prior assumption of 100 percent variability of mail processing labor costs must be set aside, and Dr. Bradley's analysis must be adopted. Following the filing of his direct testimony, Dr. Bradley responded to hundreds interrogatories on his variability analysis addressed by the parties and also provided detailed responses to a number of Presiding Officer's Information Requests

(POIRs).

The first issues surfaced in a Presiding Officer's Information Request basically questioning the effect on Dr. Bradley's analysis of certain operational matters. In response to POIR, No. 3, item 29, Dr. Bradley explained that his groupings of MODS codes is completely consistent with any local customization of those codes when he stated that he controlled "for any local variation in assigning the individual three-digit [MODS] codes by grouping those codes at the mail processing activity level." He gave the example of grouping all Opening Unit-Pref MODS codes into one activity and estimating one equation for the activity. *Tr. 11/5413.*

In response to POIR No. 3, item 30, Dr. Bradley explained how the Postal Service restructuring in FY 1993 affected his time trend. In pertinent part, Dr. Bradley stated, "These types of changes would affect the time trend significantly if the subsequent regime is materially different from the previous regime. If so, the external forces on the operation would have changed and the estimated coefficients would reflect this change." *Id. at 5414.*

In response to POIR No. 3, item 31, Dr. Bradley concluded that certain DPS or BCS machines might be located in facilities not included in his analysis did not preclude estimation of a reliable variability. As Dr. Bradley said:

> It is not necessary to have data from every site that uses a BCS to estimate an accurate equation for the BCS activity. Given the volume of data that I already have for estimating a BCS variability (22,572 observations), I believe that sufficient data have been collected to be representative of all BCS operations.

Id. at 5415.

POIR No. 4 asked a variety of questions, primarily concerning economic theory and technical aspects of Dr. Bradley's analysis. Item 1 of that POIR asked whether short run or longer run cost effects are more relevant for ratemaking and further inquired whether an analysis using AP data addressed longer-run cost effects. Dr. Bradley responded that "[t]he relevant costs for rate purposes are the actual marginal costs incurred from a sustained change in volume." *Id. at 5417.* He quoted Dr. Baumol's Docket No. R87-1 testimony:

> "A final matter to be touched on briefly here is the choice of marginal costs upon which the rates should properly be based. Should these marginal costs be short run or long run in nature? As I will show, the answer is that they should be the *actual* marginal costs, whichever of those that may be. When an output of a service is increased (or decreased), there is only one amount of cost actually added (or saved), not two or three. The actual marginal costs are normally closest to what economists call short run marginal costs (SRMC). But is must be emphasized that these actual marginal costs do include costs consequences of a current volume changes that may occur in future periods."

Id. (emphasis in original). Dr. Bradley also quoted Dr. Panzar in the instant docket:

> One should attempt to base prices on the marginal costs that will actually be incurred by the firm to serve a sustained increase in volume over the time period during which the prices will be in effect. Taken literally, this would require that some version of short-run marginal costs should be used.

Id. at 5417-18. Dr. Bradley further explained that his accounting period data do reflect longer run cost effects. He pointed out, however, that short-term variations in hours caused by temporary variations in volume could cloud estimation of the true variability and should be controlled for in an analysis. He also noted that his dataset covered nine years and thus would take account of capacity changes over time. He

cited the alternative econometric analyses based on annual and SPLY data presented in his direct testimony, stating that those results indicated "that the econometric results are not a manifestation of the frequency of the data." *Id. at 5418-19.*

Item 2 of POIR No. 4 asked for an explanation of the statistical properties assumed in Dr. Bradley's errors-in-variables analysis. Dr. Bradley defined the primary assumption as being "that the measurement error is unobservable" and explained that "[c]onsequently, there are no statistical tests that can be run to confirm the stochastic assumptions." *Id. at 5420-21.*

Item 3 of POIR No. 4 basically requested that the Postal Service provide econometric equations which would "ferret out the roles played by the fixed-effect estimator and other variables in the model." *Id. at 5422.* Dr. Bradley responded by specifying a translog functional form for both a pooled model and a fixed-effects model for TPH alone, for TPH and lagged TPH, and for all variables. In addition, each set of variabilities was presented both corrected and uncorrected for serial correlation. *See id. at 5422-30.* Dr. Bradley pointed out several patterns in the results. He first noted that the results demonstrated the importance of facility-specific effects. He next noted that the effect of including a lagged TPH term was material and generally increased the variabilities. Finally, he noted that the manual ratio and time-related variables were important for control of non-volume effects and also generally increased the variabilities. *Id. at 5424-26.* Dr. Bradley concluded that the results "clearly and dramatically demonstrate that the pooled model presents biased estimates" and affirmed that "they are not proper candidates for consideration by the

Commission." *Id. at 5423 and 5424.* As requested, Dr. Bradley gave his operational interpretation of the models, stating:

> [T]he fixed effects model gives the hours response to volume changes controlling for non-volume difference across sites. The pooled model, on the other hand, gives a biased measure of the hours response to volume changes by confounding it with other non-volume bases for variations in hours across facilities.

Id. at 5432.

Item 4 of POIR No. 4, asked for a discussion of what was assumed to be a contradiction in witness Moden and Dr. Bradley's testimonies concerning staffing in certain operations and the variabilities in those operations. Dr. Bradley distinguished between impacts on activities due to "unexpected changes in daily conditions, like machine breakdowns" and those due to sustained volume increases. *Id. at 5433.* Dr. Bradley also pointed out that witness Moden's testimony and his own were consistent regarding discussions of staffing at manual operations when those operations serve a "backstop" function. *Id.*

Item 5 of POIR No. 4 asked whether Dr. Bradley's analysis assumed that TPH for each activity in each facility was proportional to the volume of mail processed in that activity. Dr. Bradley explained, "My analysis provides the first elasticity, the elasticity of cost with respect to the driver. This does not depend upon any assumptions about the second elasticity, the elasticity of the driver with respect to volume." *Id. at 5435.*

The Presiding Officer also questioned Dr. Bradley when he appeared for oral cross-examination. The Presiding Officer presented Dr. Bradley with what he

described as a plot of the panel data used by Dr. Bradley for the manual letter operation. *Id. at 5578.* Dr. Bradley was then asked whether that plot resembled "a straight line with a roughly 1-to-1 slope." *Id. at 5581.* Dr. Bradley responded:

> It looks to me like a blob of data with many, many data points, and one's eye would be tempted to draw a straight line through it, but I think that would be a mistaken inference, because the actual straight line should come from an econometric regression. My experience has been that when looking at simple plots they can be misleading. So I'd be hesitant to say so.

Id. Dr. Bradley concluded that he thought the plot would be a good illustration of the problem of economies of scale being overwhelmed by exogenous factors when estimating a pooled model. *Id. at 5582.*

The Presiding Officer also asked Dr. Bradley if he had investigated individual facility variabilities and Dr. Bradley stated that he had not. *Id. at 5584.* The Presiding Officer then asked Dr. Bradley to accept, subject to check, specific wide variability ranges for certain operations, but Dr. Bradley found it impossible to accept the numbers. Dr. Bradley explained, "I don't know how they were calculated so I can't accept it. Were they calculated on individual equations? Were they calculated with this equation?" *Id. at 5584-85.* In further discussion with the Presiding Officer, Dr. Bradley indicated that the Chow test could be used to determine whether individual coefficients differ significantly across facilities. *Id. at 5586.* When asked whether other models should be investigated to see if results were more homogeneous or less affected by inclusion of dummy variables and autocorrelation, Dr. Bradley's response was unequivocal:

> No. I think the inclusion of dummy variables is the appropriate

> technique and what one should do and the right approach to using panel data -- and serial correlation I think is a characteristic of time series economic data, not a function of the model, so I think one needs to address those issues, as I have, but I don't think alternative specifications would be the way to address those issues.

Id. at 5587.

The Presiding Officer also questioned Dr. Bradley about the cross-sectional model he estimated in his workpapers for purposes of calculating intermediate statistics. Dr. Bradley stated that he rejected the results:

> Cross-sectional data are well-known to be subject to what's known as heterogeneity bias. It's very well-known in the literature, and because of the size and importance of that bias in these analyses, the cross-sectional results should be rejected.

Id. at 5590. Dr. Bradley was also asked a variety of questions concerning the relationship between TPH and volume, primarily following up on his response to POIR No. 4, item 5. Dr. Bradley made clear that any changes in the relationship between TPH and volume either across facilities or over time would not have any impact on his coefficients because his "estimated coefficients are hours to TPH." *Id. at 5594.*

POIR No. 7 again asked a number of detailed questions about Dr. Bradley's analysis. Item No. 1 basically requested that Dr. Bradley generate site-specific variabilities under a particular procedure, which would have required "the estimation and interpretation of 2,369 regressions, each corrected for serial correlation." *Tr. 19E/9671.* Dr. Bradley estimated that running, reviewing, and interpreting the regressions as envisioned would take between approximately 25 and 50 workdays. *Id. at 9672.* Dr. Bradley, nonetheless undertook the procedure for the BCS cost pool and provided the econometric output for the first eight regressions. Dr. Bradley

stated that examination of that output demonstrated "immediately that the proposed procedure for estimating site-specific variabilities will not work, because of multicollinearity in the data at the site level." *Id. at 9673.* Dr. Bradley further stated, "For example, multicollinearity would explain the site-specific variabilities for the manual letter and flat activities with the wrong signs and implausible magnitudes cited by the Presiding Officer in his questioning of me." *Id. at 9674.* Dr. Bradley thus estimated the site-specific variabilities with a non-mean centered version of the equation reflected at page 36 of his direct testimony. Dr. Bradley further computed and presented the average of these site-specific variabilities, producing results which were very close to those presented in his direct testimony. *See id. at 9676.* Dr. Bradley, citing Commission precedent, still did not recommend the disaggregated site-specific approach. *Id.*

In response to this same question, Dr. Bradley indicated that the fact that site-specific variabilities are not identical does not, in any sense, preclude use of a single variability for each of the MODS cost pools. Dr. Bradley explained:

> Finally, it is important to recognize that the use of a single variability for a cost pool does not require the assumption that the evaluated variability at each site is the same. One does not have to assume that the variabilities are identical across sites as the old 100 percent methodology implicitly did. Rather, one can directly estimate the system response to a small sustained increase or decrease in volume. For the four important reasons given at Tr. 11/5494-5496, the best way to calculate the system response is with a single fixed effects equation.

Id. at 9679.

In response to Item 2 of POIR No. 7, Dr. Bradley corrected the misconception

in the question by indicating that he had "already provided evidence that the site-specific effects are correlated with volume. . . ." *Id. at 9738.* In that response, Dr. Bradley also demonstrated both mathematically and by analogy, that there was "no inconsistency between agreeing that the site-specific effects are correlated with volume and recognizing that the site-specific effects in the regressions. . .contain no volume effects." *Id. at 9742.*

Item 3 of that same POIR asked why Dr. Bradley had not used a full-form translog equation in estimating his variabilities. Dr. Bradley responded that he had used an "augmented translog" and further explained that it was standard econometric practice to include various control variables without their cross products. *Id. at 9744.*

Item 4 of POIR No. 7 asked a series of questions concerning a paper co-authored by Dr. Bradley. In a particularly instructive portion of that response, Dr. Bradley said:

> In USPS-T-14, I am estimating activity level equations, not facility level equations for labor cost. Therefore, the appropriate way to account for site-specific effects is the alternative approach, through the use of the fixed effects model, or heuristically, the inclusion of the site-specific effects. . . . It is well known that omission of these dummy variables will lead to biased coefficient estimates. For example, I am attaching a graph from a well known econometric text book that demonstrates why *it is wrong to simply plot the data and draw a straight line through it.* If it does not account for the dummy variables, that straight line will be biased and erroneous. The graph contains a plot of points which would appear to have a steeply sloped regression line running through them, a regression line that runs through the origin. However, that regression line ignores the fact that the points in the ploy are really generated by a much flatter regression line, one that shifts with variations in the values for the dummy variables. Failure to recognize the heterogeneity in the data generating process would cause one to mistakenly overstate the slope of the regression line. This is why the econometrics literature contains strong prohibitions against using

simple pooled models in the face of unit-specific effects.

Id. at 9748 (emphasis added) (footnotes omitted).

In response to item 5 of POIR No. 7, Dr. Bradley computed the ordinary least squares estimate of the 13th difference version of equation 2 from page 36 of his direct testimony and compared the results with the first-difference and fixed effects models presented in his direct testimony. Dr. Bradley concluded that the results confirm "that the variability for the mail processing activities is less than one." *Id. at 9753.* He further concluded that the difference between these results and those initially presented in his direct testimony were not due to measurement error for TPH, both because his initial errors-in-variables analysis illustrated that measurement error did not significantly effect manual letter and flat activities, and because measurement error was not an issue for automated and mechanized activities, where machine counts provide TPH. *Id. at 9753-54.*

On December 10, 1997, witness Degen testified on two Inspection Service audits concerning MODS, in response to the Presiding Officer's request. *See Tr. 18/8243.* The details of that testimony are set out more fully in the immediately preceding section. Suffice it to say, however, that witness Degen was able to show clearly that neither of the audits was a statistically valid sample. He also demonstrated that, even if the audits could be viewed as having applicability beyond the specific sites studied, the various shortcomings in MODS identified in those audits would have little or no impact on Dr. Bradley's analysis. Specifically, misclocking in MODS is not a problem for Dr. Bradley's analysis because most misclockings

primarily occur within the set of MODS operation numbers within an activity or cost pool. To the extent there may be problems with FHP measures, Dr. Bradley's analysis relies exclusively on TPH, for which only manual letters and manual flats are even minimally effected.

The Commission issued Notice of Inquiry No. 4 on Mail Processing Variability (*NOI #4*), which requested that parties statistically test whether the restriction in Dr. Bradley's fixed-effects model, that the slope coefficients of his explanatory variables are identical across facilities, is supported. Dr. Bradley first discussed various issues which had to be addressed in calculating the requested F-statistics, including non-invertability, serial correlation, and mean centering. *Tr. 28/16075-77.* As a result of the statistical tests, Dr. Bradley concluded that site-specific heterogeneity is important and, thus, that a pooled model should not be used. *Id. at 16081.* Dr. Bradley indicated that either a fixed-effects or site-by-site approach could be used. *Id.* Dr. Bradley admitted that the results of the F-tests reflected "a preference for site-by-site estimation of the regression equations." *Id. at 16082.* He concluded, nonetheless, that a number of other factors favor the fixed-effects approach. These include allowing estimation of a more sophisticated model, the need to produce an aggregate variability for each cost pool in any event, the inability to estimate equations for some of the sites, the burdensomeness of estimating equations for each activity at each site, the inability of the site-specific variabilities to be directly applicable to sites not included in the data, and the multicollinearity in the site-specific equations. *Id. at 16082-84.*

Moreover, Dr. Bradley stated that "the site-by-site results strongly suggest that the true underlying variability is not 100 percent." *Id. at 16085.* Also, Dr. Bradley demonstrated that the average variability for the site-by-site regressions is lower than both the fixed-effects and pooled variabilities. *Id. at 16086.* In conclusion, Dr. Bradley summed up, "[T]he specification tests establish that if one uses statistical tests to reject the fixed-effects model, those same tests can only imply a simultaneous rejection of the hypothesis that the mail processing variability is 100 percent." *Id. at 16087.*

In his rebuttal testimony, Dr. Bradley addressed two cross-examination exhibits which the Presiding Officer had used to question UPS witness Neels and OCA witness Smith. The first cross-examination exhibit was titled "Nested Sequence of Models," and purported to diagram the types of models that had been tested and rejected on the record of this proceeding and those that had not. *See Tr. 28/15776.* Dr. Bradley indicated that both OCA witness Smith and UPS witness Neels, upon review of this exhibit, had appeared to imply "that time-period specific effects had not been tested against a pooled model that did not allow such effects." *Tr. 33/17903 (footnote omitted).* Dr. Bradley stated that this was false. He explained that the Gauss Newton Regression tests performed for his initial testimony (USPS-T-14) "had indicated rejection of the null hypothesis of not time-period-specific effects." *Id.* Based on this result, Dr. Bradley *specifically had included time-period-specific effects* through use of time trends and further had estimated an alternative"two-way" model, which expressly allowed "for both facility-specific and time-period-specific effects." *Id.*

(emphasis added). Dr. Bradley also noted that his trend model permitted the "change in hours with respect to TPH" to vary over time and concluded that it accordingly was incorrect to suggest that his fixed effects-models lack time-indexed coefficients. *Id.* As Dr. Bradley summarized, "In terms of PRC/UPS-XE-1 (Tr. 28/15776), this means that there has been testing of 'the right hand flow.'" *Id.*

Finally, Dr. Bradley commented on PRC/UPS-XE-2, "Comparison of Bradley and Neels Econometric Results," which compared results from some -- but not all -- of the models presented in this proceeding. *Tr. 28/15785.* Dr. Bradley concluded that the results he obtained when estimating a cross-sectional model including capital variables explained "the apparent variation in variabilities" shown in the cross-examination exhibit. *Tr. 33/17912.* The cross-examination exhibit had shown that two sets of UPS witness Neels' results were very near to Dr. Bradley's, but the variabilities from Dr. Neels' cross-sectional model were much higher than the others and were well over 100 percent. Dr. Bradley concluded:

> Dr. Neels speculated that the difference between his cross-sectional results and all the other results came about because his cross-sectional results were "long-run." *We see now that the difference comes* not because of that reason, but rather *because of specification bias. . . .*
>
> * * * *
>
> The capital variables in my cross-sectional models are statistically significant because they are embodying the important facility-specific effects. The fact that they are statistically significant signifies that omitting them from the cross-sectional equation causes an omitted-variables bias. That bias causes the cross-sectional variabilities to be artificial[ly] forced upward and to be well above one hundred percent.

Id. at 17912-13.

As the above discussion unequivocally demonstrates, all issues advanced by the Presiding Officer or the Commission have been thoroughly and thoughtfully addressed on this record. The large body of resulting work leads to an inescapable conclusion -- the variability of mail processing labor costs is less than 100 percent. It also makes quite manifest that Dr. Bradley's fixed effects model is the best specification for determining accurate and reliable variabilities.

2. The Postal Service has provided the correct distributions of volume-variable cost pool costs to complete the estimation process for subclass mail processing marginal costs

As discussed below, the mail processing cost distributions presented by the Postal Service provide the final link in the correct estimation process for the development of marginal mail processing costs by subclass. The alternatives presented by intervenors are flawed, and should be rejected by the Commission.

a. Witness Degen properly uses direct and mixed-mail tallies to distribute the volume-variable costs in each cost pool to the subclasses handled in that cost pool

As explained earlier in the general overview of the integrated approach presented in this case for the allocation of mail processing costs, witness Degen testified regarding the new distribution methodology, which is the link between the cost driver (TPH) and volume by subclass. Like Dr. Bradley's variability analysis, Mr. Degen's distribution analysis is conducted at the activity, or cost pool, level. His new methodology is described in USPS-T-12, and full details are provided in USPS-LR-H-146.

Mr. Degen uses accounting and operating data from the National Workhours

Reporting System (NWRS) and the Management Operating Data System (MODS) to partition clerk and mailhandler salary costs into cost pools. His cost pools, based on workhours reported in functionally related groups of MODS operations, correspond closely to the activities (also defined using MODS codes) for which Dr. Bradley has estimated variabilities. Using Dr. Bradley's variabilities, Mr. Degen next calculates the variable costs of each cost pool, which are then distributed to subclasses using In-Office Cost System (IOCS) tally information. As discussed above, Prof. Bradley's variabilities are measurements of the elasticity of costs in the cost pool with respect to the cost driver, which is generally piece handlings (TPH). Mr. Degen is relating the cost driver to the volumes by subclass of mail, thereby completing the second step of the "volume variability/distribution key" method. Tr. 34/18222-23.

The core economics of Mr. Degen's approach, expressed in mathematical terms, are most fully presented in his response to Item 5 of POIR No. 4. Tr. 12/6598-6604.[53] In that response, he shows that the limited assumptions he makes in using IOCS tally information to relate piece handlings to subclass volumes for BY 1996 are no different than those implicit in the previous methodology used by the Postal Service in FY 1996 and in all previous years. In each cost pool, a subclass' proportion of IOCS tally costs is equivalent to the elasticity of the cost driver with respect to the volume of that subclass.[54] In other words, Mr. Degen uses IOCS

---

[53] Much of the same ground, of course, is also covered in Dr. Christensen's rebuttal testimony at Tr. 34/18217-27.

[54] Mr. Degen notes that the number of TPH in a particular cost pool per RPW piece volume of any particular subclass is a number that is likely to change over a

tallies to supply the last link necessary to derive unit volume variable costs by subclass for each cost pool, which validly represent the marginal increase in accrued cost pool costs caused by a marginal increase in subclass volume.

When viewed in the context of its intended function within the new integrated mail processing cost allocation process, Mr. Degen's approach to distribution makes perfect sense. Dr. Bradley has informed us as to how total costs in each cost pool vary with piece handlings. The role of Mr. Degen's analysis is to inform us as to how the piece handlings in each cost pool vary with subclass volume. He does this using the proportions of handlings in each cost pool that relate to each particular subclass. His reliance on IOCS data is much more limited (at least with respect to MODS offices) than the reliance placed on IOCS by the old methodology, which also needed IOCS to partition the costs into the many different subcategories.

The basic logic of Mr. Degen's methodology neither requires him nor allows him to disaggregate his cost pools into subpools of direct costs, mixed mail costs, and not handling costs. Instead, he uses a combination of information from IOCS direct tallies and mixed mail tallies to derive the proportions of handlings relating to each subclass, and uses those proportions to distribute the total volume variable

---

period of years, as mail mix and mail processing operations mix change. Tr. 12/6603. As he states, however, since his distribution methodology would reevaluate that number every year (based on the IOCS tallies for that particular year), changes over the years do not affect the validity of his base year distributions, using base year (1996) IOCS tallies. Id. No assumptions regarding broader aggregations of TPH or RPW volumes are necessary for Mr. Degen's analysis. Tr. 12/6604. Of course, as Dr. Bradley has stated separately, no assumptions at all regarding the relationship between TPH and volume, along time or any other dimension, are necessary for his variability analysis. Tr. 11/5434-35.

costs of the cost pool. USPS-T-12 at 9. Although the use of mixed mail tally information is based on a process that is complicated and has generated controversy, its technical complexity should not inhibit recognition of its essentially simple purpose -- to draw reasonable inferences regarding the types of mail being handled in the cost pool in instances for which direct information is not available.[55] The principles underlying the new mixed mail distribution are plainly articulated in USPS-RT-6 at 6-13. Both direct and mixed mail tallies provide relevant and useful information on the subclasses of mail being handled in the cost pool, and it is therefore on that information that Mr. Degen's distributions of cost pool volume variable costs rely.

Conversely, by their very nature, not handling tallies generally do not provide useful information on the types of mail being handled in a cost pool. Thus, as Mr. Degen explains quite clearly in his rebuttal testimony, the new method minimizes the reliance on not handling tallies, and they are effectively ignored in most cost pools. USPS-RT-6 at 3. This is possible because, in the new methodology, the focus is simply on determining subclass proportions of the costs determined to be causally related to the cost driver -- piece handlings in the operation.

As Mr. Degen also explained, another focus of the new methodology is to identify the subclass(es) being handled with the operation into which the employee is

[55] Of course, how to use mixed mail tallies was equally controversial in past cases under the LIOCATT procedure. Under either the new or old methodology, the implementation of mixed mail distributions is daunting because of the number of computer programs involved. Unlike LIOCATT, however, the new mixed-mail distribution is all done in SAS, and a number of intervenors in this docket have been able to replicate the process.

actually clocked at the time of the reading. USPS-T-12 at 7. This maintains consistency between the variability estimation procedure and the distribution procedure. USPS-RT-6 at 16. It also reflects reality. For example, to the limited extent that there are instances of an employee moving between cost pools without reclocking, there is no apparent reason why the subclass being handled after the move should escape responsibility for the variable cost of the employee's time. As long as each tally is associated only with the MODS operation into which the employee is clocked, there is no danger of double counting. No data recording system is perfect, but as an accounting system, MODS has many features which compare favorably with alternatives, such as the absence of sampling error. USPS-RT-6 at 16-17.

The fundamental purpose of Mr. Degen's approach, to relate the variable costs of the cost pool to the subclasses handled in the cost pool, requires consistent application across all cost pools. This includes even the cost pools relating to the LDC 17 "allied labor" operations, in which proxy workload measures were used to measure variabilities. As explained in the rebuttal testimony of Dr. Christensen, the subclass proportions of handlings within an activity -- be they handlings of individual mail pieces, or handlings of containers -- are the appropriate focus of the distribution exercise. Tr. 34/18226-27. For allied operations, like other operations, those proportions are available from IOCS direct and mixed mail tallies. It is particularly important to apply the tally information from within the cost pool to the distribution exercise when, as Dr. Christensen notes, the alternative would be to ignore the

proportion of time spent in allied activities handling mail which does not reach the piece-sorting operations in that facility, and is therefore not included in the proxy workload level measures used in the variability analysis. *Id.* Because we know that the mail which bypasses the piece-sorting operations is presort mail, ignoring that portion of allied workload would lead to bias in the distributions and understatement of presort costs. *Id.*

In summary, despite the formidable complexities of implementation, the analytic thrust of Mr. Degen's analysis could hardly be more straightforward. Using cost pools for which Dr. Bradley has provided variabilities that establish causal linkages, Mr. Degen simply distributes the variable costs of each cost pool to the subclass volumes that are handled in the cost pool and that cause such costs. In pursuing this objective, witness Degen presents a distribution analysis which is fully integrated into the overall cost allocation process that produces valid economic marginal costs.

b. None of the Suggested Alternative Distribution Methods Rely on a Coherent Economic Framework of Causality, Or Result in Reliable Estimates of Marginal Costs

Four intervenor witnesses present alternative distribution methodologies for mail processing costs -- MPA witness Cohen, DMA witness Buc, Time Warner witness Stralberg, and UPS witness Sellick.[56] In each case, the proposed methodology violates the coherent economic framework of causality, or relies on

[56] Dow Jones witness Shew also provides testimony criticizing Mr. Degen's approach, but does not develop any specific alternative subclass distributions.

causality assumptions contrary to the evidence of record.

Mr. Buc advocates the use of the Docket No. R94-1 (LIOCATT) method for cost distribution purposes, but does not offer specific recommendations regarding variabilities. Tr. 28/15455-56. Mr. Buc also presents a "DMA alternative" to both the Postal Service and the LIOCATT method which implements Dr. Bradley's variability factors, but rejects both Mr. Degen's cost pools and distribution keys. The DMA alternative differs from other methods (including LIOCATT) in that it treats volume-variable costs that witness Buc associates with both mixed-mail and not-handling-mail IOCS tallies for an office group (i.e., MODS, BMC, non-MODS) as overhead to volume-variable costs associated with direct tallies in the same office group. Tr. 28/15385-6.

The method presented by Ms. Cohen and Mr. Stralberg implements both Dr. Bradley's variability factors and Mr. Degen's MODS-based cost pools to form the total pool of volume-variable costs to be distributed. Like the DMA alternative, the Cohen/Stralberg proposal disaggregates the pools of volume-variable costs for each office group into subpools associated with direct, mixed-mail and not-handling mail. Unlike the DMA alternative, Cohen and Stralberg further disaggregate their mixed-mail and not-handling-mail cost pools into categories that generally correspond to distribution categories in the LIOCATT method. Witnesses Cohen and Stralberg also reallocate a portion of their not-handling-mail cost pool among the Cost Segment 3 components based on the IOCS operation code of the associated tallies. Mr. Stralberg provides a detailed description of this alternative method at Tr. 26/13871-

82.

Mr. Sellick's alternative employs Mr. Degen's cost pools and distribution keys in conjunction with what he describes as the "historical attribution level of mail processing labor costs." Tr. 26/14171. Mr. Sellick's variability assumptions are based on Dr. Neels' rejection of the econometric approach to variabilities. *Id.* at 14162. To implement the previous variability assumptions in the MODS-based cost pool framework, Mr. Sellick associates costs from the MODS-based cost pools with tallies that were formerly associated with the fixed mail processing component of Cost Segment 3.1. The "fixed" costs are removed from the cost pools and treated as non-volume-variable. Additionally, Mr. Sellick reassigns costs associated with "migrated" tallies to the IOCS-based Cost Segment 3 component. *Id.* at 14172. While witness Sellick recreates the old attribution level, he does not fully implement the old causality assumptions. In this regard, an omission in his crosswalk to the old variability assumptions is that he did not separate the "not-handling" costs associated with the "variable overhead" component and treat them as overhead to all of mail processing.

Of these four witnesses, three (witnesses Buc, Cohen, and Stralberg) clearly question the use of Mr. Degen's cost pool-based distribution keys. Mr. Buc additionally rejects the use of the MODS-based cost pool amounts. The deficiencies of the testimony of these three witnesses, along with those of other witnesses making similar points, will be addressed in the next several sections. UPS witness Sellick, to the extent that his proposal raises distinct issues, is addressed in a separate section which follows later.

i. All methodologies under discussion use some type of cost pools, and make certain assumptions about those cost pools.

There has been a good deal of posturing in this proceeding about the nature of the assumptions employed in the development of Mr. Degen's proposed distribution methodology. Witnesses Buc, Cohen, Shew, and Stralberg all criticize Mr. Degen's use of "untested" assumptions. As Mr. Degen indicated, this criticism applies equally to the LIOCATT distribution assumptions employed by Mr. Buc, Ms. Cohen and Mr. Stralberg, none of which have been formally tested. USPS-RT-6 at 7. Mr. Degen observes that all of the proposed mixed-mail methods employ fundamentally the same assumption: for each mixed-mail category, the unknown subclass distribution is the same as the distribution of a category of tallies for which the subclass distribution is known. USPS-RT-6 at 6. Thus, the issue is not whether to use, in a generic sense, cost pools. The mixed-mail categories based on basic function, CAG, and IOCS activity code under the old methodology are also "cost pools" for purposes of distribution. Such cost pools, however, do not have the operational meaning of the MODS-based cost pools employed by witness Degen. USPS-RT-6 at 9-10, 12.

The traditional mixed-mail assumptions have been controversial, and were highly criticized in previous cases. Indeed, in Docket No. R94-1, Mr. Stralberg argued that the LIOCATT mixed-mail distribution assumptions were "highly questionable" and that the resulting cost distribution was "in all likelihood severely distorted." Docket No. R94-1, Tr. 15/7133, 7135. In the present proceeding, Mr. Stralberg has been forced to devalue his superlatives, since he now finds the new

Postal Service method so offensive that now the worst he can say about the traditional mixed-mail assumptions is that they result in "some bias." Tr. 26/13840.

The only meaningful exercise is to compare how each party's assumptions comport with operational realities. On this account, Mr. Stralberg has historically been one of the harshest critics of his current method. In Docket No. R94-1, he suggested that the LIOCATT cost distribution was inconsistent with operational realities. Docket No. R94-1, Tr. 15/7136-40. Mr. Degen notes that the reliance on "basic function" in the LIOCATT and Cohen/Stralberg methods "ignores the canonical technological and operational boundaries" within mail processing. USPS-RT-6 at 10. Since MODS is "the source of operational data for Postal [Service] operations," the cost pools based on MODS operation numbers inherently account for such boundaries. USPS-RT-6 at 9. Ms. Cohen, in her rebuttal of UPS witness Blaydon's alternative mixed-mail distribution in Docket No. R94-1, observed that counted and uncounted mixed-mail tallies differed in characteristics indicating the mail processing operation and item type. Docket No. R94-1, Tr. 26A/12358-9. Since Mr. Degen's mixed-mail distributions are stratified by cost pool and item or container type, his method controls for the types of characteristics identified by Ms. Cohen in Docket No. R94-1. For his rebuttal testimony, Mr. Sellick repeated Ms. Cohen's exercise with Mr. Degen's stratification, and found no differences in the observable characteristics of the counted and uncounted tallies. UPS-RT-1 at 6, Tr. 36/19481.

Mr. Degen stated that an additional reason for stratifying mixed-mail distributions by item type is that some items have strong associations with certain

shapes or subclasses of mail. Tr. 12/6580. Ms. Cohen attempted to rebut this statement by noting that the association between item type and the predominant subclass is not perfect. In doing so, she presented data that indicates that certain subclasses of mail are far more prevalent in certain types of items (with "direct" activity codes) than in direct tallies as a whole. Tr. 26/14048. Ms. Cohen would have one believe that no valid inference can be made about the subclass composition of the contents of "uncounted" items of these types. Her argument is undermined by common sense. For instance, in an attempt to account for the relatively high "counting" rate for brown sacks, Mr. Stralberg observes that "[b]rown sacks mainly carry magazines." Tr. 26/13831. Indeed, it is widely known that characteristics of items, such as color of a sack, are indicative of the type of mail likely to be contained in the item. Tr. 36/19480.

Finally, there are subclass associations for every cost pool. An observation of an employee clocked into an allied labor cost pool delivering a container of letter trays to a letter sorting operation may receive activity code 5610 (mixed letters) under appropriate circumstances.[57] The Cohen/Stralberg method would distribute the costs associated with such a tally on the basis of all direct tallies with letter-related activity codes in the facility type, CAG and basic function. Tr. 26/13877. However, the actual subclass distribution of that mail will depend on the employee's cost pool.

---

[57] Of course, it could also receive activity code 5750, in which case the LIOCATT and Stralberg/Cohen methods would not even recognize the observed mail as letters. Mr. Stralberg conceded during hearings that this information can generally be obtained from IOCS Question 21 data. Tr. 26/

If the employee is working a cancellation/mail prep operation, the mail will almost certainly be First-Class nonpresort mail. USPS-RT-6, Table 1, Tr. 36/19336. However, if the employee is working in the bulk business mail opening unit, the mail is more likely to be Standard (A) presort letters. USPS-T-12, Table 4, column "1OpBulk." In applying a distribution key based on a composite of all operations to such tallies, Ms. Cohen and Mr. Stralberg hope that, in Mr. Sellick's words, "somehow or other, it all balances out in the end." Tr. 36/19479. Since the composition of direct tallies is different across cost pools, there is, in fact, no reason to rely on witness Cohen's wishful predictions that the errors "may" cancel. Mr. Degen's method, in contrast, is not dependent on such assumptions since, by construction, it does not distribute "mixed mail costs" across cost pools.

ii. Witness Stralberg's belief that the Postal Service's cost distributions are biased against presorted mail is unfounded

A key assumption underlying Mr. Stralberg's critique of the Postal Service's mail processing cost distribution is that the distributions are biased against presorted mail subclasses, particularly Regular Rate Periodicals. Tr. 26/13828. The foundation for this assumption is Mr. Stralberg's belief that presorted mail generates a disproportionately high percentage of "direct" tallies, since such mail tends to arrive at Postal Service facilities as "identical mail" and to remain intact as it is processed. Tr. 26/13827. However, Mr. Stralberg's beliefs are not well founded, either with regard to operational reality or to IOCS tally coding issues. In fact, until corrected by witness

Degen's new methodology, the true direction of the bias was in favor of presort mail.

Mr. Stralberg's expectations with regard to bias are based on a number of faulty assumptions. He does not take into account the fact that "mixed-mail" is a residual category, so identical mail that is not identified as such may generate a mixed tally rather than a direct tally. See USPS-LR-H-21. Nonetheless, Ms. Cohen and Mr. Stralberg seem to understand that certain types of mailer-prepared "items" and "containers" containing presorted mail would be inherently difficult to identify as identical mail, and therefore comprise part of the "mixed-mail" universe. Tr. 26/13942, 14118. Their allegations of bias also do not account for the fact that the operations which process mail that bypasses piece sorting, and which therefore should handle relatively more identical mail containers, have relatively few direct tallies. Tr. 12/6227-28. Consequently, there should be more mail of presorted subclasses in the "mixed-mail" universe than Ms. Cohen and Mr. Stralberg would expect.

Furthermore, since direct tallies are overwhelmingly generated in piece sorting operations, the LIOCATT mixed-mail distribution keys are heavily weighted toward less-presorted subclasses. As a result, as Mr. Degen states, Mr. Stralberg is correct that there has been a bias, but the bias in the LIOCATT-based methodology actually understated costs for more highly presorted subclasses. Tr. 36/19353. Therefore, when the new method assigns a larger share of volume-variable costs to the more-presorted subclasses, this is a manifestation of the correction of the LIOCATT system's biases, not an amplification of them.

Mr. Stralberg (and Ms. Cohen) seem to assume that "mixed-mail" tallies necessarily represent mail of many different subclasses. E.g., Tr. 26/13830, 14136. Under IOCS coding rules, the term "mixed-mail" is something of a misnomer. The essential feature of mixed-mail observations is not that they are mixed per se, but rather that the subclass distribution of the sampled mail is unknown. Under cross-examination, Ms. Stralberg agreed that in order to result in a direct tally, an identical mail container has to be recognized as such by the data collector. Tr. 36/19296. If the data collector cannot tell that there is identical mail in the container, then the test should result in a mixed-mail tally, even though there could be identical mail in the container. Indeed, Mr. Stralberg understands that there are some circumstances in which it would be very difficult for data collectors to determine whether there was identical mail in a container. Tr. 26/13942.

In fact, observations of rolling containers are far less likely to result in direct tallies than observations of piece or item handlings. Tr. 36/19307; Tr. 12/6217; USPS-LR-H-277. The next lowest direct tally-generating category is items that are not subject to the top piece rule, i.e., sacks and pallets. Tr. 26/13863. Of course, essentially all pallets of non-identical mail will be mailer prepared as well, since the Postal Service does not palletize mail other than in NMO operations at BMCs. Most of the mail that bypasses piece sorting operations arrives on pallets or in rolling containers. Tr. 36/19300. Once the mail is removed from a sack, pallet, or rolling container, there is no reason at all to expect presorted mail to result in more direct tallies than nonpresorted mail. Both Ms. Cohen and Mr. Stralberg concede that for

items subject to top piece rule sampling, i.e., bundles and trays, there is no reason why a mailer-prepared item of presorted mail should be more likely to result in a direct tally than an item prepared by the Postal Service. Tr. 26/14148; Tr. 36/19297.

Mr. Stralberg's bias story is also difficult to reconcile with the differences in direct tally proportions by operation. Direct tallies tend to occur in piece sorting operations where mail tends to be handled as pieces or top piece rule items, while "mixed-mail" tallies tend to appear in allied operations where mail is often handled in containerized form. Tr. 12/6227-8. Some, but by no means all, of the mail handled in allied operations requires piece sorting. Tr. 26/13990. Nonpresorted mail will naturally tend to make up most of the direct tally base, simply because it requires the most piece sorting. A cost distribution scheme such as LIOCATT, using broadly defined cost pools, will therefore tend to distribute "mixed-mail" tallies of rolling containers and pallets, which are relatively likely to contain mail bypassing piece sorting operations, on direct tallies recorded in the very sorting operations the presort mail is expected to bypass. Tr. 36/19353. This will tend to overstate the costs of nonpresort mail.

A final related issue is Mr. Stralberg's claim that increasing presortation should reduce the measured costs of Periodicals. More finely presorted containers of mail can make a larger portion of their processing journeys while remaining "intact." The less the container's contents need to be handled, the less expensive it should be to process that mail, other things equal. Mr. Stralberg's data on presortation, however, can be misleading. Witness Degen notes that presort rate eligibility for Periodicals is

primarily based on package presort, not container presort. This means that a 5-digit bundle on an SCF pallet can be paid at the 5-digit rate, even though the total processing costs for that bundle would be higher (because of the need for additional bundle handling) than if the same bundle were on a 5-digit pallet. Tr. 36/19346, 19350. It also means that statistics purporting to show increasing presortation of Periodicals must be taken with a grain of salt: containers of carrier-route packages will not, as a rule, be transported intact to the delivery unit. Mail characteristics data indicate that Periodicals have been shifting to less presorted containers, which could be more expensive for the Postal Service to process. *Id.*

In short, the direction of bias in the previous cost distribution system was to understate costs for presorted mail subclasses. It should be no surprise that a method designed to correct for these biases would tend to increase the share of volume-variable costs distributed to the more presorted subclasses. Tr. 36/19353.

iii. By Actually Calculating Coefficients of Variation for His Distributed Costs, Mr. Degen Has Proven That Allegations of "Sample Thinness" Provide No Legitimate Grounds to Reject His Methodology

As witness Degen states in his rebuttal testimony, the accuracy of a distribution methodology can be evaluated along two dimensions -- bias and efficiency. USPS-RT-6 at 4-5. Debate in the past regarding the old methodology focused on bias. *Id.* In this case, however, intervenor witnesses Buc and Cohen have argued that the number of distribution keys in the new methodology causes concerns of "sample thinness," and leads them to question the reliability of the

resulting cost distributions. *Id.* at 17. These issues relate to efficiency.

Mr. Degen makes three points in rebuttal. First, elimination of bias is the top priority, and nearly always takes precedence over efficiency. *Id.* Because it has less bias, the new methodology is therefore strongly favored on grounds that are likely to outweigh any efficiency concerns. Second, the most meaningful measure of efficiency for a costing system is the efficiency of the final cost estimates. *Id.* The allegations made by witnesses Buc and Cohen are not focused on the final cost estimates, and therefore are of dubious validity. Third, to evaluate this matter correctly, witness Degen estimates coefficients of variation for the mail processing cost estimates (including all effects of mixed-mail and not-handling mail tally distributions) for both the new methodology and the old one (LIOCATT). *Id.* at 18-19. His results make clear that the elimination of bias in the new methodology was achieved with no significant loss of efficiency. *Id.* During oral cross, UPS witness Sellick effectively agreed with Mr. Degen that the coefficients of variation reported in USPS-RT-6 should put to rest any lingering concerns regarding sample thinness and efficiency. Tr. 36/19499-501.

iv. The new Postal Service methodology accurately reflects the causality of "migrated" mail processing costs

A result of the MODS-based partitioning of costs by component is that certain IOCS tallies "migrate" among components. For instance, some tallies that were classified as part of the administrative component (Cost Segment 3.3) on the basis of

the IOCS operation code are, in the new method, classified as part of mail processing (Cost Segment 3.1) on the basis of MODS operation codes. Mr. Degen's response to POIR No. 3 indicated that most of the migration involves mail processing support operations. Tr. 12/6590-95. The Cohen/Stralberg and Sellick alternatives all propose to move part or all of the "migrated" tallies back to their original cost components. Underlying each of these proposals in the presumption that the IOCS operations code is a more accurate indicator of activity than the MODS code is.

Mr. Sellick concedes that he has not examined in detail the appropriate classification of the migrated costs, and that Mr. Degen's approach may be reasonable. Tr. 26/14222. Mr. Stralberg, however, erroneously believes that the IOCS operation code always indicates the activity actually performed by the employee. This is not necessarily the case. In particular, "administrative" IOCS operation codes may be assigned residually to activities that are difficult to classify in IOCS question 18. Tr. 26/14000. More generally, the IOCS operation code reduces hundreds of possible question 18 responses – thousands if the MODS operation recorded in question 18A is included – to roughly 30 broad categories. These, in turn, are condensed into the three "traditional" Cost Segment 3 components. It is a strange measure of Mr. Stralberg's faith in IOCS that he apparently believes these categories definitively partition clerk and mailhandler activities.

The Postal Service method takes into account information provided by MODS to refine its classification of certain costs. Dr. Bradley and Mr. Degen reviewed the interpretation of the MODS operation codes with Postal Service operations experts.

See, e.g., USPS-T-14 at 88. As a result of this investigation, Dr. Bradley and Mr. Degen were able to identify certain cost pools as representing support of "Function 1" mail processing, "Function 4" mail processing, and total mail processing. Mr. Degen appropriately employs tally information from all of the supported cost pools in forming the corresponding distribution keys.

For the vast majority of the migrated tallies, Mr. Degen is simply making use of the fact that, in some cases, the MODS classification of Postal Service activities is finer than the IOCS classification of the same activities. Tallies representing general administrative activities, for instance, receive an IOCS operation code corresponding to Cost Segment 3.3 in the old classification.[58] In contrast, MODS distinguishes between general administrative activities performed in mail processing plants, which are reasonably expected to be causally related to mail processing activities, and similar activities performed in an area office, which would support a broader range of Postal Service activities. See Exhibit USPS-14A; USPS-LR-H-146, Section I. In other cases, such as breaks/personal needs tallies, an administrative IOCS operation code is assigned if the employee "on break from" part of IOCS question 18G is unanswered. (See USPS-LR-H-21.)

Mr. Degen's tally classification takes into account the ability to recover the "on break from" operation from the MODS activity recorded in IOCS question 18A. In

[58] Some clerk and mailhandler costs are explicitly "migrated" among components in witness Alexandrovich's worksheets to account for additional cases in which the IOCS operation code does not properly classify the employee's activity, e.g., certain clocking in/out and empty equipment costs.

many such cases, the "on break from" operation can be identified on the basis of the MODS operation recorded in question 18A. Mr. Stralberg stated that he considered the classification of costs less important than the application of appropriate variability and distribution factors. Tr. 26/13851-52. In this situation, the only way to correctly specify variabilities and distribution procedures is to employ consistent MODS cost pool definitions to distinguish mail processing support costs from general administrative costs. Any movement of costs among components after estimation of variabilities results in inconsistency between the costs pools used to estimate variabilities and the cost pools to which those variabilities are being applied.

v. Illusory "Automation Refugees" and Other Unfounded Allegations of Inefficiency Provide No Legitimate Basis to Reject the Postal Service's Proposed Allocation of Mail Processing Costs

In this case, as in other recent cases, mailers have made allegations of a variety of inefficient practices on the part of the Postal Service which, they argue, should excuse them from being charged with some portion of the costs that the costing systems report as associated with their mail. Proponents of such claims include witness Stralberg (TW-T-1 at 26-40, Tr. 26/13840-54), witness Cohen (MPA-T-2 at 12-15, 33-38, Tr. 26/14036-39, 14057-62), DMA witness Buc (Tr. 28/15420-27), and witness Haldi (ANM-T-1 at 22-24, Tr. 22/11793-95).[59] To a substantial

[59] In addition, particularly with respect to Periodicals, there are industry witnesses who lament general cost trends for their mail, echoing some of the same sentiments as the more technical witnesses. These include Little (MPA-T-1, Tr. 27/14542-49), Crain (ABP-T-1 at 2-5, Tr. 28/15279-82), Hehir (MH-T-1, Tr. 27/14709-11) and Heath (NNA-T-1, Tr. 27/14765).

extent, it is possible to address (and refute) these types of claims collectively, because they share many of the same deficiencies.

(a) These types of allegations were made long before the Postal Service proposed the new methodology

As the Commission is well aware, allegations of inefficiencies and "automation refugees" were raised and rejected in cases filed and litigated well before the Postal Service presented its new approach to the allocation of mail processing costs. This is not to suggest that all of the issues raised by these arguments are necessarily unrelated to the new methodology. Indeed, as we will discuss below, the proposed approach provides the only plausible framework to come to grips with some of these issues in any meaningful fashion. The Commission should be aware, however, that whether or not the Postal Service had introduced the new methodology, these types of complaints would have been raised. The mere fact that such long-standing controversies have surfaced again in this proceeding should not inhibit the evaluation of the new approach on its own merits as an improved tool for the measurement of the actual cost information necessary for ratemaking, and not as something ever intended to be a panacea for all past and present postal ills, real or perceived. This is particularly true, moreover, because at their core, most of these allegations lack any substance whatsoever.

(b) There is No Corps of "Automation Refugees"

Witness Stralberg defines "automation refugees" in the following statement from his direct testimony:

> However, as early as R90-1 my testimony postulated the existence of considerable additional "not handling" time, in the form of "automation refugees," i.e. employees no longer needed in manual letter sorting but still in the system, having been reassigned to manual operations, particularly opening units, where productivity is least monitored in postal facilities.

Tr. 26/13841. Postal Service rebuttal witness Steele, an Area Vice-President, explains that the concept of "automation refugees" is entirely foreign to actual postal operations in today's environment. Tr. 33/17847. Specifically, Mr. Stralberg's current testimony completely ignores the fact that the Postal Service in the early 1990s negotiated provisions within its collective bargaining agreements that were designed to avoid exactly the type of scenario he has described. Transitional employees were hired for the express purpose of maintaining the flexibility to curtail staff when automation reduced staffing requirements. Tr. 33/17848-49. As witness Steele testified, that was the plan, and the plan worked. *Id.* The number of transitional employees peaked between December of 1993 and June of 1995, and by now they have practically disappeared from the plants. *Id.*

Mr. Steele attests to the useful experience postal managers acquired in the periods immediately following initial automation deployment:

> Certainly, veteran managers can tell stories of the early days of automation in the 1980s when we weren't sure exactly how to manage this new technology and the complex mail flows it engendered, but I am not aware of anything resembling a systematic problem of "automation refugees" even then. In any case, by 1990 at the latest, operations management had a clear picture of what needed to be done.

Tr. 33/17848. Interestingly, in Docket No. R90-1, Mr. Stralberg reached the same conclusion. In his testimony filed in that case in the summer of 1990, Mr. Stralberg

cited automation savings that had begun to materialize in late 1989, and concluded that by "eliminating the automation induced excess labor from its workforce, the Postal Service should no longer have the same need to assign these excess employees to non-letter operations." Docket No. R90-1, Tr. 27/13303-04. As Mr. Steele has testified, to whatever limited extent there might have been difficulties adjusting the work force following automation deployment, Mr. Stralberg's expectations that such problems would be transitory have been realized.

In witness Stralberg's statement quoted above from Tr. 26/13841, he closely links "automation refugees" with the growth in "not handling" time, particularly in "opening units." He makes the same linkage at Tr. 26/13846, claiming that "the sharply increased not handling costs brought about by automation are mostly concentrated at platforms and opening units, operations where productivity is least monitored and therefore favored places to send people not needed elsewhere."[60] Mr. Degen demonstrates in his rebuttal testimony, however, that the actual pattern of growth in "not handling" costs completely contradicts witness Stralberg's claims. The higher growth rate (which largely leveled off by 1994) is found not in allied operations, but in non-allied operations. USPS-RT-6 at 25-26. These data directly refute the

[60] Witness Steele also sharply disagrees with the claim that opening units are the "least monitored" operations. As he explains, the very fact that there are no readily available workload measures in such operations makes them prime candidates for close management attention, lest hard-earned productivity gains in direct operations be carelessly eroded. Tr. 33/17854. With the clear message to plant managers and tour supervisors to maintain and improve the "bottom line," which Mr. Steele clearly describes as the managing policy of field operations, it is plain that shuffling supposedly excess employees between operations would be a completely futile strategy. See Tr. 33/17849-54.

theory that "automation refugees" are being assigned to allied operations in increasing numbers. *Id.*

In Docket No. R90-1, the Commission rejected the "automation refugee" claims of periodical mailer witnesses as "speculative." PRC Op., R90-1, App. J at 11. In Docket No. R94-1, the Commission likewise did "not find sufficient evidence to adopt the theory that automation refugees have increased the costs of certain types of mail." PRC Op., R94-1, at III-12. In this case, nearly a decade after its inception, and well into the period in which the Postal Service has demonstrated that it can manage automation effectively despite major turnovers in staff following the 1992-1993 restructuring, it would seem that it is time to put the "automation refugee" myth to rest once and for all.

(c) Neither The Growth of Not-Handling Tallies Nor Cited Extrinsic Evidence Support the Claim That the Postal Service is Inefficient

Both witness Stralberg (Tr. 26/13841-45) and witness Cohen (Tr. 26/14058-62) attempt to equate increases in the proportion of not-handling tallies with inefficiency or unproductive time.[61] As witness Degen discusses in his rebuttal testimony,

---

[61] In Mr. Stralberg's discussion of not-handling costs, it is somewhat ironic that he includes a hypothetical regarding the possible effect of an automation-induced increase in not-handling time in the broader context of testimony opposing operations-based cost pools. His hypothetical (Tr. 26/13845) initially posits a two-subclass system handled by one operation (manual), and not-handling costs distributed between the two subclasses in proportion to direct costs. His complaint is that if new automation increases system-wide not-handling costs, reduces direct costs for one subclass, but has no effect on the direct cost of the other subclass still handled manually, and if not-handling costs across the system are still distributed in proportion to direct costs, the disfavored subclass is disadvantaged not only because

however, these claims are not substantiated. One reason that not-handling tallies increased over the years was a change in data collection instructions in the 1992-1993 period. USPS-RT-6 at 3-4. Another reason is changes in the makeup of the mail and the technologies with which mail are handled. *Id.* Witness Degen lists some examples of perfectly productive activities which must be performed, but which would or could generate a not-handling tally. *Id.* at 20-23. As witness Degen concludes, the proportions of not-handling tallies vary across cost pools because the nature of the activities, including not-handling activities, varies across cost pools. *Id.* at 4, 23-24. Mr. Degen also refutes the claims of witness Cohen that observed productivity trends in MODS data by operation support her allegations of increased inefficiency. *Id.* at 43-44.

Going outside the body of information upon which the Postal Service's proposal relies, witness Cohen cites a draft Christensen Associates report, from an analysis intended to develop benchmarks by studying various mail processing facilities, to estimate "inefficient mixed- and not-handling costs." Tr. 26/14060-62. As witness Degen testified, however, her application of the results of that effort are inappropriate and incorrect. USPS-RT-6 at 41-43. First, as clearly labeled at the

---

the pool of not-handling costs has increased, but because its share of that pool rises as its share of system-wide direct costs increases. Id. The obvious solution to this dilemma is to create separate cost pools for automation and manual, and no longer distribute system-wide not-handling costs on system-wide direct costs. In this event, the automation subclass would benefit from the decrease in its direct costs, but also bears the burden of any increase in its not-handling costs, while neither the direct nor the not-handling costs of the subclass still in the manual cost pool are necessarily affected. This is essentially what Mr. Degen has proposed, and, ironically, what witness Stralberg claims to oppose in the balance of his testimony.

time, the report was a draft, and reflected only preliminary analysis of a broader body of research that has yet to be completed. *Id.* Work subsequent to the date of that report suggests that the results reported therein would change substantially. *Id.* Moreover, the purpose and methodology of the report do not support the types of conclusions which witness Cohen is trying to draw. Mr. Degen, as one of the authors of the draft, correctly recommends that the Commission ignore Ms. Cohen's misapplication of this inchoate effort. *Id.*

By comparing, among other things, Postal Service TFP growth with manufacturing sector multifactor productivity growth and TFP for the railroads, DMA witness Buc suggests that "the inefficiency and low levels of productivity of the Postal Service indicate that there is excess mail processing labor." Tr. 28/15420. As Dr. Christensen testifies on rebuttal, however, "[c]omparisons of the entire Postal Service to the manufacturing sector or to the railroad industry are misleading." USPS-T-7 at 12-15. First of all, citation to Postal Service TFP cannot be used to determine productivity trends specific to mail processing. To the extent that one nonetheless wants to make TFP comparisons for the Postal Service, however, the relevant and appropriate basis for comparison is a much broader sector of the economy, such as the private nonfarm business sector. *Id.* Dr. Christensen provides the figures to make the more valid comparison, and concludes that it does not suggest postal inefficiency. In fact, on average, the Postal Service has exceeded the productivity growth of the private nonfarm business sector in the period 1972-1994. *Id.* at 15-16.

(d) The increase in the mail processing costs of Periodicals is being exaggerated, and the actual increase in recent years appears to be explained by changes in mail makeup

Witnesses Stralberg and Cohen, among others, have attempted to buttress their claims about "automation refugees" and other alleged inefficiencies by citing to above-average and allegedly unexplained increases in the mail processing costs for Periodicals since 1986. When viewed objectively, however, the facts do not support their claims. As witness Degen shows, much of the Periodicals increase of which they complained occurred in 1986-1989. USPS-RT-6 at 27. Since then, Periodicals mail processing costs closely tracked overall clerk/mailhandler wages in 1990-91, declined substantially relative to such wages in 1992, and then increased somewhat relative to such wages in 1993-1996. *Id.* When we account for the fact that overall clerk/mailhandler average wage growth has been slowed since 1993 by growth in REC sites (which would not be expected to have any material effect on Periodicals), the substantial decline relative to inflation in 1989-1992 has not quite been offset by 1996. *Id.* at 27-28.

Is there any plausible explanation for the cost decline in 1992, and the relative increase in 1993-1996? Mr. Degen identifies changes in mail makeup as the likely explanation.[62] Specifically, Mr. Degen suggests that an increase in more aggregate pallets (e.g., 3-digit pallets replacing 5-digit pallets) between 1993 and 1996

[62] Another contributing factor relates to the correction made within Second-Class mail costs in Docket No. R94-1 to properly reflect earlier eligibility changes for Within-County Mail. That adjustment, which shifted cost from Within-County to Regular Rate, was never made for costs for years before FY 1993.

increased the amount of time necessary to break down pallets and conduct more bundle sortation. *Id.* at 28-32. To support this view, he cites discussions with field operational personnel and information from the 1993 and 1996 mail characteristics studies. *Id.*[63] The information he cites is entirely consistent with the observed cost trends for Periodicals.[64]

The rebuttal testimony of witness Degen, however, does acknowledge that there are reasons why past cost trends for Periodicals may not continue into the future. USPS-RT-6 at 37-41. In particular, there are equipment deployments anticipated that should be beneficial, and there are ongoing efforts to coordinate with the mailers on service and cost issues. *Id.* These efforts could lead, for example, to changes in mail makeup requirements that directly affect the types of concerns witness Degen identified regarding pallets. *Id.* at 38-40. In working with mailers to

---

[63] During cross-examination, there was some discussion as to whether the figures from the mail characteristics studies cited at page 31 of Mr. Degen's rebuttal testimony (i.e., a decrease of the percentage of palletized mail on 5-digit pallets "from 43 percent to 11 percent") had been correctly developed. Tr. 36/19431-38. As Mr. Degen stated at that time, however, his purpose in citing the study was to show that there had been a significant decline between 1993 and 1996, not to rely directly on any specific amount of decline:

> Even if [the decline is] 35 percent to 11 percent, I'm simply observing that there has been what I believe to be a significant increase in five-digit pallet use in '92 and '93 and then a decline therefrom in subsequent years.

Tr. 36/19438.

[64] Witness Degen also shows that the concerns raised about recent trends in Periodicals costs provide no reason to disfavor the new methodology, as using that approach would, in fact, result in a lower growth rate for Regular Periodicals costs over the 1993-1996 time period. USPS-T-6 at 28, 30, 33.

improve service and control costs, it is possible that the resulting initiatives could slow down, stop, or reverse current unit cost trends for Periodicals. *Id.* at 40-41.

(e) Intervenor Witnesses Making Allegations of Inefficiency, Excess Capacity, and Slack Time Appear to Not Appreciate Fully the Significance of the Variability Analysis In the Overall Economic Framework

Witnesses Cohen and Stralberg both agree that, based on the results of Dr. Bradley's empirical analysis, the Postal Service is proposing to treat measured portions of each cost pool as non-volume variable, and both support this portion of the integrated new methodology. Mr. Stralberg states:

> Besides being intuitively obvious, this [i.e., mail processing cost variability of less than 100 percent] is confirmed by the considerable slack time in mail processing evidenced by the large and fast growing pool of break time and other general overhead "not handling" costs identified in the IOCS.

Tr. 28/13817. Yet witness Stralberg proposes to enlarge the portion of non-volume variable costs even further:

> The evidence Degen presents to link mixed mail and not handling costs to specific subclasses and special services is so weak that I recommend the Commission consider treating, at least in this docket, even some volume variable costs as institutional.

Tr. 28/818. Later, also on the topic of not-handling costs, Mr. Stralberg also states:

> The existence of such large and still growing not handling costs unrelated to specific productive activities is clear evidence of considerable slack time in the postal system, reflecting an inability of USPS managers to manage their workforce efficiently in the automated environment. It also constitutes an independent verification of Bradley's conclusion that mail processing costs cannot be 100% volume variable,

> since a significant volume increase would (or at least should) provide the Postal Service with an opportunity to get more work out of its existing workforce, rather than just hiring more employees. . . . [T]he Commission should seriously consider treating even the volume variable portion of these costs as institutional, until such time as the Postal Service produces convincing evidence linking them to specific subclasses and special services and explaining satisfactorily why these costs have grown so much in the past ten years.

Tr. 28/13849-50.

After also praising the Bradley variability analysis, witness Cohen makes very similar remarks regarding the institutionalization of some portion of volume-variable costs:

> First, for mixed- and not-handling tallies, there is very limited information available to establish a causal link between these costs and individual classes or subclasses of mail. Second, if mail processing costs are inflated due to inefficiency in mail processing operations, no class or subclass should be held responsible for the portion of these costs resulting from this inefficiency.

Tr. 28/14058. Yet Ms. Cohen also acknowledges the primary difficulty inherent in her proposal:

> However, developing an estimate of the inefficient portion of volume-variable mixed-mail and not-handling costs is not a simple matter. There is limited information available in this case to precisely quantify the inefficient portion of these cost categories.

Tr. 28/14060.

In fact, however, there is no need to become entangled in the bramble bush into which pursuit of witness Cohen's quest for identifying costs as "inefficient" would inevitably lead us. Prof. Panzar addressed this matter squarely in his direct testimony:

> However, it is important to realize that it is not necessary to assume

> perfect cost efficiency to apply the methodology being developed here to the calculation of Postal Service marginal costs. Nor is it necessary to assume that the Postal Service is perfectly cost efficient for pricing analysis to be meaningful. . . . [T]he efficiency of the Postal Service operating plan is not an issue for the analyst. **As long as it is given that postal services will be produced following Postal Service practices and procedures, the relevant marginal and incremental costs for pricing purposes are those calculated based on the Postal Service operating plan.**

USPS-T-11 at 16, 17 (Emphasis in original). This has been restated as the "actual marginal cost" standard -- "One should attempt to base prices on the marginal costs that will actually be incurred by the firm to serve a sustained increase in volume over the time period during which the prices will be in effect." Tr. 9/4636, 11/5417-18.

As discussed above at some length in the context of the integrated framework, between Dr. Bradley and Mr. Degen, the Postal Service has measured the actual marginal cost by subclass in each cost pool. More specifically, Prof. Bradley has econometrically estimated, for each cost pool, the rate at which the total costs in the cost pool actually vary with changes in the cost driver. His analysis included all costs in the pool, whether they be associated with activities that would be recorded in IOCS as direct tallies, mixed-mail tallies, or not-handling tallies.[65]

The variability analysis identifies the causal link between the cost driver and all costs in the cost pool, and it explicitly answers the question as to what will be the total level of additional costs incurred by the Postal Service to serve a sustained increase in the cost drivers. To the extent that witness Degen has accurately identified the proportion of the cost drivers in each pool associated with each

[65] Ms. Cohen effectively conceded this point during hearings. Tr. 36/19268.

subclass, he and Dr. Bradley have done everything that needs to be done to associate all volume variable costs in the pool with the subclasses that cause them. USPS-RT-7 at 11-12. In the context of the two-step analysis presented by the Postal Service, witnesses Stralberg and Cohen are in error to suggest that the requisite causal link established for mixed-mail or not-handling tallies is any weaker than the causal link established for direct tallies.[66]

---

[66] Of course, outside the context of the Postal Service's integrated two-step analysis, their arguments regarding causal links would carry much more weight. It is considerably more difficult to relate the concept of "actual marginal cost" to an untested assumption of expected cost causation than to an empirical measurement of causation using historically observed operating data. Without a supporting variability analysis, distribution of all accrued costs in a cost pool on the basis of the subclass tallies identified in that cost pool (as, for example, witness Sellick proposes) reduces to a mere postulation that because those tallies are there, the subclasses must cause those costs. In this context, the issues raised by witnesses Stralberg, Cohen, Buc, etc., are much more troubling.

With a direct measurement of cost pool variability, actual marginal costs can be identified, and the question of whether or not those costs might be lower with a more efficient management structure becomes irrelevant for ratemaking purposes (unless some discernible change in management structure is reasonably anticipated). Of course, witness Degen argues that intervenors have not shown that the existing management structure is inefficient, and that conditions such as varying rates of not-handling tallies across cross pools are functions of the differences in the nature of the activities in cost pools, and not manifestations of inefficiencies. USPS-RT-6 at 20-23. Yet it is those same differences in the nature of activities across cost pools that also leads Mr. Degen to expect that variabilities will differ across cost pools as well. Id. at 22. There is strong evidence that mail processing costs do not vary proportionally with volume. For purposes of calculating actual marginal costs, it is irrelevant whether variabilities of less than 100 percent are due to the nature of specific operations, or inefficiency. But to assume 100 percent variability, the Commission must reject Dr. Bradley's analysis and present some other explanation for all the perceived inefficiencies identified by the intervenors. Without a direct measure of variability, the presence of potential inefficiencies becomes critical to the issue of causation. When the need is to know actual marginal cost, merely assuming that there "should be" direct proportionality between hours and handlings does not get you over this hurdle.

Therefore, as both Dr. Christensen and Mr. Degen testify on rebuttal, the proposals of witnesses Cohen and Stralberg to treat a portion of what Dr. Bradley has found to be variable costs as institutional costs should be rejected. Mr. Degen correctly observes that to use Dr. Bradley's results, yet subsequently still treat some variable costs as institutional, would be tantamount to double-counting. USPS-RT-6 at 21-22. Dr. Christensen testifies that, in fact, there is no economic basis to do so. USPS-RT-7 at 11-12. Witnesses Cohen and Stralberg simply fail to recognize that because Dr. Bradley's analysis has already identified the actual level of variability in each cost pool, any attempt to treat more costs as non-variable would be incorrect.

vi. UPS witness Sellick's proposed application of the new distribution methodology is inappropriate without a consistent theory of cost causality

In this case, UPS witness Sellick (UPS-T-2, UPS-ST-2, and UPS-RT-1) presents distributed mail processing costs that he represents as based on Mr. Degen's distribution key method (with modifications he describes as "minor"), while returning to "the historical attribution level of mail processing costs." Mr. Sellick's "minor" modifications are intended to identify costs, treated as mail processing under Mr. Degen's analysis, that historically had been associated with the fixed mail processing, window service and administrative components. Tr. 26/14171-2. Mr. Sellick derives his variability assumptions from Dr. Neels' recommendation that the Commission reject all available econometric variability analyses and revert to the

traditional assumptions. Tr. 26/14162; Tr. 28/15633.[67]

Mr. Sellick correctly identifies the mixed-mail redistribution process as the essentially mechanical procedure of estimating the unknown subclass distribution of certain categories of mail observations in IOCS. Tr. 26/14171. The underlying true subclass distributions obviously depend on the types of mailpieces actually contained in the corresponding items and containers, and not on economic causality relationships. To the extent that Mr. Sellick's testimony restates some of the advantages of the new distribution methodology when applied in the context of the Postal Service's comprehensive and integrated economic framework, it provides useful support for the work of Mr. Degen.

However, Mr. Sellick's proposal specifically applies the Postal Service's cost distribution methodology outside its economic framework. In particular, he wishes to gloss over the need for an analysis of causality at the MODS cost pool level, while performing a distribution analysis that relies on strong assumptions on causality patterns that are inconsistent with traditional assumptions and are flatly contradicted by the empirical evidence on this record. USPS-RT-7 at 8. This is inappropriate, and the result of Mr. Sellick's analysis is a set of mail processing costs by subclass that

---

[67] Although Dr. Neels provides some alternative variabilities, he disavows their use. Tr. 28/15633. Moreover, even Dr. Neels could not seriously claim that these alternative variabilities provide anything other than, at most, very weak and very indirect support for his ultimate recommendation to return to an aggregate variability level of 100 percent. His Table 1 results range from a high of 159 percent to a low of 45 percent. In fact, of the 23 variabilities presented in that Table, only 1 of 23 falls between 95 and 105 percent, only 4 of 23 fall between 90 and 110 percent (of which two are actually at 110, and a third is at 109), and only 5 of 23 fall between 85 percent and 115 percent. Tr. 28/15593.

lack the causality required by the Postal Reorganization Act.

Mr. Sellick took some pains to restore the former level of mail processing variability, to the point of quibbling with a Postal Service analysis over the treatment of specific activity codes that were associated with the fixed mail processing component in the FY 1996 CRA. Tr. 26/14186. However, Mr. Sellick's distribution of not-handling costs within MODS cost pools flouts the traditional approach of spreading those broadly, over cost pools based on basic function. Tr. 36/19287. The historical causality assumptions for not-handling costs do not confine them to the MODS cost pools in which they occur.

While the historical assumption was that mail processing labor costs were essentially 100 percent volume-variable overall, there was no assumption that "not-handling" costs were caused by mail handlings in the same (MODS) operation. Not-handling costs classified in the direct labor component were assumed to be caused by handlings in all operations present in each "basic function" cost pool. Variable overhead costs were not assumed to be causally related to any specific mail processing operations, but rather variable with direct mail processing as a whole. Tr. 36/19399. Since Mr. Sellick's approach assumes all costs, except the small portion identified as fixed, are causally related to handlings within each (MODS) cost pool, he is actually employing causality assumptions that are radically different from the traditional method.

While this may appear to be a minor point, it is not. The proportions of not-handling tallies, like the proportions of non-variable costs estimated by Dr. Bradley,

differ significantly across cost pools. The subclass distributions of mail being handled also differ significantly across cost pools. This means that the distribution of all costs within a MODS pool, including not handling costs, will result in a very different distribution of not handling costs than would result from application of the traditional approach. Tr. 36/19219. Mr. Sellick cannot validly claim that his method relies on the traditional attribution assumptions. To do so, he would have to remove not-handling costs from each MODS pool and distribute them over broader cost pools, such as those employed in the LIOCATT method.

Instead, Mr. Sellick believes that there are no causality issues involved in the treatment of not-handling costs, including the costs traditionally identified as mail processing variable overhead. Tr. 26/14171. Insofar as the overhead component in the FY 1996 CRA is some five times larger than the fixed component ($2,848 million vs. $552 million), it is far from obvious that Mr. Sellick's omission is trivial.

Furthermore, a cursory glance at the testimonies of Dr. Bradley, Mr. Buc, Dr. Christensen, Ms. Cohen, Mr. Degen, Mr. Higgins, Dr. Shew, Mr. Stralberg, and Dr. Ying would suffice to indicate that full attribution of costs to the subclasses handled within cost pools is highly controversial as a general matter. As Dr. Christensen indicated, even though Mr. Sellick rejects Dr. Bradley's framework through his association with Dr. Neels' analysis, Mr. Sellick is nonetheless highly dependent on Dr. Bradley's framework to justify his distribution of all non-fixed costs by cost pool. Tr. 34/18224. This internal contradiction undermines the economic basis for Mr. Sellick's cost estimates. Id.

Since the MODS-based cost pools are new to this proceeding, it is clear that Mr. Sellick's strong assumptions regarding cost causality were never contemplated, much less adopted, in previous proceedings.[68] Moreover, there is absolutely no econometric support on this record, including the alternative analyses performed by Dr. Neels and the analyses responsive to NOI No. 4, for Mr. Sellick's assumption that every cost pool has essentially the same (near-100 percent) variability. As stated by witness Degen, differences in the activities performed in the various cost pools make it unreasonable to expect that variabilities would be the same for all cost pools. USPS-RT-6 at 22.

Mr. Sellick is proposing to distribute all costs in each cost pool on the basis of the handlings within that cost pool, yet he lacks any econometric basis deemed reliable by his colleague Dr. Neels to assert that handlings in the cost pool actually cause all of the costs in the cost pool.[69] Tr. 36/19224. Mr. Sellick is omitting a

---

[68] Not only are the MODS-based cost pools new, but many of the them include mechanized or automated operations that did not exist when the basic assumptions of the old methodology were instituted.

[69] There is also another tension between the testimonies of Dr. Neels and Mr. Sellick. Dr. Neels is highly critical of Dr. Bradley's use of MODS data in his analysis, citing an Inspection Service report relating to those data. See Tr. 28/15601-02. Dr. Neels is unpersuaded by Dr. Bradley's explanation of why any potential impact on his conclusions is minimal. Id. (In fact, as explained in Dr. Bradley's rebuttal testimony and addressed elsewhere in this brief, it is Dr. Neels whose analysis of this issue is flawed.) Mr. Sellick, however, is perfectly willing to consider Mr. Degen's explanation of why other MODS data are reliable as "adequate." Tr. 26/14171. Yet during a hearing convened expressly to address MODS data and the Inspection Service audit reports, Mr. Degen also stated his views as to why the MODS piece data that Dr. Neels questioned were also adequate for use in Dr. Bradley's analysis. E.g., Tr. 18/8291, 8299, 8338, 8342-43, 8351, 8359. Mr. Sellick makes no attempt to distinguish why Mr. Degen's comfort with use of one type of MODS data is sufficient,

critical step from the appropriate economic framework. As Dr. Bradley stated in his direct testimony, the Postal Service's analysis was undertaken in response to broad concerns raised by the Commission in Docket No. R94-1 regarding the continued viability of the previous IOCS-based allocations in the context of a changing operational environment. USPS-T-14 at 4. If Mr. Sellick agrees with Dr. Neels that Dr. Bradley's research is not helpful, Mr. Sellick should have undertaken some other means by which to address the Commission's concerns. Instead, he is proposing to take an assumption which was questioned before, and extend it in an entirely new context. Mr. Sellick's distributions are wrong, not only because Dr. Bradley's variabilities should be adopted, but also because, even if they are not, no adequate substitutes exist to take their place within the economic framework upon which the distribution methodology is grounded. Mr. Sellick must provide some justification for the causality assumptions which underlie his distributions before the Commission could give any weight to his proposal.

3. ANM's theories on Nonprofit Standard (A) costs are not compelling

Dr. John Haldi, testifying on behalf of the Alliance of Nonprofit Mailers (ANM-T-1), posits several theories for what he views as "the unusually large increase in the average cost of nonprofit non-ECR mail." Tr. 22/11774. He lays the cost increase on

---

while Mr. Degen's comfort with another type of MODS data is not sufficient. In fact, as Mr. Degen explained, while no data system is perfect, the ability of Dr. Bradley's analysis to successfully model the relationship between MODS hours data and MODS TPH data across a wide range of operations and facilities is itself a validation of the intrinsic reliability of the MODS data as used by Dr. Bradley.

the door of one or more of four conceivable causes. First, he touches upon the "automation refugee" issue that has been the province of Time Warner witness Stralberg (TW-T-1) for the past few Postal Rate Commission proceedings. Dr. Haldi next offers criticisms of the Postal Service's Transportation Cost System (TRACS), to conclude that the system mistakenly misattributes transportation costs to nonprofit mail.[70] Additionally, Dr. Haldi points to some IOCS tallies that reflect unexpected weight results, and concludes that these tallies "cast doubt upon the integrity" of the IOCS. Tr. 22/11775. Finally, he describes a theory that discord between the Postal Service's volume and cost systems results in unit costs for nonprofit Standard (A) regular mail that are inappropriately high. Dr. Haldi's musings should not be seriously considered.

a. Dr. Haldi's commentary on anomalous IOCS weights does not stand up to alternative explanations.

It is Dr. Haldi's observation that, of the 2,632 tallies recorded for Nonprofit Standard Mail (A) Regular tallies, seven record a weight greater than 16 ounces, the maximum weight permitted for Standard (A) mail. Tr. 22/11801. He also identifies tallies whose recorded weight is between half of a pound and 16 ounces, and uses these weight results to argue that "misidentification of nonprofit mail is occurring." Tr. 22/11802, and that, generally, the IOCS is producing "obvious garbage." Tr. 22/11875.

The gist of ANM's argument appears to be that the unusual weights must be

[70] These issues are discussed in the portions of this brief that address other mail processing issues and purchased transportation costing issues, respectively.

the fault of IOCS data collectors recording the wrong subclass for the piece sampled. Because of his understanding that "recording weight is a relatively simple and straightforward task," Tr. 22/11875, and that IOCS CODES procedures would require the data collector to make *two* erroneous entries in order to misidentify weight, *id.*, he finds it unlikely that an error could have been made regarding the weight of the pieces in question, as opposed to an error made recording the subclass. *Id.*

However , Dr. Haldi later conceded that an error in recording weight was not nearly as inconceivable as he had initially contended. He agreed that a data collector only needed to err in one field within the CODES software in order to record, say, a six ounce piece as a six pound piece. Tr. 22/11904. In contrast, Dr. Haldi acknowledged that, in order for a data collector to misclassify a piece of Standard (A) commercial mail as Standard (A) nonprofit, he or she would need to go through three separate entries in CODES, Tr. 22/11905, and that a piece on which the data collector does not specifically note nonprofit indicia, Standard (A) IOCS tallies receive Standard (A) commercial activity codes. *Id.*

Moreover, Dr. Haldi confirms the possibility that some of his inconsistent tallies are not the result of inaccurate data recording, but may have correctly measured the weight of a piece that actually weighed more than the 16 ounce limit on Standard (A) mail, but which had been improperly entered. Tr. 22/11902.

Dr. Haldi does not maintain that the Postal Service uses the IOCS-recorded weight of a piece in computing its costs. Tr. 22/11839. He also confirms the likelihood that the weight distribution of Standard (A) nonprofit tallies is consistent

with an average weight per piece of 1.1 ounces. Tr. 22/11877. He simply has not supported his claim that the weight information about which he complains constitutes support for his theory that the IOCS results which measure costs are not reliable.

b. Dr. Haldi's alleges discord between the Postal Service's data collection systems.

Another of witness Haldi's hypotheses for the cost behavior of nonprofit Standard (A) mail is that, because Postal Service volume and revenue data are recorded in a separate system (the Revenue, Pieces and Weights system), than processing cost data (which is measured by the In-Office Cost System), the possibility exists for volumes of mail and their corresponding costs to fail to match. He warns that an IOCS data collector recording information for a piece of mail marked with nonprofit indicia is unable to determine whether that mailpiece was truly entered at rates corresponding to its indicia. Tr. 22/11806. Dr. Haldi claims that these circumstances lead to problems with cost estimation: a subclass that is credited with volumes but without corresponding IOCS tallies will have a lower unit cost than it should, while the subclass assigned costs (IOCS tallies) without having the corresponding volumes attributed to it will have a higher unit cost than it should. Tr. 22/11806.

Witness Haldi states that there are three conditions under which mail volumes are recorded as regular Standard (A), but the corresponding IOCS tallies would be recorded as nonprofit Standard (A). First, various mailings by nonprofit organizations have been assessed the difference between the nonprofit rates at which the mail was originally sent, and the regular rate postage subsequently ruled applicable. Tr.

22/11808-09. This mail would bear nonprofit indicia, but, according to witness Haldi, it would be recorded as regular rate volume, if a revised or amended Form 3602 were filed. Tr. 22/11809. In this instance, he hypothesized that the costs of this mail would have been charged to nonprofit Standard (A) mail, but the volume credited to regular Standard (A) rate mail. Tr. 22/11810.

In the second instance discussed by Dr. Haldi, a nonprofit organization prepares a mailing using nonprofit indicia, but the Postal Service requires payment of the regular Standard (A) rates before allowing the mail to be entered. Tr. 22/11810. He claims that a revised 3602 form would be filled out, and so volumes and revenue for this mail would be attributed to regular Standard (A) mail, while any corresponding IOCS tallies would be recorded as nonprofit Standard (A) mail, because of the indicia on the mailpiece. *Id.*

In the third instance examined by witness Haldi, nonprofit organizations enter certain mail at regular Standard (A) rates because they are aware that certain types of solicitations are not eligible for nonprofit rates, *id.*, but these pieces may have nonprofit indicia on them. Tr. 22/11811.

Witness Haldi states that the resulting "non-synchronization" between costs and volumes for nonprofit Standard (A) mail was a result of "rigorous" enforcement of new regulation concerning eligibility for nonprofit Standard (A) mail beginning in the base year. Tr. 22/11808. As evidence of this rigorous enforcement of the new regulations, witness Haldi cites 79 Revenue Investigations against nonprofit organizations from October 1, 1996 to March 31, 1997, reported by the USPS

Inspector General.[71] *Id.*

To support the hypothesis that an increase in nonprofit Standard (A) mail unit costs had resulted from revenue and cost data being "out of sync," the Alliance of Nonprofit Mailers undertook a survey of nonprofit organizations ("ANM Survey"). Tr. 22/11811. This survey, conducted in December 1997, was sent to over 700 "Members and Friends of the Alliance of Nonprofit Mailers." Tr. 22/11832-33, 11893-94. The survey asked for the respondents to report volumes entered at commercial rates, and what indicia were used on these mailings, as well as for volumes entered at nonprofit rates, but which were subsequently ruled ineligible for nonprofit rates and therefore sent at regular rates. Tr. 22/11833-34. Of the 108 responses reported in the revised Exhibit 1, ANM-T-1, Tr. 22/11827-30, witness Haldi reported that 78 respondents related mailing at commercial rates with nonprofit evidence of indicia or with mailing entered at nonprofit rates but which were subsequently assessed regular rates. Tr. 22/11812. The ANM survey results purport to show that 1.66 million pieces of mail were originally sent at regular rate, but entered with nonprofit indicia, while 9.2 million pieces were originally entered at nonprofit rates, but regular rates were later assessed. Tr. 22/11883. Dr. Haldi's testimony claims that the results of the survey indicate that the phenomenon of using nonprofit indicia on regular Standard (A) mail is widespread, because the responses came from all major geographic areas. Tr. 22/11812.

---

[71] Dr. Haldi admitted during oral cross examination that this was not, in fact, the number of revenue investigations that took place during the base year, Tr. 22/11891, and stated that he was not aware of what that figure might be. *Id.*

In order to develop an estimate of the degree to which nonprofit costs may therefore be overestimated, witness Haldi estimates the volume of Standard (A) mail with nonprofit evidencing of postage paid for base year FY96. Tr. 22/11813-14. He applies the growth rate for nonprofit mail over the 12-year period from 1980 to 1992 to 1992 volumes, to extrapolate an estimate of 1996 volumes. Tr. 22/11813. Using his "conservative" estimate that two-thirds of all mail entered by nonprofit organizations at commercial rates has nonprofit indicia, he determines that 1,040 million pieces fall under this category. Tr. 22/11813. Given that the volume of nonprofit mail in 1996 was 12,209 million pieces, Tr. 22/11813-14, witness Haldi estimates that 7.85 percent of all mail with nonprofit "evidencing of postage" were entered at the commercial rate. Tr. 22/11814. Dr. Haldi claims that, since the IOCS is a random sample, "it is reasonable to infer that 7.85 percent of all valid mail processing tallies, as well as the mail processing costs arising from those tallies, have been incorrectly attributed to nonprofit mail," Tr. 22/11814, and therefore the Commission should adjust mail processing costs, including piggybacks, attributed to nonprofit Standard (A) mail accordingly. *Id.*

i. The bases for Dr. Haldi's conclusions are an ill-founded survey and speculative volume assessments.

Central to witness Haldi's arguments are the results of the ANM Survey. The survey is flawed on numerous accounts, and its results cannot be relied upon to make inferences on the universe of nonprofit mailers. In addition, Dr. Haldi's base year estimate of the volume of Standard (A) mail with nonprofit evidencing of postage

paid is insupportable. Because of these failures in his analysis, Dr. Haldi's estimate that 7.85 percent of mail processing costs have been incorrectly attributed to nonprofit mail is unreliable. Witness Haldi has therefore failed to show that any mismatch between volumes and cost tallies have resulted in an overestimate of nonprofit costs.

(a) The ANM survey methodology virtually guarantees biased results.

The first and most significant flaw in the ANM Survey was that the respondents have not been shown to be representative of the universe of nonprofit mailers, although Dr. Haldi freely uses the survey's results to reach conclusions about them. The *universe for the ANM survey* was "members and friends" of ANM. Tr. 22/11833. Neither ANM nor witness Haldi determined how representative these "members and friends" are to the *universe of all nonprofit mailers*. In fact, he stated that "we did not construct a universe and then sample the universe," Tr. 22/11894, and he further admits that "[f]or a fully representative survey, one would need a random sample of the entire universe of mailers that entered mail at nonprofit rates in FY1996." Tr. 30/16410. Witness Haldi does not know how many organizations were actually surveyed, beyond knowing that "over 700" organizations were sent the survey. Tr. 22/11869 and 11893. No effort was made to follow up on nonrespondents. Tr. 30/16410. At most only 108 organizations responded, Tr. 22/11894, and so the response rate was at most only 15 percent. Tr. 36/19597. This response rate is considerably lower than what is generally considered to be necessary to produce statistically valid estimates. *Id.* There was no analysis reported by ANM on how

representative the respondents were of even the organizations surveyed, let alone of the universe of nonprofit mailers. Tr. 36/19598. Providing such analysis is considered standard in survey research, especially in cases with mail (i.e., facsimile) survey, and especially in cases of self-reported surveys with such a low response rate. Tr. 36/19597-98.

Another flaw in the ANM survey methodology relates to the design of the survey form itself. For sample instrument design, the proper technique is to draft the survey form so as not to divulge the underlying result wanted, if any, in an effort to elicit unbiased and representative responses. Tr. 36/19596. The first paragraph of the memo to ANM members that constitutes the survey form includes the following warning: "the ongoing postal rate case litigation before the Postal Rate Commission threatens to hit nonprofit Standard (A) mailers with substantial increases...could be as high as 15-18 %." Tr. 22/11833. In the second paragraph, it exhorts the recipient to act "[I]In order to best protect your interests and the interests of your colleagues in this critical coalition..." *Id.* A member of ANM receiving this survey, and not having had any mailings that were disqualified for nonprofit rates, would, quite logically, be likely to perceive that it is not in the best interests of ANM for them to report "negative" results, and so would be disinclined even to respond to the survey. Tr. 36/19596.

Witness Haldi's claim that the fact that responses came from all major geographic areas indicates that the phenomenon of using nonprofit evidencing on Standard (A) mail is widespread, Tr. 22/11812, is not justified. Geographic dispersion

of a phenomenon does not imply magnitude of that phenomenon. Tr. 36/19597. In addition, for this circumstance, the universe of originating nonprofit mail is not geographically disperse, since many nonprofit organizations use mailing houses and large printing firms concentrated in the Midwest and East. Tr. 36/19598. There is no *a priori* reason to believe that acceptance and accounting procedures vary across facilities in the Postal Service, as these practices are governed by national rules. Tr. 36/19598.

ii. The ANM survey responses cannot be used to make inferences on the degree to which inconsistencies between volume and cost data systems affect nonprofit costs.

Because the ANM survey results were neither generated from a random sample of nonprofit mailers, nor developed from a survey designed using supportable statistical methodology, they cannot be used to develop inferences on the population of nonprofit mail as a whole.

An analysis of the survey responses provided by ANM in ANM-LR-1 was performed by Postal Service witness Schenk (USPS-RT-22, Appendix A; Tr. 36/19599). She found a number of instances where responses on the ANM survey forms were misinterpreted or recorded incorrectly. Tr. 36/19600. Two different survey forms, with differently-worded questions, were used, yet the data were compiled into one set of results. Tr. 36/19599. In addition, a number of survey forms were marked with two response numbers on a single response form, indicating that the (already very low) response rate reported by ANM was probably overstated. Tr. 36/19600.

In addition, the ANM survey responses do not indicate how the volumes for the mailing reported were recorded in Postal Service databases. Tr. 36/19595. Witness Haldi thus bases his conclusions as to how volume for the mailings in question are recorded on speculation. His analysis amounts to speculation based on speculation, and therefore his conclusion that nonprofit costs must be adjusted to reflect this speculation is unfounded.

Witness Haldi estimates that two thirds of all mail entered at commercial rate had nonprofit evidencing of postage paid, and derives this estimate exclusively from his reliance on the ANM survey. Tr. 22/11862. Given the many problems with that survey's methodology, his characterization of his estimate as conservative, *id.,* is unfounded. In fact, considering the potential for response bias, the true value is likely to be considerably less than two-thirds.

iii. Witness Haldi's volume estimation methodology is flawed, and overestimates the volumes of mail affected by "mismatching."

Dr. Haldi overestimates the volume of Standard (A) mail bearing nonprofit evidencing of postage paid in the base year, and therefore his estimate of the degree to which nonprofit costs are overstated is too high. Witness Haldi claims that some of the growth in commercial rate mail is due to nonprofit organizations entering mail at the commercial rate, in spite of the fact that witness Haldi's own table shows that regular third-class bulk mail volumes increased by only 1.07 percent from 1995 to 1996, Tr. 22/11815, which is the time period during which he claims that "rigorous" enforcement of regulations concerning the content of nonprofit mail lead to volumes

and costs being "out of sync." Tr. 22/11808.

Witness Haldi estimates 1996 nonprofit Standard (A) volumes, by applying the growth rate in nonprofit Standard (A) mail over the period 1980 to 1992 to the 1992 volumes. Tr. 22/11813. He does this even though the growth rate over the period 1980 to 1992 (3.5 percent annual compound rate, Tr. 22/11813) was higher than the growth rate between 1992 and 1995 (when nonprofit volumes fell in two of those years, Tr. 22/11815). Even Dr. Haldi admits the difference in growth rates. Tr. 22/11812. His estimated growth rate is an extrapolation, Tr. 22/11899; which is particularly inappropriate in this case because of the changes in the time series behavior of nonprofit volumes. Therefore, witness Haldi's estimate cannot fail to overstate the volumes sent at regular rates with nonprofit indicia.

iv. The Postal Service's investigation of the inconsistency between volumes and costs for nonprofit Standard (A) mail found that the true rate of inconsistency was much lower than opined by ANM.

In response to witness Haldi's theory on the high incidence of inconsistency between nonprofit Standard (A) volume and cost data, the Postal Service undertook as thorough an investigation of the situation as was possible given the time constraints imposed by filing deadlines for rebuttal testimony. This investigation, reported in the testimony of witness Schenk (USPS-RT-22), involved the use of national data systems, as well as data collected in a survey of thirty representative postal facilities.

(a) PERMIT and accounting data show that the incidence of mail entered at nonprofit rates, but later assessed regular Standard (A) rates, is infrequent, and does not necessarily lead to inconsistency between volume and cost data systems.

Nonprofit mailings can be disqualified for nonprofit rates after acceptance, if a determination is made that the mail contents did not follow the official guidelines for nonprofit mailings. These instances are infrequent in occurrence, and do not result in a discrepancy between volume and cost data. Tr. 36/19602.

When a nonprofit mailing is disqualified after acceptance, a revenue deficiency (the difference between revenues under regular and nonprofit rates) is identified. When a revenue deficiency is identified, the official USPS accounting procedure is to record the deficient amount in revenue account 41511, Revenue Postage Other (AIC 119, "Revenue Deficiency Found"), with an offset to an Accounts Receivable, general ledger account 13412 (AIC 814, "Suspense"). Tr. 36/19602.

Any revenue deficiencies recorded in AIC 119 are not also recorded into a PERMIT system revenue account. *Id.* There is no shifting of volumes between nonprofit and regular rate categories when the revenue deficiency is recorded in AIC 119; the original nonprofit volume entry in PERMIT is not changed. *Id.* The disqualified nonprofit mail volumes remain in the Postal Service volume and revenue systems as originally recorded in PERMIT (i.e., as nonprofit Standard (A)), which is how the pieces for that mailing were endorsed. Tr. 36/19602-03.

Revenue deficiencies recorded in AIC 119 include those for mailings identified in Postal Inspection Service Revenue Investigations. Therefore, the revenue

deficiencies identified in the 79 Revenue Investigations cited by witness Haldi, Tr. 22/11808, would be recorded in AIC 119, and would not result in any inconsistency between volume and cost data. Tr. 36/19603-04.

Witness Schenk also identified another accounting procedure used on rare occasions for accounting for a disqualified nonprofit transaction. In some cases, the original PERMIT entry is netted out, and the same volumes (but at the regular rate) will be recorded in PERMIT under a Form 3602-R. Tr. 36/19604. This procedure is sometimes known as a "reversal." *Id.* From PERMIT system transaction-level data, witness Schenk determined that 6.1 million pieces were moved from nonprofit to regular rate in FY96. *Id.* Given that the most common (and intended) use of the reversal procedure is to correct for data entry errors, the estimate of the percentage of nonprofit volumes that are switched to regular rate after disqualification is considerably less than 6.1 million pieces. Tr. 36/19604-05.

(b) The Postal Service's survey results show that the incidence of mail with nonprofit indicia paying regular rates at acceptance is minimal.

In order to respond to witness Haldi's allegations regarding the amount of mail entered at commercial rates with nonprofit indicia, a qualitative survey was conducted at 30 randomly selected sites to determine the magnitude of this phenomenon. Tr. 36/19605. Where possible, contacts at each of the sites were asked to provide data on volumes of mail sent at regular rates with nonprofit indicia as noted by entries in acceptance logs. These volumes included both mail initially entered by the mailer at regular rates with nonprofit indicia, or mail ruled ineligible for nonprofit rates during

the acceptance procedure. In cases where acceptance logs could not be located or were no longer available, knowledgeable contacts were asked to estimate the number of mailings sent at commercial rates with nonprofit indicia during FY96, and the associated volumes or postage due.[72]

From the survey results, witness Schenk estimates that 30.32 million pieces were entered at commercial rates but bore nonprofit indicia, or were ruled ineligible for nonprofit rates during acceptance in FY96. Tr. 36/19621. This represents only 0.4 percent of all nonprofit volume for FY96. Tr. 36/19606.

In general, when examining the results of surveys, there are several objective criteria that one can use to evaluate the reliability or credibility of the results. These criteria include: how the sample was drawn (e.g., is it representative of the population under study), how the study was conducted (e.g., how was nonresponse handled), and how the sample results were analyzed and inflated to the universe (e.g., were any assumptions used reasonable). In evaluating the survey conducted by witness Schenk, it can be seen that the sample sites were randomly chosen from the universe of all sites handling bulk nonprofit Standard (A) mail, that the response rate was high, and that the sample results were properly inflated to the universe. The methodology used for this survey lends credence to the estimates obtained. On the other hand, the ANM Survey used in witness Haldi's analysis was not drawn from the

[72] Given that new content-based restrictions on nonprofit mailings went into effect in 1996, this was a noteworthy period for business mail entry. The mailings that raised questions regarding their indicia also tended to be memorable for acceptance unit personnel, the acceptance process for such mailings would require extra steps.

universe of nonprofit mailer, had a low response rate, provided no analysis of the representativeness of the respondents, contained errors in the data reported, used two separate survey forms, and even had single survey responses with multiple survey numbers on them. In addition, witness Haldi used questionable assumptions in his expansion methodology. All these conditions indicate that the ANM Survey results are not credible, and cannot be used to evaluate the incidence of inconsistency between volume and cost data for nonprofit mail.

(c) PERMIT data show that there are volumes initially paying regular rates which later are assessed nonprofit rates.

In order to fully investigate the instances where the rates paid and markings on the mailpiece do not match for Standard (A) mail, witness Schenk also investigated the incidence of mail paying nonprofit rates with regular rate indicia. Tr. 36/19607. The only circumstance under which mail is allowed to have regular rate indicia but pay nonprofit rates is when the mail is sent pending approval or reapproval for nonprofit rates.[73] Tr. 36/19607. The Postal Service accounts for these transactions by originally entering them as regular rate volumes, and then when the nonprofit rate is approved, filing a reversal in PERMIT. In addition, when a mailing is disqualified for nonprofit rates during the acceptance process, but later ruled eligible on appeal, a reversal can be filed when the appeal is approved. Tr. 36/19607.

---

[73] In addition, when a mailing is disqualified for nonprofit rates during the acceptance process, but later ruled eligible on appeal, a reversal can be filed when the appeal is approved. In this case, however, the indicia and (eventual) volume data will both be nonprofit, and so no inconsistency between cost and volume data exists in these cases. Tr. 36/19607.

In FY96, the transaction-level PERMIT data shows that an estimated 12.9 million pieces were moved from regular rate to nonprofit. *Id.* Since some of these volumes had nonprofit indicia on them, the nonprofit costs would be underestimated. The volume of mail moved from regular rate to nonprofit in FY96 represents 0.1 percent of PFY nonprofit Standard (A) volume. Tr. 36/19609.

v. The Postal Service's investigation shows that witness Haldi's theory is not supportable, and *therefore that it does not support his claim that* nonprofit costs are overestimated.

Witness Schenk shows that, because of mail sent at regular rates but with nonprofit indicia, $0.006 billion of IOCS costs are attributed to nonprofit Standard (A) mail, but should be attributed to regular rate mail. Tr. 36/19608. But, witness Schenk also shows that $0.0002 billion in IOCS costs that should have been attributed to nonprofit Standard (A), were instead attributed to regular Standard (A) mail. Tr. 36/19609. The net effect is that $0.4 million of the IOCS costs attributed to nonprofit Standard (A) mail should have been attributed to regular Standard (A) mail in FY96. Tr. 36/19609. This net effect of $0.4 million represents only 0.18 percent of nonprofit Standard (A) IOCS costs, which were $0.228 billion for FY96. Tr. 36/19609. This contrasts with witness Haldi's estimate that nonprofit mail processing costs are *overestimated by 7.85 percent Tr. 22/11814.*

The 0.18 percent estimate developed by witness Schenk is based in part on national data systems, and in part on a representative sample of sites accepting bulk nonprofit Standard (A) mail. As such, this estimate of 0.18 percent is more credible that the estimate of 7.85 percent given by witness Haldi, Tr. 22/11814, which is

based on the ANM Survey, and which has been shown to have numerous flaws. Witness Haldi's 7.85 percent estimate is a gross exaggeration of the extent to which nonprofit volumes and costs may not be consistent. Because the degree to which nonprofit mail processing tallies are inconsistent with nonprofit volumes is much less significant than surmised by witness Haldi, his suggested adjustment to nonprofit costs is not warranted.

D. Witness Brehm Provides Updated Window Service Variabilities

Using the framework for analysis of window service cost variabilities adopted in Docket No. R90-1, witness Brehm estimates window service clerk cost variabilities based on three components: demand-side variability, supply-side variability, and network variability. Direct Testimony of Christopher S. Brehm on Behalf of United States Postal Service, USPS-T-21. Witness Brehm presents a new window service transaction time study, USPS-T-21 at 10, and uses its result to update the supply side variabilities. He then computes new variability factors for selling stamps, setting meters, weigh and rate transactions, Express Mail, and money orders. Because witness Brehm develops estimated supply-side variabilities, rather than assuming 100 percent variability as in the last two rate cases, his variability factors are generally lower than those adopted in Dockets No. R90-1 and R94-1. USPS-T-21 at 23.

The proposed variability estimates have not been opposed by any participant in this docket. The Postal Service urges the Commission to adopt them.

E. Improvements To City And Rural Carrier And Special Delivery Messenger Costing

The Postal Service in this case introduced a series of refinements designed to improve the accuracy of cost estimates in cost segments relating to city and rural delivery carrier costs, as well as special delivery messengers. The evidence of record supports adoption of these refinements.

1. The evidence of record confirms witness Baron's conclusion that prior treatments of coverage-related load time have overstated volume variable costs.

In this proceeding, Postal Service witness Baron significantly advanced the analysis of volume-variable load-time costs. His testimony provided a refined approach to the estimation of volume-variable load-time costs generated on city carrier letter routes, and demonstrated how these refinements lead to improved accuracy in estimation. USPS-T-17 at 5-42. Witness Baron also evaluated alternative methods of splitting accrued letter route running time cost into variable access costs and fixed route time costs, and demonstrated that a basic quadratic model produces the most accurate and sound results. *Id.* at 43-66. Mr. Baron also introduced improvements to rural carrier volume variability estimation procedures. *Id.* at 68-72.

Mr. Baron's testimony went essentially unrebutted in the direct cases of all intervenors. The only exception was the direct testimony of MPA witness Sander A. Glick, who identified what he believed to be an anomaly in the Postal Service's proposed methodology for distributing rural carrier costs, and suggested a means to correct the anomaly. Tr. 28/15478-86. The extent of the discrepancy identified by

witness Glick, however, was exceptionally small. His proposed correction would decrease Periodical rural carrier costs by $4.2 million. Id. at 15485.

Although no party had deemed it appropriate to rebut Mr. Baron's analysis of city delivery costs, the Commission sought to encourage such rebuttal. On January 12, 1998, the Commission, expressing concerns about the state of the record, issued Notice of Inquiry No. 3 concerning the changes that witness Baron proposed to the analysis of coverage-related load time. The NOI focussed on witness Baron's contention that the residue of cost that remains after deducting elemental load time costs from accrued load time costs cannot be associated exclusively with coverage and should not be used to analyze the variability of load time. The Commission first summarized Mr. Baron's three-step analysis of load-time variability. It observed that Mr. Baron first measures a "stops effect" equal to fixed time per stop, and that he deducts this fixed time from initial accrued load time. The Commission then claimed that Mr. Baron regresses the remaining load time on delivered volumes to determine "elemental load time," and that he further regresses this same remaining load time on possible deliveries to determine a "deliveries" coverage-related load time. Finally, the Commission proceeded, *sua sponte*, to raise questions regarding the validity of this interpretation of the Baron approach. The Commission solicited comments from the parties regarding three technical questions, and suggested that the parties refer to hypothetical delivery scenarios in responding to the NOI.

Only two responses were filed, one by the Postal Service, the other jointly by a group of parties consisting of AMMA, DMA, MOAA, Parcel Shippers Association and

Advo, Inc. ("Joint Parties"). In its Comments, the Postal Service raised a number of procedural concerns. The Postal Service was concerned that by issuing the NOI, the Commission could be viewed as signaling to parties who had foregone their rebuttal opportunity that the Commission, based upon its own extra-record review, considered certain aspects of the Postal Service's presentation to be questionable and that the Commission wished to promote the creation of evidence potentially in conflict with Mr. Baron's presentation. The Postal Service also stated that because of the limited time available (at this point, only two weeks remained before rebuttal testimony was to be filed), it would be difficult to subject the information being sought to the full adversarial testing required by the *MOAA* decision. *See Mail Order Ass'n of America v. United States Postal Service*, 2 F.3d 408, 430 (D.C. Cir. 1993).

In an effort to make as full a response as possible, however, the Postal Service submitted a Statement addressing the issues by its witness, Mr. Baron.[1] Mr. Baron's comments corrected inaccuracies in the Commission's representation of his approach. He observed first that the NOI mischaracterized his approach as defining the stops effect to include all time spent preparing to load mail. Mr. Baron noted that his direct testimony defines the stops effect as solely that pre-loading time which is fixed in length with respect to volume loaded and deliveries accessed. Mr. Baron's comments on NOI No. 3 observe further, again contrary to the Commission's representation, that the Baron approach does not estimate any regressions, but

[1] Consistent with its position that the required full adversarial testing likely would not be available, the Postal Service did not file its comments as testimony, nor did it seek to have the Statement admitted as evidence.

simply interprets the Commission's regressions as equations defining true load time as a function of volumes and deliveries. Mr. Baron also pointed out that the Commission appeared to be adopting a view of the "stops effects" at odds with its prior decisions. Mr. Baron noted that in prior cases, the Commission consistently defined the effect of going to a new actual stop as being invariant with respect to the amount and mix of volume delivered to that new stop. He noted further that in its NOI No. 3, the Commission now appeared to be allowing that effect to vary with volume. Mr. Baron then demonstrated that the Commission's concerns regarding the validity of his methods were misplaced, and could undermine the longstanding functional approach to analyzing load time. Response of United States Postal Service to Notice of Inquiry No. 3 on Coverage-Related Load Time (February 2, 1998), Tr. 29/16149-56.

The Joint Parties responded to the NOI with a proffer of new testimony by witness Antoinette Crowder, along with a request that procedures be adopted to facilitate admission in evidence of the Crowder testimony. In her testimony, witness Crowder agreed with witness Baron that the established method used by the Commission to analyze volume variable load time significantly overstates such load time. However, her reasoning differed from witness Baron's. First, she argued that the traditional approach of using a load time regression model to estimate elasticities is inconsistent with the use of a completely unrelated Street Time Survey (STS) data set to estimate the accrued load time to which those elasticities are applied. Tr. 29/16182-85. Contrasting LTV modeled elemental load time with STS-based

elemental load time, she found that the STS-based estimate is 47 percent higher than the LTV modeled load time. *Id.* She also found fault with witness Baron's interpretation of the stops and deliveries effects on load time, contending that all non-elemental load time should be considered variable to the same extent as accrued access time. She also argued that it is not necessary to estimate separately a deliveries variability for MDR and BAM stops. *Id.* at 16188-89.

Witness Crowder proposed an "integrated, internally consistent approach" developed from the LTV and CCS data which she contended is in some ways conceptually similar to the traditional approach taken by the Postal Service and the Commission in previous cases. The first step is to use the LTV models and base year CCS data to produce a total system-wide load time. She then used the LTV models specified with base year CCS data to develop "elemental or direct volume-variability." When multiplied by system-wide stop load time, a measure of elemental load time is produced. Finally, the residual of non-elemental load time is multiplied by a stops-coverage variability estimated from the actual stops models developed from base year CCS data. *Id.* at 16189-93. The end result is accrued load time and volume variability measures which are much lower than those produced by the methods used by the Commission in recent cases.

On February 4, 1998, the Presiding Officer ruled that both submissions made in response to NOI No. 3 would be received into evidence at a hearing to take place on March 2, 1998, one week before the scheduled filing of rebuttal testimony. An additional two weeks of discovery on the submissions was also allowed. Presiding

Officer's Ruling No. R97-1/95 (February 4, 1998).

Shortly after the hearing on the NOI submissions, rebuttal testimony on the same issues was filed by both the Postal Service and the Joint Parties. Witness Crowder did not address any of the points made by witness Baron in his response to NOI No. 3. In particular, she did not contradict Mr. Baron's argument that unless the increase in time resulting from a new actual stop is regarded as fixed with respect to volume, this stops effect is no longer a distinct, observable function requiring a separate, distinct measurement (such as the coverage-related load time measure) in the load-time analysis. Witness Crowder did, however, defend the mathematical validity of her system-wide accrued load-time equation, which she had used in her NOI 3 response to derive, mathematically, a definition of system-wide volume variable cost as equaling the sum of elemental and coverage-related load-time. This defense was made in reaction to witness Baron's response, a week earlier, to questioning from the Presiding Officer. In this response, Mr. Baron had asserted that the Crowder equations are mathematically invalid because they violate the rule that the expected value of the function $g(X)$ does not, in general, equal the value of g evaluated at the expected value of X. *See* Tr. 29/16166-68.

Witness Crowder also argued that, even if her equation defining system-wide accrued load time were mathematically flawed, a mismatch between STS-based load time and LTV model-based load time would still exist. Moreover, this mismatch, according to Ms. Crowder, requires either the use of LTV modeled load time as the correct measure of system-wide accrued cost, or a substantial downward adjustment

of the elasticities produced by the LTV model that are applied to the STS-based accrued load-time cost. Tr. 34/18355-56.

In his rebuttal, Postal Service witness Baron agreed that the discrepancy identified by witness Crowder between the LTV-model-based load time costs and the traditionally-used STS-based load time costs raises a serious issue, but withheld judgment regarding the potential superiority of a model-based cost estimate until sufficient time is available to evaluate the implications of using a model-based approach. Tr. 33/17725. He identified several concerns which must be resolved before model-based estimates of accrued costs can be employed with confidence. First, he contended that all ambiguity regarding the treatment of the excess of the STS-based costs over the modeled costs must be removed. Id. at 17726-30. Second, the question of whether and how the STS proportions defined for street-time activities other than load time should be used to estimate accrued costs for those activities must be explored and resolved. Id at 17730-32. Finally, the mathematical validity of the equation that defines system-wide accrued load time must be established. According to Mr. Baron, witness Crowder's derivation of her measure of system-wide volume-variable load-time costs rests on an incorrect assumption: that the average of load times over all system-wide actual stops (S) equals load time at a single stop that gets the average volume. This assumption, however, violates the well-known law of mathematics that if g is a nonlinear function of a random variable x, the average (expected) value of g does not equal the value of g evaluated at the average (expected) value of x. Id. at 17735-38.

Witness Baron also disputed witness Crowder's analysis of the deliveries effect. Ms. Crowder had argued that the positive effects on load time at multiple-delivery stops resulting from increases in actual deliveries caused by volume growth are already accounted for by the elasticities of load time with respect to the five volume variables. Ms. Crowder therefore concluded that Mr. Baron's addition of a distinct deliveries effect elasticity to the aggregate elasticity of load time with respect to the volume variables double counted the deliveries effect. She purported to prove this point by deriving a form of the equation for load time at a multiple delivery stop in which volume terms alone account for both the volume effect and the deliveries effect of volume growth on load time.

Mr. Baron identifies two incorrect assumptions on which the derivation of this form of the equation is based. The first assumption is that actual deliveries at a stop are strictly a function of volume at the stop, rather than a function of both volume and possible deliveries. The second is that the time taken to deliver mail pieces at one delivery is a simple linear function of total volume at that delivery. Mr. Baron concludes that the failure of both assumptions invalidates the Crowder form showing load time at a multiple delivery stop as a function of volume alone. Tr. 33/17739-43.

Witness Crowder responded to this critique in her answer to redirect examination from Mr. McLaughlin on March 18th. This oral-cross response was directed solely at Mr. Baron's statement of what he called the first assumption underlying her new load time form. In it, Ms. Crowder first stated that her direct testimony analysis did not, in fact, make this assumption. She asserted, in particular,

that her direct testimony did not define actual deliveries at the multiple delivery stop as being strictly a function of volume. Instead, argued Crowder, her equation for actual deliveries, $bv - cv^2$, where v is volume, picks up the effect of possible deliveries on actual deliveries through the b coefficient. Ms. Crowder claimed, further, that this possible deliveries effect "embedded in the b variable" shifts the actual deliveries curve ($bv - cv^2$) "up or down" as the number of possible deliveries increases or decreases. Tr. 34/18438-39.[2]

Regardless of the validity of Ms. Crowder's interpretation of her "b" parameter, witness Baron's rebuttal also shows that the Crowder approach conflicts with operational reality. He states that the simplified Crowder form of the equation for load time at a multiple delivery stop, unlike the Baron analysis, fails to account for the additional increase in load time that results when new volume is directed to previously uncovered delivery points, compared to when it goes into already-covered deliveries. Mr. Baron concludes that only his analysis directly accounts for the additional movement required to reach a new receptacle, and that it does so through an explicit inclusion of the actual deliveries effect. Id. at 17743.

Mr. Baron also addressed the testimony of MPA witness Glick. He

[2] Since the hearing schedule did not permit an opportunity to respond Ms. Crowder's argument that the parameter b in the actual deliveries function $D = bv - cv^2$ somehow embodies a possible deliveries shift effect, the Postal Service can only urge caution in evaluating such a claim. The mathematical issue, not explored on this record, is whether b, a slope coefficient, can account for the effect of a change in volume on deliveries for a given location of the actual deliveries (D) curve, or whether only an intercept term, which witness Crowder failed to include in her expression for D, would account for such a shifting effect.

acknowledged that Mr. Glick had indeed brought to light a minor error in the cost segment 10 workpapers. He showed, however, that Mr. Glick's proposed solution to the problem, however small in effect, was misdirected, in that it incorrectly focussed on the flats adjustment procedure. In actuality, the error occurred after the flats adjustment procedure was correctly performed, in that the remaining letters delivered pieces still included DPS and sector segment pieces, thereby causing errors in the cost distribution to the letters delivered category. Tr. 33/17753. Mr. Baron showed how the letters distribution key could be properly adjusted by removing DPS and sector segment pieces. The true correction raises Periodicals rural carrier cost in the base year by approximately $2 million. Id. at 17754-59.

Like a certain notorious weather pattern currently dwelling in the Pacific, the Commission's NOI No. 3 generated unusual and unexpected torrents in this case. The belated flood of testimony concerning the econometric methods used to estimate load time has called into question a number of proposed refinements to the methods used by the Commission in recent cases to estimate load time variabilities and accrued load time. It has also identified a potential mismatch between traditional STS-based costs, and LTV-based modeled load time costs.

While the time available in the case was not sufficient to permit a full airing of the technical and mathematical issues involved, several fundamental conclusions can be drawn from the debate. First, witness Baron has shown that the established methods used by the Commission produce overstated volume variable costs and should be revised. While witness Crowder disagrees in some respects with the

methods advanced by witness Baron to estimate these costs, and suggests refinements of her own, both witnesses offer evidence which demonstrates the over-attribution which would occur should the Commission continue to use the established method. The only issues are the extent of the overestimation and which set of refinements offers the best solution to the problem at this time.

While witness Crowder deserves credit for raising interesting issues surrounding the conflict between a model-based estimate of system-wide accrued load-time cost and the traditional STS-based estimate of accrued cost, the specific model-based approach she proposes has not been adequately explored. Moreover, it is sufficiently problematic from a mathematical standpoint that it should not be relied upon. As witness Baron has shown, the implications of using a model-based approach to estimating system-wide accrued load-time cost have not been sufficiently developed on this record. While it appears that a mismatch between the traditional STS-based costs and LTV-based modeled costs exists, it is unclear whether the problem rests with the STS data, the LTV data, with differences in cost definition between the two studies, or with some other factor not yet determined. Certainly the continued use of STS-based costs in analyzing city carrier street activities other than loading, such as street support, driving time, Route/Access FAT, Route/Access CAT and collection, has not been examined sufficiently on this record. See Tr. 33/17730-32. Far from offering a "consistent" or "integrated" approach, witness Crowder proposes to do away with the STS in one instance, but tacitly assumes that its purported defects would not prevent it from being used to analyze the other five

components of street-time cost: driving time, route/access FAT, route/access CAT, street support, and collections. Similarly, key assumptions employed by Ms. Crowder are clearly at odds with fundamental principals of mathematics, undermining the reliability of her proposed econometric refinements. Finally, witness Crowder has not presented a formulation of the excess of STS-based estimates over LTV-modeled costs which is operationally sensible. Until these issues are resolved, the Crowder testimony should be viewed simply as confirmation of witness Baron's conclusion that the established estimates of volume variable costs must be revised downward.

The testimony of witness Baron, on the other hand, accepts the STS-based approach traditionally relied upon by the Commission. In straightforward fashion, he calculates volume variable load time as the accrued cost times the elasticity of load time with respect to volume. He recognizes, as has the Commission, that there is a fixed component, called fixed time at a stop, that is invariant with the amount or mix of mail at a stop or at a group of actual stops. His testimony thus produces the only measure of fixed time at a stop that is credible, because it is the only measure that really does stay constant for a given number of actual stops, no matter how much the amount and mix of volumes at those stops vary. His testimony also correctly recognizes that there are two distinct effects of volume growth at a multiple-delivery stop, the increase in load time resulting from increased volume, and the increase resulting from increased deliveries accessed.

The Baron approach should be followed by the Commission as the most accurate and reasonable yet developed to estimated volume variable delivery costs.

To the extent that the Commission should find merit in the Crowder critique, moreover, the Commission should recognize that the critique is, at best, an incomplete demonstration that volume variable cost estimates must be further reduced, and it should accept the Baron estimates as a conservative first step in this direction.

2. *The Hume methodology to estimate reclassified test-year unit delivery costs should again be used by the Commission.*

The testimony of Peter Hume develops test-year unit delivery costs by shape and rate category for city carrier and rural carrier cost segments. His analysis updates and, in some cases, refines the development of test-year delivery costs originally advanced by witness Hume and used by the Commission in Docket Nos. MC95-1 and MC96-2.

The basic thrust of the testimony of witness Hume has not been criticized by any witness in this proceeding. In fact, the only witness to propose any alternative to the Hume approach, ABA/EEI/NAPM witness Clifton, largely agrees with the Hume testimony. Witness Clifton claims merely that Mr. Hume's model of test year delivery costs, while on the right track, does not adequately reflect move update savings said to flow from new move update requirements effective July 1, 1997. Tr. 24/12474-77. Based on an assumption that new software systems for workshared mail will reduce by 25 percent the number of workshared pieces that need to be forwarded, he develops an additional 0.262 costs savings.

Unfortunately, the assumption employed by witness Clifton was shown to be erroneous. As Postal Service witness Murphy, an expert in mail forwarding, has

shown, there are unlikely to be any significant move update savings in the test year. The assumption used by witness Clifton, far from being "conservative", is, in fact, highly optimistic. Tr. 33/17643-68. Given the uncertain and unlikely nature of the Clifton adjustment, no basis on this record exists for further adjustment to the reclassified test year delivery costs developed by witness Hume. See Section V.A.3.b.iii for further discussion of witness Murphy's testimony.

Given the lack of controversy surrounding the Hume analysis, the absence of credible alternatives, and the fact that the analysis is merely a refinement and extension of principles previously endorsed by the Commission, it is clear that the Commission's continued reliance on Mr. Hume's analysis is justified on this record.

3. Witness Nelson's Costing Refinements and Data Collections Are Uncontested and Should Be Accepted

The testimony Postal Service witness Nelson presents the development of portions of the costs of city delivery carriers (both in-office and street time) as well as special delivery messengers. It advances a series of analytical refinements related to special purpose route carrier activities and driving time on motorized letter routes. The refinements are based upon data from four new field surveys of carrier and messenger activities: the Motorized Letter Route Survey, the Special Purpose Route Survey, the Expedited Mail Survey, and the Labor Distribution Code (LDC) 24 survey.

Based on the new survey data, Mr. Nelson is able to correct a double-count of costs in which certain carrier distribution and delivery activities costs have been borne by Express Mail in both cost segments 6 and 9. USPS-T-19 at 4-5. He also was able to separately analyze the cost of sweeping Express Mail collection boxes to

reflect the fact that such boxes are operationally distinct from ordinary collection boxes. Id. at 5. Moreover, the new data permitted him to improve the analysis of park-and-loop driving time by separately accounting for driving time between parking points on all types of motorized letter routes, and the different activities that occur at parking points. He also calculates volume variabilities for routine looping points, deviation deliveries, and collection-related driving, and develops appropriate new distribution keys. Id. at 5-6. He updated the time proportions, distribution keys, drive-time-to-stop variability and econmetric models used to analyze special purpose route costs. Id. at 7. He provided a functionally more detailed analysis of special delivery messenger costs. Finally, he performed a number of refinements to the analysis of interfacility service costs, collection box access and fixed stop time, and residual fixed costs in cost segment 9. Id. at 8-10.

The refinements proposed by witness Nelson are conceptually sound, well supported on the record, and have not been controverted in this proceeding. The Commission should take advantage of the new data provided by witness Nelson, and accepts all of his proposals.

F. The Commission Should Adopt Dr. Wade's New Estimate Of The Variability Of Vehicle Service Driver Costs

In USPS-T-20, Dr. Steven Wade provided a new econometric analysis of the variability of Vehicle Service Driver (Cost Segment 8) costs. Using data from 1993 from postal data forms, a survey of VSD facilities, and postal accounting systems, Dr. Wade estimated the relationship at the facility level between VSD costs and volumes.

In his analysis, he reviewed a number of models before selecting the one which best integrated theory, his understanding of postal operations, and the data he had available. Based on his original analysis, as described in the testimony he filed with the case, Dr. Wade estimated total VSD variability at very slightly under 60 percent. USPS-T-20 at 22. During the course of discovery, a series of very minor errors were detected. After performing all necessary revisions, the version of his testimony entered into the record still showed that total VSD variability rounded (to the nearest percent) to 60 percent. *Id.* No party filed any testimony challenging the validity or the results of Dr. Wade's analysis, or filed any contrary analysis. The Postal Service urges the Commission to adopt Dr. Wade's estimated level of variability for VSD costs for purposes of this proceeding.

G. The Postal Service Makes Use Of The Two Step Volume Variability/Distribution Key Method for Purchased Transportation Costs.

Domestic purchased transportation costs, classified in Cost Segment 14.1, include all contract air, highway, rail and water transportation, amounting to approximately $3.1 billion in the base year. Direct Testimony of Joe Alexandrovich, USPS-T-5, Exhibit 5A at 44.[3] These costs are allocated to the classes and subclasses of mail using the same two-step analytical procedure generally used in other cost segments.

[3] International purchased transportation, the cost of moving mail between the United States and other countries accounted for an additional $688 million and are treated separately in Cost Segment 14.2. USPS-T-5, Exhibit 5A at 46.

In the first step, cost accounts are organized into cost pools, each of which is then analyzed to determine the extent to which its costs vary with actual resource usage. A variety of techniques are used to determine this relationship. In this case, Dr. Michael Bradley (USPS-T-13) conducts a sophisticated econometric analysis to estimate the variability of purchased highway transportation.[4] Dr. Bradley conducts a series of cross sectional analyses of purchased highway contracts. In these analyses, Bradley estimates the variability of highway contract costs with respect to cubic foot-miles of transportation capacity. Using these variabilities, pools of volume variable costs are developed in the workpapers of the Postal Service's base year cost witness, (USPS-T-5, Workpaper B14.0.1).

In the second step, the volume variable costs are distributed to the classes and subclasses of mail using distribution keys. In general, distribution keys indicate proportions of transportation service that were provided for various postal products. There are four sources of distribution keys. The first and most important source is the Transportation Cost System or TRACS. In TRACS, postal data collectors sample mail as it is either loaded on air transportation or unloaded from highway and rail transportation. Using relative proportions from this sampling effort, distribution keys are developed. These keys are used to distribute volume variable costs to mail

[4] Also, the variabilities of dedicated air network transportation, including the Eagle, Western and Christmas networks, have been changed (Direct Testimony of Norma B. Nieto, USPS-T-2). The treatment of network air costs is an integral part of the incremental cost analysis (Direct Testimony of William M. Takis, USPS-T-41) described elsewhere in this brief.

classes and subclasses. TRACS is discussed extensively in the testimony of Postal Service Witness Norma Nieto (USPS-T-2).

In addition to TRACS data, the Postal Service from time to time conducts special data collection studies for many activities not covered by TRACS, including Alaska and Hawaii air operations and plant load rail and highway transportation. A third technique pioneered in this case is another type of special study used to develop a distribution key for Christmas seasonal air operations. Using air contract payment data supplemented by TRACS data for mail moved on passenger airlines and the Eagle and Western networks, witness Nieto develops a new distribution key for Christmas air costs. (USPS-T-2 at 7-9.) Finally, remaining cost pools (e.g., Alaskan Highway, Area Bus, Inland Water) are distributed based on either comparable operations measured in TRACS or on the distributions of related cost pools (e.g., empty equipment highway contracts). Detailed distribution of these costs to classes and subclasses of mail is provided in the workpapers of witness Alexandrovich (USPS-T-5, Workpapers B14.0.2 and B14.0.3).

1. Dr. Bradley presents a new variability study of purchased highway transportation costs.

    a. Dr. Bradley's variability study fulfills a Commission request raised in Docket No. R94-1.

In Docket No. R94-1, the Presiding Officer requested that the Postal Service perform an update of the econometric analysis done in Docket No. R87-1 on the variability of purchased highway transportation costs (See Presiding Officer's Ruling

No. R94-1/48, June 29, 1994, at 6). In the current docket, the Postal Service has fulfilled that request by presenting a comprehensive new study. The new highway transportation variability study is based on the methodology of the previous study, with numerous enhancements, and uses data from an exhaustive new data source, the Highway Contract Support System (HCSS).

Dr. Bradley's testimony, USPS-T-13, presents an update and refinement of the Commission's Docket No. R87-1 purchased highway transportation variability model. Dr. Bradley estimates variabilities based on the relationship between cubic foot-miles of capacity and purchased highway contract costs for both the regular and emergency Intra-SCF, Inter-SCF, Intra-BMC, and Inter-BMC cost accounts, and, for the first time ever, the two highway plant load accounts. Dr. Bradley follows the Commission's methodology of estimating a translog equation using mean centered data, USPS-T-13, at 5-6, and estimates it with cross-sectional data. It is worthy of note that there was not a single criticism of the econometric techniques used.

b. Cubic foot-miles is a good cost driver.

It has been suggested that Dr. Bradley's and the Commission's previous analyses, though robust,[5] are inappropriate, as their application rests on the assumption that actual mail volume and cubic foot-miles of capacity are directly related. Tr. 7/3823; Tr. 7/3620. First, this criticism is wrong because the estimation of

[5] Dr. Merewitz even conceded that "there is a close fit of cost to cubic foot-miles" (Tr. 22/11408), yet, in a desperate attempt to discredit the analysis, made the astonishing and totally unsupported assertion that "highway costs are 0% volume variable." Tr. 22/11641.

the variability in no way depends upon this assumption. Second, this criticism is wrong because the assumption has been carefully evaluated on the record and accepted by the Commission. PRC Op., R84-1, para. 3289; see generally PRC Op., R87-1, Vol. 2, App. J., CS XIV. However, the assumption is only that if there is a small sustained increase in volume, the cubic foot-miles of capacity increase accordingly.

Dr. Bradley's variabilities were questioned on the basis that empty space exists on the transportation network. Tr. 7/3816-18. However, tied to the direct relationship between mail volume and network capacity is the direct relationship between mail volume and empty space. That is, on the aggregate, when a sustained increase in mail volume is incurred, not only is there a proportionate increase in network capacity, but also a proportionate increase in empty space on the network. Tr. 7/3847-48. This is because, as Postal Service operations expert Young has testified, empty space is an inherent by-product of the provision of a reliable and economical transportation service. Tr. 35/18858. He also said that the network must provide the transportation necessary to deliver mail "everywhere, everyday" (Tr. 35/18859) and be able to accommodate both anticipated and unpredictable spikes in volume. Thus, as volume increases, capacity increases, and so does the *absolute* amount of empty space, as the Commission stated in Docket No. R84-1:

> Having considered the issue again on this record, we find that capacity, which includes both utilized and *unutilized* portions, is directly related to volume if a reasonable time period is examined. In Docket No. R80-1, we found that unused capacity should not distort the relationship between volume and costs. (PRC Op., R84-1, at 244). (emphasis

added)

Dr. Bradley acknowledges that, under some circumstances, it would be preferable to compare actual mail volume to purchased highway transportation costs, and that in an ideal world we would have detailed information on volume of mail on each truck, by class. This would permit eliminating the volume-capacity assumption, as well as the need for a distribution key study like TRACS. Tr 7/3836. However, "it's impossible to measure ongoing volumes on trucks". Tr. 7/3806. As should be obvious, there is no feasible way to measure actual volumes on trucks that deliver mail "everywhere, every day". Tr. 35/18859. Referring to TRACS, Postal Service Pickett even explained how it would be a gargantuan undertaking to measure a sample of actual volumes on even a small sample of trucks. Tr. 35/18771.

c. The Docket No. R87-1 approach is still applicable.

Dr. Bradley conducted extensive analyses, both qualitative and quantitative, to determine that "[t]he structure of the purchased highway transportation network has not changed in a dramatic way" (USPS-T-13 at 11) since 1986. Postal Service transportation operations and contracting expert Young provided corroborating testimony that the nature of the highway transportation network is essentially the same as it was in 1984. Tr. 35/18908 and 18924-25. Thus, the general methodology of the Docket No. R87-1 model remains applicable today.

d. The new database used for Dr. Bradley's study has allowed variabilities to be estimated based on a census rather than a sample of contracts.

Ten years ago, highway contracts were maintained only in hard copy form. Thus, the Commission's Docket No. R87-1 variability model was based on a sample of contracts -- only 2,099 of 12,846 in force in 1986. See Docket No. R87-1, USPS-T-9, WP-1, at 2-3. Today, contracts are developed and stored electronically in HCSS. Thus, instead of relying on a sample, Dr. Bradley's model uses a comprehensive census of over 15,000 contracts. The HCSS data set essentially represents the population from which the Docket No. R87-1 data were drawn. Tr. 7/3579. This is a *vast* improvement over the previous model in three regards: 1) the precision of the estimates is substantially increased, 2) potential for unrepresentative sampling is eliminated, and 3) the parameters of the model capture "any changes in the transportation system that have taken place since Docket No. R87-1." USPS-T-13 at 13.

i. The HCSS data are accurate and reliable for use in estimating variabilities.

HCSS is the actual management information system that transportation managers use to specify and maintain contracts. This, in and of itself, ensures a highly accurate database. Contract entries into the system are subject to triple check by a transportation specialist, the highway contractor, and an administrative official who makes payments on the contract. Tr. 7/3692, 3644, and 3687. This further ensures the integrity of the data.

Dr. Bradley first estimated the Commission's Docket No. R87-1 model using HCSS data, and generally replicated their results. The similarity of results further affirms that the HCSS data set is suitable for estimating the variability of purchased transportation costs. USPS-T-13 at 20-26.

The construction of cubic foot-miles from HCSS data required a slightly different approach than the Docket No. R87-1 model in order to accommodate occasional contracts with multiple vehicle sizes. USPS-T-13 at 18-19. To ensure that this change did not materially affect the analysis, Dr. Bradley re-estimated the Commission's Docket No. R87-1 model (with the 1987 data) using the new method of calculating cubic foot-miles. Dr. Bradley demonstrated "that the results were not affected". USPS-T-13 at 19.

Dr. Bradley further reviewed the data to detect "unusual observations" that might distort the underlying relationship between cost and capacity. USPS-T-13 at 36-49. The analysis revealed contracts that are not necessarily invalid, but clearly atypical of the general cost-generating function (e.g., a mule route, a windsled route, transportation of baby chicks, and a rare contractor who charges a mere pittance of $1 annually. See USPS-T-13 at 47, n. 20, Tr. 7/3694-95, and USPS-LR-H-181). Dr. Bradley recommends the variabilities calculated without the unusual observations. This recommendation is based on the marked difference in the unusual observations' contract characteristics, the increase in the resulting variabilities, and the increase in the goodness of fit of the econometric equations. Nonetheless, Dr. Bradley's results are presented both ways, so that the Commission may see the results of dropping the

unusual observations. USPS-T-13 at 47-49.

Dr. Bradley has answered scores of interrogatories as well as a question from the Presiding Officer regarding HCSS, in both this docket and Docket No. MC-97-2. Tr. 7/3643-722 and 3845. As evidenced by those responses, the data are clearly sufficient and adequate for ratemaking.

e. A cross-sectional rather than a time series analysis is appropriate in this instance.

It has been suggested that because Dr. Bradley's cross-sectional analysis of highway contracts does not deal with volume changes through time, it is thus inappropriate. Tr. 7/3813-15. First, as demonstrated above, actual volume is not required for an accurate variability analysis. Second, a cross-sectional data base is a reliable way of estimating variabilities. A cross section is, in effect, a "snapshot" of all highway contracts in use at a single point in time. This allows Dr. Bradley to "look at large contracts and small contracts ... and estimate how quickly cost rises or falls with increases or decreases in volume without the necessity of tracing the size of total accrued cost through time." Tr. 7/3808-09.

f. Dr. Bradley's analysis makes a number of methodological refinements representing a significant improvement over the Docket No. R87-1 analysis.

Dr. Bradley's analysis offers several methodological refinements over the Docket No. R87-1 analysis. For the first time, he estimates the variability of highway plant load costs. USPS-T-13 at 33-34. Second, Dr. Bradley's analysis used a dummy

variable for each Postal Service geographic area to account for any possible non-volume related regional variation in cost. USPS-T-13 at 27-31. Third, Dr. Bradley has also adjusted for within-account heterogeneity where it exists, in the Inter-SCF and Intra-SCF cost pools. This adjustment was accomplished by recognizing that two separate technologies (tractor trailer and straight body truck) existed within those accounts. Dr. Bradley estimated separate econometric equations for each of those technologies. USPS-T-13 at 35-41. Dr. Bradley also included a correction for heteroskedasticity. USPS-T-13 at 41-46. Finally, Dr. Bradley expanded the analysis of Intra-BMC transportation to include power-only contracts. USPS-T-13 at 22-23. Each of these refinements has either expanded the coverage of the variability analysis or improved the econometric rigor of the analysis.

Coupled with the benefits of the HCSS information system discussed previously, Dr. Bradley's analysis is more thorough and represents a significant improvement over the Docket No. R87-1 variability analysis. Accordingly, his results should be accepted in this case.

2. The TRACS system generates distribution keys for application to the pools of volume variable costs.

The Transportation Cost System (TRACS) is a statistical sampling and data collection system that generates distribution keys used to estimate various purchased transportation costs by rate category. TRACS provides separate distribution keys for the following components of purchased transportation: passenger air, the Eagle network, the Western network, freight rail, AMTRAK, and intra-SCF, inter-SCF, intra-

BMC and inter-BMC highway. Postal Service witness Nieto's testimony (USPS-T-2) and library references present the design, methodology, and description of TRACS.

Witness Nieto's testimony also presents two changes made in the calculation of the Eagle Network distribution keys: an adjustment for TNT product traveling on the network, and a change in the treatment of premium costs associated with the Eagle Network, consistent with the incremental cost methodology presented in the testimony of Postal Service witness Takis (USPS-T-41). In addition, Witness Nieto introduced an improvement in the methodology to calculate the Christmas air network and Christmas air taxi distribution key. This key uses actual volumes from the Air Contract Support System (ACSS), supplemented by additional detail from TRACS. In the past, the Postal Service simply used the passenger air distribution keys. These changes have been uncontested on the record. In fact, issues raised in this case have been limited largely to the purchased highway component of TRACS.

a. The Postal Service has expanded documentation and provided all electronic data for TRACS.

In past proceedings, the Postal Service has filed one representative quarter of TRACS programs and documentation. The TRACS programs do not vary significantly from quarter to quarter, and thus, this level of documentation provided information sufficient to understand the programs. Beginning with Docket No. MC97-2 and continuing in these proceedings, the Postal Service has expended considerable effort to provide all four quarters of TRACS programs and data files for the base year. The TRACS data files contain a number of commercially-sensitive variables. Rather than deleting this proprietary information as it had in the past, the Postal Service has

undertaken the difficult, laborious, and expensive process of encrypting material in all data files and programs, so that participants could replicate the Postal Service's results. For example, witness Merewitz was able to replicate certain distribution keys. See Tr. 22/11634.

b. Claims that TRACS has never been scrutinized in Postal Rate Commission proceedings are unfounded.

FGFSA witness Merewitz contends that TRACS "has never been tested or examined or evaluated on the record." Tr. 22/11415. In fact, when TRACS was introduced in Docket No. R90-1, TRACS underwent substantial scrutiny and evaluation, as evidenced by Postal Service witness Rogerson's 600-page transcript volume solely on TRACS, which witness Merewitz confusedly admitted that he did not review. Tr. 22/11568. Also, in Docket No. R94-1, Postal Service witness Barker responded to interrogatories, many from the Florida Gift Fruit Shippers Association, of which Dr. Merewitz also was unaware. Tr. 22/11571. In every proceeding since Docket No. R90-1, including Docket No. MC96-3, Special Services Reform, which raised no transportation cost or TRACS-related issues, intervenors have had an opportunity to examine, scrutinize, and evaluate TRACS.

c. Sampling "imbalances" in TRACS do not result in over-attribution of costs to mail on the inbound legs.

FGFSA witnesses Ball (Tr. 22/11365) and Merewitz (Tr. 22/11432-33) claim that the sampling proportions in the TRACS intra-BMC highway component, which sample more inbound movements, result in an over-representation in those classes of mail found on inbound movements in the calculation of the distribution key. As has

been repeatedly explained by both witness Nieto (Tr. 7/3267-68, 3476, 3482-83, 3486) and witness Pickett (Tr. 35/18768-769, 18810-12), the sampled movements are weighted according to the actual occurrence of inbound and outbound movements in the population when calculating the distribution keys. Thus, there simply cannot be any over-attribution of costs to mail traveling on a particular type of movement.

d. ANM witness Haldi's characterization of TRACS' treatment of route-trip-segments is incorrect, and the selection of route-trip-destination days is logical.

Witness Haldi says that "TRACS breaks the route into independent segments" (Tr. 22/11822), and says that this treatment is incorrect because route-trips are jointly determined. The allegation that TRACS breaks up route-trips into segments is not correct -- TRACS does not "artificially" break a route up into segments (Tr. 22/11818); rather, it reads in route-trip segments from the National Air and Surface System (NASS), which is the Postal Service's database used by operations in the field for transportation scheduling. USPS-T-2 at 1-2. Dr. Haldi's characterization is also incorrect because TRACS samples route-trip-destination-days, not route-trip-segments. See USPS-T-2 at 2, lines 7-12.[6]

No one disagrees with the argument that the cost of a contract is jointly determined by all of the route-trips which are served on the contract. What is incorrect is the notion that a round-trip is the only correct sampling/expansion unit. Some intervenors presume that a contract consists of a single pair of trips which

[6] For each route-trip-destination-day, mail offloaded at the sampled destination may include mail from all previous stops. Tr. 35/18769-18770.

together comprise a round-trip. In reality, contracts are more complex and can contain multiple route-trips. Tr. 7/3256. Witness Young further discusses why it is not a straightforward assumption that two route-trips follow the same path in opposite directions:

> . . .any one of our networks – typically has pairs of trips, one going out and one coming back, but they are not necessarily related to each other. Tr. 35/18893.

In addition, witness Pickett discussed the many logistical and practical reasons why a route-trip-destination-day (not segment) is the appropriate primary sampling unit. The increase in data collection resources required to support alternative sampling strategies would be dramatic, and would cause "significant disruption to other data collection systems." Tr. 35/18771.

e. Dissatisfaction with the highway transportation cost distribution is not evidence of problems with TRACS.

Dissatisfaction with the highway transportation cost distribution is limited to three specific subclasses: Regular Rate Periodicals, Nonprofit Non-Carrier Route Standard (A), and Standard (B) Parcel Post. Intervening parties have proposed a number of specific theories why these cost distributions are unfair. The Postal Service, however, has demonstrated that these either are not valid or do not have any significant impact on cost distributions.

Much scrutiny and discussion regarding the distribution of transportation costs in this case has been focused on empty space in trucks and the allocation of that empty space to classes of mail. TRACS allocates the percentage of empty floor space on a truck to the mail on that truck proportionately. Intervenors have argued

that dropshipping has greatly reduced the volume on inbound trips, for example, from the SCF to the BMC on intra-BMC movements. Tr. 22/11426-27. Thus, they claim, it is the outbound mail volumes which cause empty space on the inbound legs, and thus inbound mail should not pay for the empty space found on movements on which it travels. See Tr. 22/11817-26.

These intervenors present an overly simplistic picture of intra-BMC highway transportation. In reality, the intra-BMC transportation network is extremely complex, consisting of many movements which do not simply travel straight between a BMC and an SCF once a day. Witness Young presents many instances in which real movements vary from the hypothetical movements posited by intervenors. For example, witness Young stated:

> ...we typically don't have coming out of a BMC a single trip to a facility, because in reality what happens is you're running transportation not to very, very small places out of a BMC, but to SCF-type facilities, and making some intermediate stops at these small facilities...I can't think of an example, any case where there's just one trip from a BMC to one of its intra-facilities within a 24-hour period – just as an example, there may be 40 trips a day running from the Washington Bulk Mail Center to Baltimore...25-30 trips running to Norfolk Virginia, with some intermediate stops in places like Farmville and Richmond and so forth. (Tr. 35/18870)

The intervenors' erroneous conclusions about the impact of TRACS' empty space allocation on their transportation costs is a direct result of their erroneous oversimplification of the nature of the highway transportation network.

i. The empty space allocation in TRACS does not have a material effect on the distribution of costs.

Witnesses Haldi, Merewitz, and Hehir all cite the TRACS empty space

allocation for cost increases in Nonprofit Non-ECR Standard (A) Mail, Parcel Post, and Regular Rate Periodicals, respectively. See, for example, Tr. 27/14712. Using witness Merewitz's analysis, witness Pickett demonstrates that the removal of the empty space algorithm in TRACS has an insignificant impact on cost distribution, and the treatment of empty space "cannot be the source of significant highway cost increases in this proceeding." Tr. 35/18768. The table below presents the per-piece changes in cost for selected categories after the removal of empty space allocation.

Category of Mail	Per-Piece Change in Cost
Standard (A) Mail	$0.00004
Parcel Post	$0.00230
Periodicals	($0.00006)

Source: Tr. 35/18781, 18777, 18778, respectively.

Thus, the empty space allocation in TRACS is simply not the source of an unfair distribution of costs, as claimed by these intervenors.[7]

ii. The expansion to container size and space above the container is defensible and correct.

Witness Haldi contends that assigning the cube of a container to the mail in the container is an arbitrary process. He presumes that any space remaining in a container "could just as easily have been filled with something else." Tr. 22/11820. In his rebuttal testimony, witness Pickett lists the following reasons why this presumption

[7] In fact, the removal of the empty space algorithm actually causes a minute *increase* in Parcel Post costs, contrary to Dr. Merewitz's theory.

is not true:

1. container contents are sampled at destinations after some settling has occurred, thus causing the appearance of empty space in the container;

2. to meet dispatch times, partially-filled containers are loaded on trucks; and

3. for safety reasons, the weight of the mail in a partially-filled container rules out additional loading.

Tr. 35/18764-65.

In addition, witness Pickett also discussed why any space above containers is unusable for any other mail, and thus reasonably assigned to the mail in the container below. The physical aspects of handling containers such as the raised bridge that spans the gap between the platform and trailer, the use of forklifts which raise the container during loading and unloading, and restrictions in stacking containers preclude the use of space above containers. Tr. 35/18765-66. Witness Young further corroborated this notion:

> The discussion you were having earlier, the truck's about...8 foot 3? And a container is...about 6 foot tall. And so you've got about two feet of space up to there that's unusable for all practical purposes. Tr. 35/18884.

Contrary to Dr. Haldi's contention that expansion to container size and space above containers is "indefensible", the Postal Service has demonstrated compelling evidence why it is both logical and fair to distribute these costs to mail found in containers.

f. FGFSA's reliance on Dr. Merewitz's Standard (A) to Standard (B) ratio is flawed and is not evidence of problems in TRACS.

FGFSA witness Merewitz compares two ratios: the ratio of Standard (A) Mail

volume to Standard (B) Mail volume, and the ratio of the Standard (A) Mail TRACS distribution key to the Standard (B) Mail TRACS distribution key. Tr. 22/11427-28. The essence of witness Merewitz's argument is that the ratio of volumes should be comparable to the ratio of TRACS distribution keys. Both witnesses Merewitz and Ball erroneously cite this comparison as evidence that TRACS is incorrect. Tr. 22/11364-66 and 11427-28. However, TRACS was specifically designed to move away from using simple volume data and speculative assumptions about which classes of mail travel on what types of movements. Rather, TRACS was designed to capture the proportions of mail using transportation services at any given time. Tr. 7/3334. Therefore, Dr. Merewitz's comparison is inherently flawed and meaningless. Furthermore, his execution is riddled with errors and inconsistencies. These include: the use of incompatible density methodologies for the numerator and denominator; the double-counting of volume from mail flow models; the use of inconsistent time periods (base year versus test year) in calculating the ratio; the omission of a mail flow; and the use of cubic feet rather than cubic foot-miles. See Tr. 22/11596-614. It is clear that the Commission cannot rely on this ratio for any purpose whatsoever.

g. Recent increases in purchased transportation costs reflect a variety of operational factors, not flaws in TRACS or in the variability analysis.

Several intervenor witnesses[8] complain that highway transportation costs

[8] Mr. Joseph Ball (FGFSA-T-2) and Dr. Leonard Merewitz (FGFSA-T-1) for the Florida Gift Fruit Shippers Association, Mr. Michael Hehir (MH-T-1) for the McGraw Hill Companies and Dr. John Haldi (ANM-T-1) for the Alliance of Nonprofit Mailers.

either in general or for a particular subclass have risen excessively in recent years.[9] Witnesses Ball (Tr. 22/11364-66), Merewitz (Tr. 22/11415-34) and Haldi (Tr. 22/11816-26) each blame all or part of the increase in costs on perceived deficiencies in TRACS. Witnesses Merewitz (Tr. 22/11407-15) and Hehir (Tr. 27/14712) also question the level of variability used by the Postal Service. The criticisms of both TRACS and Dr. Bradley's variability analysis are without merit. Furthermore, two Postal Service witnesses provide numerous operational reasons for greater-than-inflation increases in highway transportation costs.

Witness Merewitz conducts an analysis that indicates that the rate of inflation for the nonlocal motor freight industry is no more than 2.5 percent per year (Tr. 22/11410-11) during the 1991 to 1996 period. Drawing on over 27 years of postal experience, witness James D. Young (USPS-RT-3), the National Manager of Transportation Purchasing for the Postal Service, provides numerous operational reasons why overall purchased highway transportation costs have increased faster than Dr. Merewitz's inflation measure.

Mr. Young first notes that, on a per-mile basis, the Postal Service has actually performed considerably better[10] than Witness Merewitz's private-sector benchmark. Tr. 35/18861 and 18938. The real reason why postal highway transportation costs in

---

[9] Merewitz concentrates on the 1991 to 1996 time period (Tr. 22/11408-12); Haldi compares fiscal year 1995 to fiscal year 1996 (Tr. 22/11816); Hehir compares fiscal year 1995 with test year 1998 (Tr. 27/14712).

[10] Witness Young also notes that this performance is particularly impressive in light of the fact that the Postal Service purchases a significant amount of relatively expensive, local transportation as well as nonlocal transportation. Tr. 35/18938-39.

total have increased faster than the rate of inflation is the fact that the Postal Service is purchasing much more transportation capacity than it has in the past. This increase in capacity is attributable to a number of specific causes, as witnesses Young and Pickett discuss extensively.

Mr. Young explains that, because of "population flows", the Postal Service adds facilities. Since new facilities must be connected to the rest of the distribution and delivery network, new transportation capacity is purchased to provide the necessary links. Tr. 35/18861 and 35/18911-12. Similarly, the introduction of hub and spoke facilities (HASPs) also adds transportation capacity to the network. Tr. 35/18862.

Changes in distribution schemes brought on by delivery point sequencing have narrowed windows of service, requiring additional trips, and causing changes to the number of offices per trip. Tr. 35/18861-62 and 18912. Both these adjustments increase cubic foot-miles of capacity and transportation costs.

The effort to improve service performance as measured by the External First-Class Measurement System (EXFC) has also "resulted in additional capacity in the network, particularly at the local level." Tr. 35/18862. See also 35/18913.

In an effort to improve service and reduce labor costs, the Postal Service has increased the use of containerization in two ways. Tr. 35/18862-63 and 18906. First, automated sorting operations require the use of trays which make less efficient use of vehicle space. Tr. 12/18863. These trays as well as sacks and other loose items are increasingly transported in rolling stock and postal paks and on pallets. This

increased reliance on containerization "increases the amount of vehicle space used for a given amount of mail compared to bedloading." Tr. 35/18863 and 18884. Witness Young makes it clear that the increased use of containerization contributes to the increase in transportation costs. Tr. 35/18863. Witness Pickett provides numerous specific examples of factors that contribute to the reduced utilization of vehicle space. Tr. 35/18765-67. He also demonstrates how TRACS is designed to reflect the manner in which containers fill usable space on trucks. Tr. 35/19764-67. Finally, the increased use of containerization is a direct reflection of the Postal Service responding to the needs of its customers. Tr. 35/18805-06 and 18885.

Changes in palletization regulations have caused additional increases in transportation costs. Tr. 35/18863. Part of this result stems from fact that pallets without top caps cannot be stacked. Nor can stacked pallets be sent to destinations without requisite forklift equipment. Tr. 35/18766. Witness Young also notes that many pallets are "in reality" sometimes poorly constructed, limiting the ability to stack them and make more efficient use of vehicular space. Tr. 35/18914-15.

Over the past several years, a number of freight railroads have consolidated their operations as the result of mergers. Problems in integrating railroad operations have resulted in a short term deterioration in rail freight service, requiring the Postal Service to rely more heavily on highway transportation. Tr. 35/18863 and, generally, 35/18916-20.

The irony of mailer complaints in this case is inescapable. As Mr. Young made very clear, the customer is the ultimate driver of the requirements underlying

purchased highway transportation:

> Our customers expect the postman to come by with their mail at a certain time of the day and the idea is that in order for the mailman to get to these individuals' homes at generally the same time every day, he or she has got to leave his office and go out and deliver mail.
>
> "Now if you take that time and you back out the transportation time, the local processing time, the transportation time from the other facility to the BMC, it gives you a window for moving mail and getting it down to the facilities where it is going to be delivered.
>
> "...ultimately what drives schedules and dispatches and pull-down times is the fact that ... commitments... have been made to customers in terms of when we will get their mail to them. Tr. 35/18872.

In summary, witness Young repeatedly made it clear that the factors that have increased highway transportation costs are directly related to meeting changes in where the customers live, responding to customer requests for containerization and palletization, automating distribution operations to reduce overall postal operating costs, and circumventing potential service problems or improving service.

h. The allegation that the Postal Service's transportation is inefficient is both incorrect and irrelevant.

Mr. Ball complains that the Postal Service's purchased highway transportation network is inefficient, because it provides "capacity far in excess of the need to transport mail." Tr. 22/11366. Drawing on his experience with private sector motor freight carriers, witness Ball argues that the Postal Service should meet peak mail needs with extra trips to remedy this alleged deficiency. Tr. 22/11381. Mr. Young demonstrates that peak needs are most efficiently met first by purchasing a larger truck. This remedy is more economical because, as both witnesses Young (Tr. 35/18857, 18887, 18898) and Bradley

(USPS-T-13 at 22 and Tr. 7/3735) note, additional truck size adds very little cost to the contract.[11] And, Mr. Young notes, purchasing a larger vehicle avoids service disruptions. Tr. 35/18857-58. He concludes:

> The fact that we have less than full loads on some legs of transportation is not evidence of inefficiency. Rather, unused capacity is an inherent by-product of the provision of reliable, economical service. Tr. 35/18858.

Even if one were to concede the point that the Postal Service is inefficient in its use of purchased highway transportation, one still needs to know what to do with the cost of the inefficiency. Both witnesses Ball (Tr. 22/11366) and Hehir (Tr. 27/14712) would foist the cost of inefficiency on mailers in general, by reclassifying them as institutional costs. This approach may be expedient, but it would be contrary to sound economic analysis. Professor Panzar (USPS-T-11), a noted authority on marginal cost analysis and ratemaking, finds that even if the Postal Service is inefficient, the analysis of costs with respect to variability should be unaffected since the operating plan of the Postal Service remains unaltered. USPS-T-11 at 16.

Witnesses Merewitz (Tr. 22/11415-27) and Haldi (Tr. 22/11817-26) allege that the size of the truck on outbound runs is the cause of the "underutilization" of truck space. Therefore, they argue, trucks on inbound runs should not bear the cost of the empty space observed by TRACS data collectors on inbound trips. Tr. 22/11433 and 11819-22. This argument is

---

[11] In some instances it even may be cheaper to buy a larger vehicle. Tr. 35/18887 and 18898.

based on TRACS data which show an "imbalance" in vehicle floor-space utilization; inbound route trips have a lower average utilization of floor space than outbound route trips. Tr. 7/3259. The Merewitz and Haldi argument is flawed in numerous respects.

First, when routes are specified, average floor space utilization on a route is not even a factor in the decision-making process. Tr. 35/18855. For a given routing, the Postal Service will size its vehicle to meet its peak weekly volume. Tr. 35/18818855-19957. The rationale for this choice is clear; vehicle size adds very little (if any) cost to a contract. As Mr. Young states:

> ...the reality is that if I buy a tractor-trailer in a competitive market and I buy a straight truck in a competitive market, the difference in cost is marginal. Tr. 35/18885-86.

Furthermore, adding trips to meet volume peaks is expensive and will lead to a degradation in service. Tr. 35/18857-58.

Witness Haldi blames the increase in transportation costs for "Nonprofit Standard Mail (A) Regular" from Fiscal Year 1995 to Fiscal Year 1996 on TRACS highway sampling and the treatment of empty space. Tr. 22/11816-26. Witness Pickett demonstrates that over two-thirds of this increase has nothing whatsoever to do with TRACS highway sampling. Tr. 18763-64 and 18774. Part of the increase is the result of increases in purchased air, rail, and water costs. Part of the increase reflects Dr. Bradley's update of highway variabilities. The remaining increase reflects increases in overall transportation capacity purchased and changes in TRACS distribution keys. Witness Haldi

alleges that the TRACS keys are flawed because they allocate empty space in containers, and empty space above containers and bedloaded mail, as well as empty floor space, to classes of mail. Tr. 22/11819-21. As discussed above, both witnesses Pickett (Tr. 35/18764-67 and 18789-810, 18825-27, 18828-30) and Young (Tr. 35/18862-63 and 18913-15) demonstrate numerous reasons why occupied container, floor, and vertical space is considered fully used by the mail in the containers or on the floor. In the end, Dr. Haldi's only specific remedy is to remove the TRACS empty space algorithm. Tr. 22/11825-26. Witness Merewitz, however, confirmed that removing the allocation of empty space in TRACS actually slightly increases parcel post costs. Tr. 22/11639. Given the insignificance of vehicle size to the cost of a contract, and other flexibilities (discussed below) in meeting changes in volumes, it is not surprising that removing the algorithm that allocates empty space to classes of mail has an insignificant effect on highway cost distributions. Tr. 35/18767-68.

Of course, the entire critique of the treatment of empty space in TRACS sidesteps the significance of the fact that costs of purchased highway contracts are jointly determined by numerous factors. Tr. 5/3585. Changes in the required service are provided in one of three ways: by altering routes, adding trips, or increasing the size of the truck. Tr. 5/3586. Since truck size adds very little to the cost of the contract, it obviously makes sense to buy the biggest truck practicable for a given route. As volumes change, however, the other elements of the contract come into play. Stops are added to or removed

from the contract, as are trips. Tr. 35/18858.

Finally, the pattern of peak volume flows simply does not match the characterizations in intervenor testimony. Nearly 23 percent of route trips destinating at BMCs (which are inbound) arrive with mail occupying between 90 to 100 percent of floor space. Tr. 35/18772 and 18784. Clearly, peaks occur on inbound trips as well as outbound. Another complicating factor is the fact that a truck on a trip classified as inbound in TRACS does not necessarily carry mail inbound to a Bulk Mail Center. Tr. 35/18772. The truck, for example, can carry mail that is moving between subordinate Processing and Distribution Centers. Tr. 35/18772.

Clearly, trying to determine what causes contract specifications to look the way they do in a dynamic environment is unworkable. And requiring data collectors to speculate on the cause of empty space is futile and ill-advised. Tr. 5/3312-13 and 35/18833-36. The best approach to distributing costs to classes of mail is to charge costs to those classes of mail that use transportation services. This reasonable and straightforward procedure is the approach taken in TRACS. Tr. 35/18837.

In the final analysis, the overall increase in transportation costs can be traced to a number of factors. Aside from increases in volume and general inflation, numerous operational changes have been implemented. These changes, either directly or indirectly, reflect activities focused on improving service or controlling overall postal costs for the benefit of its customers.

H. The Postal Service's Cost Model Must Be Used. Criticisms Of It Are Baseless, And Alternatives Are Either Unsponsored Or Flawed.

In this section, the Postal Service addresses issues relating to intervenor criticisms of its rollforward model. In addition, various alternative costing presentations are discussed.

1. The Postal Service's compliance with revised Rule 54(a)(1) and intervenor use of the alternative cost presentation does not obviate the need for Commission sponsorship of its own cost model.

On May 27, 1997, in Docket No. RM97-1, the Commission issued Order No. 1176, which revised Rule 54(a)(1). Under the revision, the Postal Service was to provide "an alternative cost presentation . . . that shows what the effect on attribution would be if it did not propose changes in attribution principles" in instances where the Postal Service proposes to "change the cost attribution principles applied by the Commission in the most recent general rate proceeding in which its recommended rates were adopted." Rule 54(a)(1).

In Docket No. R97-1, the Postal Service met the new requirement of the revised rule by filing Library References LR-H-196 and LR-H-215. An initial revision was made to LR-H-196 in response to Presiding Officer's Ruling No. R97-1/2, which stated that there were some areas in the Postal Service's alternative cost presentation that did "not conform to the Commission's R94-1 methodology." Presiding Officer's Ruling No. R97-1/2, July 23, 1997, at 1. A second revision to LR-H-196 as well as a revision to LR-H-215 were made in accordance with Presiding Officer's Ruling No. R97-1/7, that directed the

Postal Service to correct "relatively minor discrepancies between the Postal Service's base year, interim year, and test year alternate cost presentations and the Commission's established attribution methods." Presiding Officer's Ruling No. R97-1/7, August 13, 1997, at 2. The Commission indicated that once the Postal Service had filed the required interim and test year presentations and had corrected its presentation as specified in the Presiding Officer's Rulings, it had complied with the requirements of revised Rule 54(a)(1). *See* Order No. 1197, October 1, 1997, at 4.

Although the Postal Service filed these library references to comply with the revised rule, it feels compelled to reiterate certain points it has maintained throughout the course of several rate proceedings and the rulemaking referenced above. First, the imposition of additional documentation requirements, added to the already substantial documentation required of the Postal Service could "encroach upon the prerogative of postal management to control the timing of rate requests and the implementation of rate changes." Comments of United States Postal Service, Docket No. RM97-1, January 31, 1997, at 5; *see also* Notice of United States Postal Service Concerning Provision of Information Pursuant to Rule 54(a)(1), July 10, 1997, at 2.

In addition, the Postal Service is of the view that its rights under due process are jeopardized by being forced to adopt a litigating position against its will by placing the Commission's unsponsored, and in some respects unexplained, alternative cost presentation on the record. Notice of United

States Postal Service Concerning Provision of Information Pursuant to Rule 54(a)(1), July 10, 1997, at 3, n. 3; Motion of the United States Postal Service for Reconsideration of Additional Part of Presiding Officer's Ruling No. R97-1/7, August 18, 1997, at 5, n. 7.

Finally, as the proceedings in this docket made clear, the Commission itself, not the Postal Service is in the best position to update and maintain its model. As the Postal Service had pointed out in moving for reconsideration of one of the above-cited Presiding Officer's rulings directing the Postal Service to make corrections to the alternate costing presentation, it was simply unable to either make or understand certain mechanics for making the changes the Presiding Officer directed. *See* Motion of the United States Postal Service for Reconsideration of Parts of Presiding Officer's Ruling No. R97-1/7, August 15, 1997, at 5, n. 5; Motion of the United States Postal Service for Reconsideration of Additional Part of Presiding Officer's Ruling No. R97-1/7, August 18, 1997, at 5-6.

The fact that certain parties in this proceeding made use of the alternative costing presentation, not only failed to dispel the Postal Service's longstanding concerns, it only reinforced them. For example, MMA witness Bentley used the results that came from LR-H-215, but offered no explanation that gave any indication whatsoever that he either understood or even cared to understand the Commission's costing methodologies and cost model. *See generally* Tr. 21/11151-318. Similarly, PSA witness Jellison used some

information from LR-H-215, but never really discussed the intricacies of the Commission's model. *See generally* Tr. 24/12943-13059. Finally, OCA witness Thompson has used the C language programs of the Commission's Docket No. MC96-3 cost model in an attempt to replicate Postal Service costs in this docket, but, as demonstrated through her interrogatories and oral cross-examination, has little or no understanding of the cost models or the costing methodologies of either the Commission or the Postal Service. *See generally* Tr.20/10492-627. In any event, by any reasonable interpretation of the matter, no one on this record has "sponsored" the Commission's costing methodologies or its cost model.

2. DMA witness Buc's proposal concerning the cost reductions in Cost Segment 2 is based on misinterpretation and speculation, and must be disregarded.

DMA Witness Buc asserts that the "the cost reduction portion of the rollforward program as it applies to Cost Segment 2" is "illogical and should be corrected" Tr. 28/15362. As a result, witness Buc recommends "that the Commission correct this obvious flaw and reduce supervision of mail processing costs by $31 million and supervision of city delivery carrier costs by $20 million" Tr. 28/15363. Witness Buc's claim rests upon his belief that the Program Managers "apparently never considered adjustments in supervisors' costs" and did not consider the viability of supervisor cost reductions in mail processing because "they simply didn't consider the issue." Tr. 28/15398 and 15400.

In arriving at this conclusion, witness Buc clearly misinterpreted Postal Service witness Patelunas's discussion of this issue. In response to DMA interrogatories, witness Patelunas explained that program managers used "their own understanding of the relationships between craft employees and supervisors when they determined these cost reduction estimates" and that "it would not be realistic to conclude from your arithmetic that program managers did not analyze the effect on supervisor and technician workyears." Tr. 13/7211 and 7222. Witness Buc first enigmatically stated that "[w]itness Patelunas's responses speak for themselves." Tr. 28/15399. Despite the clear import of witness Patelunas's responses, witness Buc illogically went on, however, to explain that witness Patelunas was incorrect and he further speculated on why the Program Managers and the Postal Service did not correctly estimate the mail processing Supervisor costs. Tr. 28/15400.

Ultimately, witness Buc conceded that "[t]hese are my opinions supported by the facts I have explained in my testimony, in my previous interrogatory responses, and in my response to USPS/DMA-T1-19." Tr. 28/15432. Witness Buc further provided an example of a purported "unfair" coin toss, which he apparently intended to demonstrate why his opinions are supported. Tr. 28/15432.[12] Witness Buc's beliefs and opinions are not

[12] One could take exception to witness Buc's description of the coin toss as it would seem that for each individual toss, the odds of it coming up heads are one out of two. In any event, however, the Postal Service's cost reduction programs can hardly be compared to a coin toss.

relevant. His conclusion that there should be some cost savings for mail processing supervisors is based solely upon his beliefs and opinions; he cannot produce any evidence that supports them.

3. Witness Sellick's simplified rollforward is insufficient.

United Parcel Service witness Sellick, UPS-T-2, presented a simplified rollforward model that attempted to produce costs using the assumption of 100% variability of mail processing labor costs. The results of witness Sellick's simplified rollforward were used by UPS witness Luciani, UPS-T-3, "to develop a Priority Mail parcel surcharge" and "to calculate a more appropriate DBMC discount." Tr. 26/14162.

The over-simplification in witness Sellick's rollforward results from his application of the "same increase in aggregate, in total, for all factors in both years of the roll-forward to my recalculated base year costs." Tr. 28/14274. This procedure assumes that the overall impact of the six discrete effects in the rollforward is nearly the same, regardless of the mail processing variability methodology employed in the base year. During oral cross- examination, however, witness Sellick agreed that a rollforward mail volume effect of 2.5% would yield a mail volume change amount of $250 million on a $10 billion base, and a mail volume change amount of $300 million on a $12.5 billion base. Tr. 28/14272. Base year mail processing volume variable costs are 12.4 billion, calculated using witness Sellick's proposed base year, and base year mail processing volume variable costs are 10.1 billion using the Postal

Service's proposed base year. Tr. 26/14271. Thus, the difference in mail processing volume variable costs between the two models is something in excess of $2 billion, even before rolling-forward these costs to incorporate the mail volume effect. Tr. 26/14271.

Witness Sellick admitted that "[t]he simplified roll-forward that I employed didn't separately account for either the year-to-year roll-forward that the Postal Service employs in its model or the separate incremental individual effects that the Postal Service employs in its roll-forward model." Tr. 28/14274. Following further questioning on the mail volume effect, witness Sellick was forced to acknowledge that "the mail-volume effect would, as you've described it, increase the volume-variable costs relative to the Postal Service's proposal in the test year," and further conceded that this would result in an increase in accrued cost in the test year. See Tr. 28/14276.

Witness Sellick's simplified rollforward model took no account of the difference in mail processing variabilities when he substituted the Postal Service's test year to base year ratios into his calculations. As he testified himself, both volume variable and accrued costs would be greater in the test year with 100% mail processing variability than with less than 100% variability. The test year costs used by UPS witness Luciani to develop "a Priority Mail parcel surcharge" and "to calculate a more appropriate DBMC discount" (Tr. 26/14162) thus did not reflect test year costs which included an accurate mail volume effect. The Commission is obligated to rely on the best available

cost estimates when setting rates. The rates which might result from an overly-simplified rollforward, such as witness Sellick's, do not meet this standard.

4. Witness Thompson's cost model does not replicate Postal Service costs nor is it easy to use.

Office of the Consumer Advocate witness Thompson, OCA-T-100, presented her version of the Commission's cost model that attempted to replicate the Postal Service's base, interim and test year results, as well as provide an easy-to-use cost model for the novice. Witness Thompson stated that she had "independently verified the Postal Service cost calculations" and had made "available to intervenors a personal-computer-based cost model that *may be used to replicate Postal Service costs and examine alternatives.*" Tr. 20/10497. Witness Thompson agreed "that, independently, you are trying to make sure that your model can be – can replicate the Postal Service's numbers" (Tr. 20/10618) and "[t]hey are two different models, so that, yes, they are not dependent" (Tr. 20/10619). Two independent models are useful and desired because the duplication of the results of one model by a second model demonstrates that both models are executing as expected. If the second model requires intervention to achieve the results of the first model, one or both of the models may not be executing properly.

Witness Thompson's cost model did not replicate the results of the Postal Service model. Rather, some results were replicated and some results of the Postal model were substituted or hard coded into the OCA model. The

distribution of "volume variable less PESSA costs," shown in the Postal Service's cost model A Report, is an output of and thus requires execution of the first stage of the Postal Service's cost model. Witness Thompson took the A Report results and hard coded them into her model. See Tr. 20/10619. This clearly is not a case of replication; it is substituting the results of the Postal model into the OCA model.

Also, witness Thompson utilized a SAS program to convert the Postal Service's manual input data file into a format that could be read by the Commission's cost model, and she agreed this was "a separate program" that was an addition to the Commission's cost model. See Tr. 20/10616. Witness Thompson further testified that when she attempted to use the output of the SAS program, in those instances where it did not replicate the Postal Service's manual inputs, "I manually went into the Base Year.Dat and made the edit changes." Tr. 20/10617. Thus, the manual inputs of the Postal model were substituted into the OCA cost model where necessary.

As another example, the OCA cost model relies on a ratio to calculate higher level supervisor costs, and this ratio was calculated using the results or output of the Postal Service model. Without knowing exactly how the higher level supervisor ratio of 59.301 percent is input into the OCA model, witness Thompson conceded, "I do calculate this information in a separate spreadsheet." Tr. 20/10620. Earlier, witness Thompson had agreed that the amounts she used in this spreadsheet calculation were obtained from the

Postal Service's A Report. Tr. 20/10620. Again, results of the execution of the Postal Service model were substituted into the OCA model.

Furthermore, witness Thompson uses the results of the Postal Service's cost model as inputs to the OCA model without understanding the results or their origin. In her discussion of the volume mix adjustment, when asked if each of the volume mix amounts are input individually into the OCA's cost model, she responded "[y]es, I believe so." Tr. 20/10623. When asked if she was aware that all of the amounts from the sources she cited in her response are generated in the Postal Service's model by executing the control strings that are listed in other parts of the question, her response was "No, I am not." Tr. 20/10624. When asked about the application of the volume mix and work year mix adjustments in her file VOLRIP1.DAT, she responded "I include the op codes 21 and 18, whatever they stand for." Tr. 20/10624. Clearly then, the Postal Service's volume mix and workyear mix results were simply substituted as the OCA model results, and witness Thompson was not clear on the origin of the amounts that were substituted or how these amounts were calculated in the Postal Service model.

In both the base year portion of the cost model and the rollforward portion of the cost model, witness Thompson used outputs of the Postal Service's cost model to provide either inputs or outputs for amounts in the OCA model, rather than have the OCA model replicate these numbers. Accordingly, the OCA model as presented does not, under any reasonable

interpretation, "replicate" the Postal Service's costs.

Witness Thompson's second goal of providing an easy-to-use model to examine alternatives to Postal Service costing methodology was likewise unsuccessful.[13] Witness Thompson contends that the OCA version merely updates the input files to the Commission's MC96-3 cost model and that the program was not changed, with her definition of "program" being the C language programs. *See Tr. 20/10625.* While witness Thompson's drawing of a semantic difference between program files and input files may be accurate, updating the input files does not result in a model any easier to use than updating the program would.

For example, six instances that she discussed as changes to the input files include the following. First, witness Thompson acknowledged making changes to component numbering in segment 21 in her R97-1 version of the cost model (Tr. 20/10606), and she further agreed that if the limit of 99 components in segment 21 was reached, "you might have to use segment 22 or segment 23." Tr. 20/10607. Second, witness Thompson explained the dual use of component 2177: first as "a summation of city carrier, special delivery messenger, and rural carrier components in the base year" and "[I]n replicating FY '97 data, 2177 is reused as the international mail distribution key." Tr.

[13] Witness Thompson asserted that "when [her] updated programs and files are used, running the Commission's cost model is easy." Tr. 20/10500. While it may well be true that running the model is easy once one has updated all the programs and files, as discussed both previously and below, performing the "updating" is quite an exacting and tangled undertaking.

20/10608.

Third, in discussing component 306, witness Thompson states "I am unable to justify the omission of component 306," and she "did not see where I should have taken off the 306, therefore, I assumed that I was incorrect." Tr. 20/10609. The correct instructions were not used in witness Thompson's model (Tr. 20/10609), but upon rerunning with the correct instructions, she thought "the change is insignificant." Tr. 20/10610.

Fourth, in her discussion of her PESSA96P.FAC file, witness Thompson testified that "48 percent of the lines of the code" were changed. Tr. 20/10611. Fifth, witness Thompson testified "I removed the NK and LA statements to see what impact they had on the updated cost model. No impact was noted." Tr. 20/10613.

Finally, testifying as to the function of the NV lines, witness Thompson stated, "after several attempts I found that adding the final NV lines allowed the updated version of the Commission's cost model to more accurately replicate the Postal Service data" (Tr. 20/10614), and responding to the cost effects that might occur in Components 215, 221, and 225 as a result of adding the NV lines, she responded "in your interrogatory you're, asking me to say what cost effects specifically are occurring, I believe. And it wasn't necessary for purposes of my testimony to understand that." Tr. 20/10615.

It is quite clear that the examples listed above, no matter if they are termed program changes or input changes, constitute a considerable amount

of work. The examples range from changing nearly half the lines in PESSA96P.FAC (162 line edits out of 335 total lines of the input file),[14] to experimenting with input files to achieve the results without understanding the cost implications. Throughout, witness Thompson kept no log of the time spent on the cost model, but from the filing of the request in this docket in early July to December 24, she was working on the project. Tr. 20/10626. It is evident from her responses that much editing went in to updating the input files and rerunning the programs to approach results similar to those of the Postal Service. Intervenors desiring to use the OCA cost model would have to undertake much of this work even to examine alternatives in this case, as the cost inputs would obviously change. The effort required to use the OCA model in any new proceeding would be even more arduous.

[14] *See OCA-LR-4 at 56-64.*

IV. THE RATE LEVELS PROPOSED BY THE POSTAL SERVICE FOR EACH SUBCLASS AND SPECIAL SERVICE REFLECT A REFINED APPLICATION OF THE RELEVANT RATEMAKING CRITERIA OF THE ACT

In the two-tier postal ratemaking process established by Congress, pricing follows costing as the second tier. The cornerstone of the pricing exercise, the rate policy portion, is to determine how much total revenue to seek from each subclass, in excess of the costs determined to be caused by that subclass during the first-tier costing process, to allow the Postal Service to achieve financial breakeven. (After rate policy issues are resolved and a target revenue has been set for each subclass, rate design is the subsequent pricing task necessary to determine how to split that revenue burden among the various rate categories and rate elements of the subclass.) In this case, as in previous cases, the Postal Service has provided a rate policy witness to explain why the rate levels proposed for each subclass and service are in accord with the statutory factors that guide the pricing process. The rate policy witness in the instant case is Dr. O'Hara, and his testimony appears as USPS-T-30.

Careful review of Dr. O'Hara's testimony will reveal that his rate level proposals rest on evaluations of the statutory factors that are very similar to those employed by his predecessors. Not surprisingly, Dr. O'Hara is proposing no great shifts in the relative shares of Postal Service costs to be borne by the respective subclasses, nor in the rates for any particular subclasses. As Dr. O'Hara has testified, nothing he has done constitutes a major departure from the types of analyses relied upon in the past by both the Postal Service in developing its rate proposals for the Commission, and the Commission in recommending rates to the Governors. USPS-T-30 at 12.

Yet there are improvements in the pricing proposal submitted by the Postal Service in this case which, even if subtle, are important. The Postal Service has provided two additional types of analyses with its filing in this case which enhance the Commission's ability to fulfill its statutory mission. The two analyses produce a comprehensive set of incremental costs, and a comprehensive set of economically-efficient (or Ramsey) prices. The Postal Service, moreover, has provided a comprehensive framework in which these two new tools can be employed to solidify the economic foundation for rational ratemaking. Within this framework, as Dr. O'Hara has demonstrated, the Commission can go about its business in a manner that approximates its current approaches, but with much greater confidence that the insights obtained from solid and well-established economic analysis have been used to maximum advantage. Moreover, this framework in no way restricts the Commission's ability to apply its judgment and discretion to achieve the same policy objectives that it has customarily pursued.

Using the new information and the new framework, Dr. O'Hara has proposed rate levels that meet all of the relevant statutory criteria in a reasonable and rational fashion. On the other hand, intervenor witnesses who have made alternative proposals or have suggested alternative pricing procedures have relied upon analyses with substantial shortcomings. In this section of its brief, the Postal Service will review the proper economic and statutory framework for pricing, will demonstrate why the rate levels proposed by Dr. O'Hara best fit within those frameworks, and will show why the proposals of opposing intervenors should be rejected.

A. The Preservation Of Economic Efficiency Is One Important Ratemaking Policy Of The Act

In the most recent previous omnibus rate proceeding, Docket No. R94-1, witness Andrew on behalf of MOAA postulated that the last sentence of 39 U.S.C. § 101(a) should be interpreted to establish a policy that postal rates should be "efficient," in the economic sense of the term.[1] The sentence in question from section 101(a) reads:

> ... *The costs of establishing and maintaining the Postal Service shall not* be apportioned to impair the overall value of such service to the people.

In its Opinion in that docket, however, the Commission questioned whether that sentence bears on ratemaking policy at all:

> [W]itness Andrew's inference that the last sentence of section 101(a) is an imperative directed primarily to the ratemaking process is questionable. The sentence does not refer to postal rates or ratemaking. In contrast, section 101(d) explicitly sets a standard of fairness and equity for the apportionment of postal cost through rates. Consequently, in light of the preceding policy declarations in section 101(a), the last sentence's reference to "apportion[ment]" of the "costs of establishing and maintaining the Postal Service" might be read more reasonably as a directive to postal management regarding the distribution of its capital commitments and expenditures on the infrastructure of the nationwide postal system.

PRC Op., R94-1, at IV-7.

The question raised by the Commission in this regard, however, is

---

[1] For a full discussion of the essential merit of Dr. Andrew's observation, see the Postal Service's initial brief in Docket No. R94-1 at VI-17 - VI-19, and reply brief at V-28, n.10.

unambiguously resolved in the legislative history. We know that the last sentence of section 101(a) was intended to pertain to ratemaking because the very same Senate report cited by the Commission (in the paragraph on IV-7 immediately preceding that quoted above) tells us so directly. The report states:

> In recommending rate decisions, the Commission is required to act in accordance with the statutory policy that the costs of all postal operations must be apportioned to all users of the mail on a fair and equitable basis, and in a manner that will not impair the overall value of the service to the people.

S.Rep. No. 912, 91st Cong., 2d Sess. at 15 (June 3, 1970).

This portion of the Senate report shows several things. First, the policy stated in the last sentence of section 101(a) was plainly intended by Congress to be applied during the ratemaking process. Second, while it may not prove that efficiency was intended to be a ratemaking policy that should be elevated above all others[2], efficiency would appear to be entitled to at least the same level of consideration as fairness and equity. Stated conversely, economic efficiency is an important ratemaking factor that should not be ignored.

In the past, the Commission has emphasized the judgmental nature of the

---

[2] The Commission apparently interpreted Dr. Andrew's testimony regarding section 101(a) as suggesting that efficiency should be pursued "to the exclusion of other relevant ratemaking considerations," that efficiency be "elevate[d] ... above" competing policy considerations, and that efficiency be allowed "to dominate." See id. at IV-6 - IV-7. In rejecting such admittedly extreme views (whether actually intended by Dr. Andrew or not), the Commission did not appear to dispute the basic notion that economic efficiency is one of the many policies incorporated into the Act. Id. Previously, for example, the Commission has stated that "the efficiency concerns reflected in Ramsey pricing principles are neither more nor less important than other statutory factors." PRC Op.&Rec.Dec, R87-1, at 108.

pricing task:

> Deciding markups and developing rate recommendations involves balancing a number of statutory pricing criteria, some of which complement each other and some of which conflict with each other. . . . Selecting a single set of rates that satisfies all of the pricing criteria requires the Commission to judgmentally determine how to interpret the various pricing criteria and the weight to be accorded each.

PRC Op., R94-1, App. F at 17. The Postal Service agrees, and has long maintained that no mechanistic approach to pricing can adequately incorporate all of the necessary considerations. Ultimately, judgment will always be required. Nevertheless, rates necessarily affect economic efficiency, and to avoid the impairment of the "overall value of the service to the people," care should be taken to allow ample consideration of efficiency tradeoffs in the development of rate recommendations.

B. Professor Panzar Has Presented the Economic Framework in Which Efficiency Concerns Must Be Addressed

In this docket, the Postal Service has presented the testimony of prominent regulatory economist John Panzar (USPS-T-11) to discuss the ratemaking framework necessary to address concerns of economic efficiency. Prof. Panzar's most basic proposition is simple, intuitive, and, not surprisingly, undisputed: "the efficient pursuit of **any** objective subject to a break-even constraint requires that one trade-off costs

and benefits at the margin." USPS-T-11 at 28.[3] Consequently:

> [T]he marginal costs of the various services are essential information for the implementation of **any** rational pricing policy. This is a logical consequence of the break-even requirement. Whatever goals the rate-maker wishes to pursue via the prices of various subclasses of mail, they can be pursued effectively only by taking cognizance of the marginal costs of expanding or contracting the relevant mail volumes.

Id. at 7. Dr. Panzar devotes a substantial portion of his direct testimony to explaining the critical relationship between economic efficiency and marginal cost information in the ratemaking process. *Id.* at 4-7, 27-30. Of course, there is nothing novel about this portion of Prof. Panzar's exposition -- the paramount importance of marginal costs in economic analysis is well established in the most basic introductory economics textbooks.[4]

Dr. Panzar also demonstrates why the unit volume variable costs measured by the Postal Service are economic marginal costs. USPS-T-11 at 13-23. The Postal Service has gone to great lengths to design and implement costing systems and

---

[3] Even NAA witness Chown agrees with this elementary principle, stating "I agree that economic efficiency requires a trade-off between costs and benefits at the margin and that marginal costs provide relevant information for making this tradeoff." Tr. 25/13325.

[4] Thus, it is not surprising that the economists who testify in this proceeding emphasize the paramount importance of marginal cost information in setting prices. A non-exhaustive list in this case would certainly include Dow Jones witness Shew (Tr. 28/15506-11, 15545-46) and Prof. Sherman in his testimony on behalf of the OCA (e.g., Tr. 26/13711-12). Marginal cost analysis, however, is not merely an "ivory tower" academic exercise. Without using the economic jargon, the rebuttal testimony of Saturation Mail Coalition Buckel (SMC-RT-1, Tr. 32/17246-48) demonstrates that it *is also the way in which real businesses make real decisions in the real world.* The realities of the marketplace must be addressed at the margin.

procedures that will achieve this objective. These efforts are worthwhile, however, because they create the necessary economic foundation for sound, rational, ratemaking.[5] And, as Dr. Panzar explains (*id.* at 4, 24-27), not only do the postal costing systems produce reliable measures of marginal costs, but they can be (and now have been) expanded to also allow the estimation of incremental costs.

In his testimony, Dr. Panzar carefully delineates the appropriate role of incremental costs in postal ratemaking. *Id.* at 8-12, 27-30. The incremental costs of a subclass are the costs of the Postal Service that would be saved by removing the subclass' entire volume from the postal system. *Id.* at 4. Conceptually, incremental costs are related to marginal costs, but the two concepts play very different roles in any rational ratemaking regime. *Id.* at 5. As Prof. Panzar stresses repeatedly, the proper role of subclass incremental costs is to test proposed rates for cross-subsidies. *Id.* at 8-10, 27-28, 30. If subclass revenues at proposed rates exceed

---

[5] While any number of valid policy objectives may guide the pricing process, unless that process begins with solid economic cost information, it is as unstable as a physical structure built upon an inadequate foundation. Recall that a shoddily constructed building conceivably may survive for its full life cycle, or at least for many years before stress resulting from relatively infrequent circumstances causes its collapse. Nevertheless, prudence dictates that we pay our builders to lay a foundation solid enough to protect against any reasonably foreseeable contingencies. The pricing process is similar. Given the wide discretion built into the Act, it is possible in many circumstances to achieve reasonable prices even if substandard cost information is employed as the foundation. But as market conditions evolve, it is also possible that misusing cost information (for example, by marking-up incremental costs) can substantially impair overall economic efficiency and the Postal Service's ability to retain markets in which it enjoys a true competitive advantage. See USPS-T-11 at 10. Our only protection against such unfavorable developments is to obtain the best available cost information and to apply it correctly. As Dr. Panzar instructs, that means basing markups on marginal costs, and using incremental costs to test for cross-subsidy.

subclass incremental costs, the test is passed, and the users of the subclass are not being cross-subsidized by the customers of all other postal subclasses. At such rates, the postal system as a whole benefits from provision of the subclass in question.

Dr. Panzar also provides instructions regarding how not to use incremental costs. *Id.* at 28-29. Unlike marginal costs, average incremental costs do not provide relevant information for conducting trade-offs at the margin. *Id.* Therefore, they should not be used as the starting point for the application of markups to enable the Postal Service to cover its total costs. *Id.* Applying markups to incremental costs instead of marginal costs would reduce economic efficiency. *Id.* In his pricing testimony, Dr. O'Hara provides a useful example to illustrate this point. USPS-T-30 at 14-16.

Dr. O'Hara also makes the important point that deviations from economic efficiency can also have a "fairness" dimension. His example shows how prices linked to something other than marginal costs can create distortions at the margin, whereby consumers of different products are faced with an unequal ability to make purchases at a price equal to or below the level at which they actually value those products. *Id.* Such disparity in treatment of customers of different products easily fits within conventional notions of "unfairness."

Prof. Panzar highlights the shortcomings of marking up incremental costs in his testimony rebutting UPS witness Henderson, who makes precisely the mistake of proposing to markup incremental costs that Dr. Panzar's direct testimony warned

against. If one correctly bases mark-ups on marginal costs, one can consider the minimum mark-up over marginal costs required to cover incremental costs, one can consider the economically efficient (i.e., Ramsey) markup, and one can bring to bear all of the other factors of the Act upon which one wishes to rely in determining the actual mark-up proposed. USPS-RT-13 at 20-21. In contrast, if one erroneously attempts to base mark-ups on incremental costs, it is still possible to consider the other factors of the Act, but the ability to bring to bear information on the economically efficient mark-ups has been lost. *Id.*

As an example, imagine two subclasses, Subclass A and Subclass B. If we start with marginal costs as the basis for our markups, the cost coverage at rates set at volume variable cost for each subclass would be 100. Let us suppose that for each subclass, incremental costs exceed volume variable costs by 50 percent, so the minimum cost coverage required to avoid cross-subsidy is 150. Further suppose that for Subclass A, at current rates (TYBR), revenue over volume variable costs is 2.0, so the TYBR cost coverage is 200, while for Subclass B, the same ratio is 1.8, and TYBR cost coverage is 180. Lastly, let us assume that the economically-efficient (Ramsey) cost coverage for Subclass A is 220, and for Subclass B is 165. Under our hypothetical, as we begin the judgmental portion of the pricing process, we can see that both subclasses cover their incremental costs, we can see that the TYBR cost coverage for Subclass B is less than the TYBR cost coverage for Subclass A, 200 versus 180, but we also can see that Subclass B is already above its Ramsey cost coverage, while Subclass A is still below its Ramsey coverage. Regardless of exactly

how we use this information, or exactly how much weight we choose to give various elements, it is all highly relevant and useful information in evaluating the rate adjustment that is appropriate for each subclass.[6]

By comparison, what happens in our hypothetical if we apply only incremental cost information in the markup process? Using that basis for analysis, we can see that the incremental TYBR cost coverage of Subclass A is 133 (the ratio of 200 to 150) and the TYBR incremental cost coverage of Subclass B is 120 (the ratio of 180 to 150). Therefore, as above, the TYBR cost coverage for Subclass A is higher than that of Subclass B. But in this mode of analysis, we have no way to know how close or how far the rates for each subclass are to their economically efficient level. It is not possible to calculate Ramsey prices using incremental costs as the only cost input. As Dr. Panzar testifies, critical information has been lost.[7]

The contrast in capabilities to take account of relevant information of a markup

---

[6] Prof. Sherman makes this point quite forcefully:

> Other considerations can warrant departures from Ramsey prices that keep welfare losses small. <u>But departures from Ramsey prices should consider the consequences they have for welfare loss</u>, which is essentially the cost of departing from Ramsey prices.

Tr. 26/13720 (emphasis added).

[7] At an even more fundamental level, it is impossible to iterate to breakeven using only incremental cost information. (Stated less abstractly, the rollforward process must use volume variable costs to estimate the cost consequences of volume changes, and cannot use incremental costs for that purpose.) As Dr. Panzar explains at page 5-7 of his testimony, the dynamics of the process that requires a marginal analysis to achieve breakeven compels the logic that relative markups should be evaluated on that basis as well.

process based on marginal costs versus one based on incremental costs is evident:

Volume Variable (Marginal)	Incremental
1. Minimum cost coverage required to cover incremental costs	1. All other factors
2. Efficient (Ramsey) cost coverage	
3. All other factors	

The markup process based on volume variable costs can incorporate all of the information captured by a process based on incremental costs, but the reverse does not hold true. Information is necessarily lost if markups are based exclusively on incremental cost information. Because it would be irrational to ignore relevant information on efficiency, it would necessarily be irrational to base markups on incremental costs.

C. The Postal Service in This Case Has Provided the Commission With All Information Necessary to Implement the Appropriate Economic Framework for Pricing

As discussed by Dr. O'Hara in his pricing testimony, the Postal Service in this case has, for the first time, been able to present comprehensive information to apply to the economic framework for pricing described by Dr. Panzar. See USPS-T-30 at 11-21. Information for each subclass and service regarding each of the quantitative components discussed above appears in the testimony of a Postal Service witness. Starting with the TYBR cost coverages, those are presented as Column (3) in Dr. O'Hara's Exhibit USPS-30A. The minimum cost coverages required to cover

incremental cost appear as Column [3] in witness Takis' Exhibit USPS-41B.[8] The economically-efficient Ramsey cost coverages can be easily derived by adding 100 percent to the Ramsey markups estimated by witness Bernstein and presented in Summary Table 2 at page 5 of USPS-T-31.[9]

With this information in place, rational postal pricing is poised to proceed. The emphasis now switches to evaluating the tradeoffs intended to be reflected in the more subjective considerations of the Act. Concerns of fairness and equity, of impact on the mailers and competitors, of availability of alternatives, and of the ECSI factors,

---

[8] That column is listed in the exhibit as the ratio of base year incremental costs to base year volume variable costs. Because of the "ratio approach" used by witness Takis to derive test year incremental costs (USPS-T-41 at 20), however, the figures presented in that column of the exhibit can also be considered, when expressed in percentage terms, as the minimum cost coverage over volume variable costs necessary to recover incremental costs. For example, Exhibit USPS-41B shows that the cost coverage floor for First-Class letters is 108.8 percent, for Standard Regular is 102.1 percent, and Standard ECR is 104.4 percent. Of course, alternatively, one can perform incremental costs tests as Dr. O'Hara has done in USPS-T-30, by directly comparing TYAR subclass revenues and TYAR incremental costs in dollar amounts.

[9] For example, the Ramsey Mark-up shown in Summary Table 2 for First-Class letters is 103.29, so the equivalent Ramsey cost coverage is 103.29 plus 100, or 203.29. Similarly, a Ramsey mark-up for Standard Regular of 78.56 converts to a cost coverage of 178.56, and a mark-up for Standard ECR of 20.12 converts to a cost coverage of 120.12.

Ramsey analysis was also presented in this proceeding by Prof. Sherman, and Ramsey cost coverages are also easily derived from this testimony. As Dr. Sherman testified, "the Ramsey prices I estimated are not very different from Witness Bernstein's, and I join him in praising such prices for their welfare effects." Tr. 26/13714. Dr. Sherman presents his estimates as "Average Revenue," based on pure Ramsey, and then with several constraints. Tr. 26/13725-30. His average revenues (shown on Tr. 26/13728-29) can be divided by the marginal costs he used (shown in witness Bernstein's Table 7 at page 40 of USPS-T-31) to compute his version of Ramsey cost coverages. For example, for First-Class letters, these range from 186 to 204, for Standard Regular, from 169 to 182, and for Standard ECR, from 119 to 121.

are just as easily evaluated and incorporated into this framework as under any other. Obviously, those factors (as assessed in the previous case) are already reflected in the existing rate structure, which heavily influences the estimated TYBR cost coverages. More formal reference to the results of findings made in previous proceedings can employ and compare cost coverage or markup indices, which relate measurements for individual subclasses with the system as a whole.[10] Thus, as Dr. O'Hara testifies, while the new framework is an improvement over previous practice, it does not constitute a major departure. USPS-T-30 at 12.

D. The Proposed New Economic Framework for Pricing is Fully Consistent With the Requirements of the Act

As described above, the framework described by Dr. Panzar and applied by the Postal Service in this proceeding is well-grounded in economic theory and practice. A framework which marks up marginal costs and uses incremental costs solely to test for cross subsidy is required to make the most rational use of available cost information and simultaneously allow the Postal Service to achieve financial breakeven. Moreover, as discussed next, such a framework comports well with the relevant criteria of the Postal Reorganization Act.

---

[10] The testimony of Dr. O'Hara explains why a cost coverage index provides a better starting point than does a markup index under circumstances in which material changes in costing procedures have occurred. USPS-T-30 at 16-20. Obviously, similar transitional problems would be expected to occur if index comparisons are attempted across cases in which the base (cost coverage or markup) has changed from "attributable" to volume-variable. That would be a one-time effect, however, and future comparisons of indices based on volume-variable costs would be no more difficult than those based on "attributable" costs in the past.

Obviously, the most critical provision of the Act in this regard is section 3622(b)(3), which includes in the list of factors which the Commission must consider in recommending rates:

> (3) 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). Early on, this provision was the source of great debate, which culminated in the Supreme Court's 1983 decision in NAGCP IV, 462 US 810. When all the dust settled, however, the Court's opinion shows that the intended scope of the subsection was nowhere near as expansive as had been previously argued.[11] Most essentially, the Court concluded that the statute's plain language and legislative history indicated a broad policy to mandate a rate floor consisting of all costs that can be reliably identified as causally linked to a subclass, and a requirement that all costs that are the consequence of providing a particular subclass must be borne by that subclass. *Id.* at 833. Congress intentionally avoided any attempt to specify how the rate floor should be calculated, other than to insure that it would include all costs that were, but only those costs that were, casually related to the provision of the subclass in question. *Id.* at 830-32. Beyond that, the Court

[11] Earlier court decisions had held that the employment of cost-of-service principles to the maximum extent possible was necessary to achieve the intent of section 3622(b)(3), that this required use of distribution keys based on cost accounting doctrines, and that Congress actually envisioned a three-tier rather than two-tier (costing/pricing) ratesetting process. See 462 US at 816-17.

found, the Commission "is to assign remaining costs reasonably on the basis of the other eight factors set forth by § 3622(b)." *Id.* at 834.

As Dr. Panzar testified, economists can immediately identify a requirement that all costs that are the consequence of providing a particular service be borne by that service as functionally equivalent to a requirement that no service be cross-subsidized by the other services. USPS-T-11 at 8. Moreover, over the last several decades, economists have developed a concept for the specific purpose of ensuring that requirements such as this are met -- the incremental cost test. *Id.* In other words, the incremental cost test of economic theory is designed to achieve precisely the result mandated by Congress in section 3622(b)(3). By definition, the incremental cost of a subclass constitutes the rate floor for that subclass envisioned by Congress.

As stated above, for the first time, the Postal Service has presented in this case incremental costs for each subclass and service. These incremental costs are derived from a thorough and comprehensive analysis which examines incremental costs by subclass for each cost component. USPS-T-41 at 5-7, 14-20. Like the volume variable (marginal) cost estimates, they are well-grounded in the substantial amount of research conducted, both in previous years and for this case, to measure empirically the relationship between cost and volume for each component.[12] Of

---

[12] Although the volume-related portions of marginal cost and incremental cost may be based on the same underlying analysis of the relationship between cost and volume, as a matter of both theory and practice, they measure different things. The volume-related portion of incremental cost are **not** equal to marginal (or in postal parlance, volume variable) costs. Until the testimony of witness Takis in this case, it would appear that no measures of the volume-related portion of incremental costs have ever been presented for use in postal ratemaking.

course, they also include consideration of product specific costs which, although not variable with respect to volume, would be eliminated if the service were no longer offered. The incremental costs presented in this case for each subclass provide reliable estimates of the totality of costs that are the consequence of providing that subclass.

In essence, once rates for each subclass cover their incremental costs, section 3622(b)(3) has served its purpose. As the Supreme Court made clear, the intent of Congress, starting with the Kappel Report and carried through on both the House and Senate sides, was to establish a rate floor of causally related costs. See 462 US at 823-25, 827-31.[13] Ultimately, that intent was expressed in section 3622(b)(3), and compliance with that intent is shown when rates pass the incremental cost test.

Beyond the language establishing the requirement of a rate floor, all that remains in section 3622(b)(3) is the final clause, "plus that portion of all other costs of the Postal Service reasonably assignable to such class or type." As all long-time participants in postal ratemaking are painfully aware, great mischief resulted from earlier efforts to read into that language more than what is there. Advocates of fully

---

[13] The Commission made this same point in its discussion at page 103 of its Opinion in Docket No. R87-1, in commenting on the legislative history reviewed by the Supreme Court. In that case, however, the Commission was greatly troubled by the proposal to perform an incremental cost test "only in suspicious cases." The Commission suggested that if incremental costs are intended to provide the rate floor required by section (b)(3), they must be presented for every subclass and service. Id. In this case, witness Takis has provided the incremental cost information necessary to achieve exactly that objective. For every subclass and service, the Postal Service has provided an unambiguous rate floor, in full compliance with section 3622(b)(3).

distributed costing used that clause as a platform to launch their schemes to inject a third tier of costs into the process, based on cost accounting principles. The Supreme Court firmly rejected those attempts in its NAGCP IV decision. In so doing, the Court provided the only reasonable interpretation of Congressional intent regarding the final portion of section 3622(b)(3):

> The Rate Commission is to assign remaining costs reasonably on the basis of the other eight factors set forth by § 3622(b).

Id. at 834.[14]

Thus, the last portion of section 3622(b)(3) is best described as a bridge between the two tiers of the ratesetting process described by the Supreme Court. The first tier is the costing tier, which includes the identification of all costs caused by providing each service, and the second tier is the pricing tier. Pricing is to be done reasonably, but (b)(3) gives no guidance on what "reasonable" in this context might mean (other than in compliance with the rate floor identified in the first tier). Instead, as the Supreme Court indicates, reasonableness in this context must be defined with reference to the other factors set forth in the Act. Unless pricing which comports with all other provisions of the Act could nonetheless somehow be construed as "unreasonable," no independent basis is created in the last clause of (b)(3) to evaluate either any particular pricing process, or the results of any particular pricing

[14] In another portion of its opinion, the Court expressed the same thought by noting that "through the process of assignment each class of service will receive its reasonable portion of all other costs." Id., 462 US at 823, n.17.

process.

More specifically, no portion of subsection (b)(3), or, for that matter, any other subsection of section 3622(b), provides any guidance on the mechanics of the pricing process. Congress intended to leave such details to the ratemaking experts. The focus of all of the factors specified in section 3622(b) is directed exclusively to the end product -- the rates and fees that are recommended. No mention is made of cost coverages, or markups, or any of a host of other terms and concepts that have developed over the years since postal reorganization to provide shape and structure to what has been and remains a mixture of art and science. Therefore, no portion of section 3622 explicitly requires that markups or cost coverages be based on marginal costs, or incremental costs, or even attributable costs.[15] What is explicitly required is that prices meet the cost floor, and that the rest of the pricing process be conducted reasonably, in accordance with the other specified factors.[16] As Dr.

---

[15] As Prof. Panzar notes in his testimony, many of the contentious issues in postal costing and pricing have their origin in attempts to have the statutory notion of "attributable costs" fulfill simultaneously the distinct roles properly played by marginal costs and incremental costs. USPS-T-11 at 5. As he suggests, not only are such attempts doomed to failure, they are unnecessary and counterproductive. Id. The framework he presents demonstrates why this is so.

[16] Taken to the literal extreme, the most that one could argue based on the actual language of the final clause of section 3622(b)(3) is that some basis is necessary to evaluate how much each subclass is contributing above its incremental cost floor. Of course, in the framework described above, such an evaluation can be made directly by comparing the minimum cost coverage required to cover incremental costs (presented in this case by witness Takis) with the TYAR cost coverage actually proposed by Dr. O'Hara. Any party wishing to take issue with the reasonableness of Dr. O'Hara's cost coverages (or any other set of cost coverages) certainly has this information at their disposal.

Panzar has testified, not only does the framework he has proposed meet this standard, but alternative pricing proposals (such as to mark up incremental costs) are, in fact, unreasonable and irrational.

In summary, now that the Postal Service has presented comprehensive and reliable incremental cost information, the basic framework sketched out by Prof. Baumol in earlier cases and reiterated in this case by Prof. Panzar provides an ample basis to meet all statutory requirements. As implemented by Dr. O'Hara, the result is rates for each subclass (except Classroom[17]) that cover incremental costs and represent reasonable allocations of the Postal Service's residual costs.

E. *The Proposed New Economic Framework for Pricing Makes Sense*

In the preceding sections, the Postal Service has shown how its proposed new framework for pricing corresponds to well-established economic theory and general ratemaking policy concerns, and fits comfortably within the statutory framework provided by Congress. Before moving on, however, it may be worthwhile to try to emphasize explicitly what is implicit in everything that has been said previously. The new pricing framework is a good idea; it makes sense.

It makes sense for consumers, whose purchases (either directly or indirectly) generate the revenues on which our postal system is run, to have rates set that most closely reflect the true resources consumed in providing more or less postal service.

---

[17] The situation with respect to Classroom Mail is unrelated to any issues relevant to this discussion.

It makes sense for commercial and organizational mailers, whose own business decisions are based on trade-offs made at the margin. It makes sense for competitors, whose concerns regarding cross-subsidies are directly addressed by the incremental cost test.[18] It makes sense for the American economy as a whole, as the efficient allocation of resources is promoted by "sending the right price signals" (USPS-T-11 at 10). It makes sense for the Postal Service, to be able to use in the ratesetting process the same type of information on marginal and incremental costs that it needs to use for internal decisionmaking purposes. And it makes sense for the Commission, to be able to address cross-subsidy concerns and markup concerns with two distinct cost concepts -- each ideally suited for its intended function -- rather than one cost concept that actually performs neither function satisfactorily.

The full pricing discretion invested in the Commission is not diminished in any fashion by the proposed new framework. In fact, the utility of that discretion is enhanced by establishment of a structure which, if consistently applied, creates a solid cost foundation on which to achieve any number of pricing objectives. In contemplating our proposal, the Postal Service urges the Commission to consider the following question very carefully: which of the policy objectives previously articulated by the Commission would be impeded by incorporation of the new framework into its analysis? The Postal Service submits that there are none. On the other hand, are

---

[18] Of course, as the Second Circuit found in the appeal from Docket No. R84-1, the Commission's task in evaluating competition-related arguments under section 3622(b)(4) is to protect competition, not particular competitors. DMA v. US Postal Service, 778 F2d 96, 106 (1985).

there policy objectives which would be enhanced? The Postal Service submits that there are at least two. First, incremental costs provide a superior test for cross-subsidy than the costs that have previously been labeled as "attributable costs." Second, in comparison once again to what have been considered "attributable costs," volume variable costs provide a superior basis to evaluate concerns of efficiency. Neither of these improvements are gained at the cost of any lessened ability to consider fairness and equity, impact, availability of alternatives, ECSI factors, or any other statutory factors.

F. The Postal Service and the OCA Have Provided Information on Economically Efficient (Ramsey) Prices To Assist in the Ratemaking Process

With its initial filing, the Postal Service included the testimony of witness Peter Bernstein regarding Ramsey pricing, USPS-T-31.[19] As witness Bernstein noted, the purpose of his testimony was to present estimates of the prices for each subclass, called Ramsey prices, which simultaneously allow the Postal Service to recover its

[19] The direct testimony of Prof. Panzar also touches on Ramsey pricing, explaining very briefly how it fits into the economic framework for costing and pricing that his testimony develops. See USPS-T-11 at 4, 17, and 28. More importantly, he explains that Ramsey prices need to be tested for cross-subsidy (and, if necessary, adjusted) using the incremental cost test. Id. at 11-12. Mr. Bernstein's analysis conforms to this admonition (USPS-T-31 at 47), and his ability to use the incremental costs provided by witness Takis for this purpose resolves one of the major objections regarding the use of Ramsey pricing raised in the past by the Commission and others. See, e.g., PRC Op.&Rec.Dec., R94-1, App. F at 24.

Dr. O'Hara also supports the utility of Ramsey prices in a broader pricing process. USPS-T-30 at 20-21. He notes that whether a particular rate level would move rates closer to, or farther away from, Ramsey prices was one of the many factors he considered in evaluating potential rate levels. He also states, however, that given other concerns, this did not have a major effect on his conclusions in this case. Id.

total costs, yet also minimize the burden on mailers that is necessary to achieve that breakeven objective. *Id.* at 2. Mr. Bernstein explains that Ramsey pricing applies to the Postal Service because the significant amount of common costs in the postal system prevent rates set at marginal costs from allowing the Postal Service to break even. *Id.* at 8. Pricing above marginal costs imposes a burden on consumers, but that burden can be minimized, while still meeting the breakeven constraint, using Ramsey pricing. *Id.* at 9-31. By definition, Ramsey prices minimize the additional burden (relative to marginal cost pricing) on consumers.[20] Witness Bernstein explains the theory and intuition behind Ramsey pricing, and illustrates how application of the Ramsey formula minimizes the burden on mailers as a whole. *Id.* at 17-31.

Moving from theory to practice, Mr. Bernstein assembles the necessary data, and then presents and explains his Ramsey prices. *Id.* at 32-48, 54-66. For purposes of comparison, he also develops and presents rates which are based on the Commission's markups from Docket No. R94-1, but which are adjusted to meet the breakeven constraint while still maintaining the same relative markups. *Id.* at 49-53. Compared with those illustrative R94-1 markup rates, his Ramsey prices reduce the aggregate burden on mailers by slightly over $1 billion, an amount commensurate

[20] In other words, there may be debate about whether Ramsey prices have been properly calculated in any particular instance, but there should be no debate that, in reality, there does exist a set of prices which, under the conditions faced by the Postal Service (including the need to break even), minimize the aggregate burden on consumers. That set of prices can be referred to as Ramsey prices or, more generically, as the economically efficient prices.

with approximately 2 percent of total revenue. *Id.* at 67-71.[21] Full results by subclass are presented and discussed in the testimony.

Mr. Bernstein, Prof. Panzar, and Dr. O'Hara are not the only witnesses in this proceeding who support reference to Ramsey prices as part of the pricing process. Testifying on behalf of the OCA, Prof. Roger Sherman also reviewed the theoretical foundations of Ramsey pricing, presented several alternative versions of Ramsey prices, and estimated the welfare cost of departing from Ramsey prices. OCA-T-300, Tr. 26/13707-44. Dr. Sherman stated that "[t]he remarkable property of Ramsey prices is that they minimize the resulting welfare losses," and that "[t]he Ramsey prices I estimate are not very different from Witness Bernstein's, and I join him in praising such prices for their welfare effects." Tr. 26/13712,13714. As quoted above, Prof. Sherman also testified that:

> Other considerations can warrant departures from Ramsey prices that keep welfare losses small. But departures from Ramsey prices should consider the consequences they have for welfare loss, which is essentially the cost of departing from Ramsey prices.

Tr. 26/13720. Dr. Sherman, therefore, strongly endorses the view that Ramsey

---

[21] During discovery, witness Bernstein was asked to estimate the additional welfare loss (relative to his Ramsey prices) of the Postal Service's proposed rates. He estimated that amount to be slightly under $400 million. Tr. 10/4999.

Also during the discovery phase, in addition to numerous interrogatories from the parties about Ramsey pricing, Mr. Bernstein provided a lengthy response to a question in POIR No. 1 regarding the potential role of nonpostal products in a Ramsey pricing exercise. Tr. 11/5068-74. His ultimate conclusion on that issue was that, as long as nonpostal alternatives are offered in a competitive environment in which nonpostal firms are pricing at their marginal cost (including normal profits), Ramsey prices for postal products will not be affected. Id.

pricing is an essential tool in the ratemaking process.

Prof. Sherman presented several versions of Ramsey pricing, ranging from "pure" Ramsey to Ramsey with single and multiple types of constraints. Tr. 26/13725-31. He also did a quite thorough welfare comparison showing, in rough terms, that the welfare loss going from prices set at marginal costs to Ramsey prices is in the neighborhood of $2 billion, and further departures from Ramsey prices of the type proposed in this proceeding can create additional welfare losses in the $1 billion range. Tr. 26/13734-45.

A more grudging (or at least less enthusiastic) supporter of Ramsey pricing than Prof. Sherman is UPS witness Henderson. In his direct testimony, Dr. Henderson expressed many of the reservations regarding Ramsey pricing that have been heard at the Commission over the years. Tr. 25/13561-62. During hearings, however, Dr. Henderson clarified his views on the potential utility of Ramsey information:

> In my view, the Commission or the Postal Service, for that matter, has no choice but to take into account demand elasticities when it's setting prices. Whether it sets those and thinks about it as setting them relative to Ramsey pricing or thinks about it as setting it with mark-up indices that have been determined in accordance with the other pricing factors in the act, no matter how they ... think about it, you have no choice but to have it in the context of today's market and the demand elasticity in today's market is part and parcel of that.
>
> So the decisionmaking is going to be informed one way or the other by demand elasticity, and I guess it's the question of whether a separate calculation of Ramsey pricing per se adds information content. My guess is that the answer to that has got to be yes because it's another indicator and indicates something; it's just not something that can be relied on to the exclusion of the other pricing factors in the act.

Tr. 25/13669-70.

With respect to the quality of the data available to conduct Ramsey pricing, Dr. Henderson stated that:

> I'm saying the data are poor and probably don't support the use of Ramsey pricing once again to the exclusion of other pricing factors. . . . What I was indicating was that if the Commission were to attempt to use Ramsey pricing to the exclusion of the other pricing factors, I think that the data requirements and the credibility ... of the data would just have to be moved up a notch.

Tr. 25/13671-72.

With respect to the purpose in his testimony (Tr. 25/13561) of the quotation from the book by Baumol and Sidak Toward Competition in Local Telephony, Dr. Henderson stated that:

> The quote is intended to show that they recognized the practical limitations of basing regulated pricing, you know, solely on Ramsey pricing, yes.
>
> Once again, I assume that -- I haven't talked to either Baumol or Sidak, but as a professional economist, we would all say that demand conditions matter, and no one -- no professional economist would tell you that such information is not relevant.

Tr. 25/13672.

Several points of interest emerge from these comments. First, Dr. Henderson acknowledges that the market information and demand elasticities that must be used for volume forecasting and the logistics of reaching breakeven constitute the same demand information that drives Ramsey pricing. Unless such information (along with marginal cost information) is so poor as to be unusable for any purpose, a condition that he agrees is not present here, then there is "information content" to be gained by

running it through a Ramsey model.[22] Demand conditions matter, and "no professional economist would tell you that such information is not relevant."

Second, Dr. Henderson's consistent caveat that the Ramsey model should not be used "to the exclusion of all other pricing factors" is, to a large extent, a red herring. No witness in any recent Commission proceeding, economist or otherwise, has advocated use of Ramsey pricing to the exclusion of the other pricing factors of the Act. In the final analysis, Dr. Henderson's views on the proper role of Ramsey pricing do not appear to be appreciably all that different from, for example, those of Dr. O'Hara.

In summary, in rather astonishing contrast to prior cases, it seems fair to say that on the record in this case, there is fundamental consensus among witnesses for the Postal Service, the OCA, and UPS, that the calculation and evaluation of Ramsey prices properly play some role in the postal ratemaking process.[23] None of these

---

[22] When Dr. Henderson speaks of moving the available information "up a notch," it is not evident as to precisely what he intended. While it is true that sound econometric demand analysis can be hard to come by in a tumultuous industry such as telecommunications, in which there have been huge structural changes over the recent past, even Dr. Henderson agreed that the situation with postal services is probably not that dramatic. Tr. 225/13673. In fact, looking back over the last decade in the postal arena, it is clear that the estimated demand elasticities for the major services have been relatively stable, and that there has been no diminution in the ability to generate reliable elasticity estimates because of data obsolescence, or any other identifiable factor. To the contrary, the quality of the available demand estimates has improved.

[23] Another witness who praises efficient Ramsey prices as an "aid" to the allocation of non-variable costs is ADVO witness Crowder. Tr. 34/18353. On the other hand, the remaining opposition to any consideration of Ramsey prices comes from AAPS witness Bradstreet, who states:

witnesses, of course, advocate that Ramsey pricing in any way obviates the need for the Commission to give very careful consideration to all other pricing factors as well. And, to be fair, Dr. Henderson obviously has more reservations about, and would presumably accord less weight to, the Ramsey analyses currently available. In the future, if circumstances warrant more direct and tangible reliance on estimated Ramsey prices to guide specific pricing determinations, the reliability of the inputs used in the Ramsey model can reasonably be expected to remain grounds for substantial debate. In the context of this case, however, the Ramsey presentations by witnesses Bernstein and Sherman adequately fulfill their intention -- providing a useful benchmark against which departures from economically efficient prices can be approximated and evaluated.

G. "Efficient Discounts" Do Not Necessarily Yield "Efficient Rates"

In Docket No. MC95-1, the Commission included a detailed discussion of various possible analytic approaches to the development of the most appropriate

---

> The introduction of the USPS of Peter Bernstein's testimony officially praising the application of Ramsey Pricing to postal ratemaking speaks out as loudly to competitors as would a formal cover letter from the PMG himself accompanying the rate case testimony declaring that his objective is to put our whole industry out of business (not just the subscription magazine part.) I am certainly not an economist, but it is clear to me from what I have read in this case (and in prior cases) that sponsoring Ramsey Pricing in a postal context is tantamount to ignoring Congress and tossing nearly the entire ratemaking criteria section out of the Postal Reorganization Act.

Tr. 23/12005. Such hyperbolic testimony bears no relationship to the reality of the proposals actually presented on this record, adds nothing to a balanced view of the merits of economically efficient pricing, and accordingly should be ignored.

worksharing discounts. PRC Op., MC95-1, at IV-94 - IV-138. The concept of efficient component pricing (ECP) was introduced in that opinion at IV-107. After discussing varying types of efficiencies (e.g., productive, dynamic, allocative), the Commission concluded:

> The most meaningful productive efficiency benchmark would be one that comes as close as possible to the efficient component price. Accordingly, it is important to examine in what respects the Postal Service's approach to calculating cost differentials for worksharing categories appears to be inconsistent with the logic of efficient component pricing.

Id. at IV-22. At least to some extent, therefore, the Commission has previously embraced the logic of efficient component pricing.

Related issues were raised in this case in the testimony of Postal Service witness Bernstein. USPS-T-31 at 72-94. For example, Mr. Bernstein addressed the question of whether or not ECP is inconsistent with Ramsey pricing. After stating the apparent conflict, he introduces some ways to re-think the matter, such as allowing migration between workshared and nonworkshared mail, and taking consideration of mailer user costs. *Id.* at 75-79.

His discussion shows that there is no necessary conflict between ECP and Ramsey pricing when the total price and cost of mail are considered. *Id.* at 80. Moreover, Ramsey pricing is consistent with ECP when the demand for workshared and nonworkshared mail is the same. *Id.* at 93. When the demands differ, the Ramsey efficient discount will differ from the ECP discount, with the less elastic category assigned a higher per piece markup:

> While this will lead to some inefficiency in mail sorting, the loss is less than the gain in consumer surplus achieved through equalization of leakage across the two products.

Id.

After addressing the theory, witness Bernstein tackled the more difficult task of seeking to apply that theory in the real world context of First-Class workshared and nonworkshared letters. *Id.* at 80-93. Further discussion of this effort also appears in his responses to POIR No. 3. Tr. 10/5075-86. While many useful insights are gained in the process of grappling with such a challenging exercise, Mr. Bernstein does not hold his empirical results out as anything more than illustrative.[24] He concludes, however, that it would seem reasonable to expect that, absent other considerations, efficient pricing of the First-Class letter subclass would involve an increase in single-piece rates, and that the discount should be increased to encourage worksharing, assuming that the resulting cost differences between types of letters reflect the Postal Service's savings. USPS-T-31 at 94.

Witness Bernstein also offers some more general conclusions. First, Ramsey

---

[24] Prof. Sherman offers some additional analysis, and some helpful suggestions as to the direction of future research. Tr. 26/13745-56. He concludes:

> Further progress in developing Ramsey prices for single-piece and worksharing letters will benefit from better information about costs. Elasticity estimates are always difficult to obtain but are important. The effort should also be based on a carefully chosen formulation for access pricing according to Ramsey principles. Worksharing has become a significant factor in postal operations and that makes a Ramsey basis for pricing it a very desirable goal.

Tr. 26/13756, 13784.

pricing of postal products is never less efficient than ECP. Tr. 10/5035-36.[25] Second, the extent to which the Ramsey discount differs from the ECP discount depends largely on two factors -- the magnitude of the difference in own price elasticities between workshared and nonworkshared mail, and the proportion of the volume that can potentially shift between the two categories. USPS-T-31 at 94. Third, the exact calculation of the net gain to be gained by setting efficient category prices is partially a function of the user costs of mailers who switch into the workshare category. *Id.* Independent of ECP or Ramsey, Mr. Bernstein believes that user costs are an important consideration for any pricing schedule that affects the assignment of potential worksharing activities. *Id.*

Professor Panzar in his rebuttal testimony echoes some of the same points made by Mr. Bernstein:

> There may be good reasons to depart from [ECP] when setting rates. For example, as Witness Bernstein points out, Ramsey optimal prices may involve different discounts. ... In other words, efficient "discounts" do not necessary yield efficient "rates." Logically, this is not surprising, as the scope of the inquiry involved in exploring efficient discounts does not address the broader issue of the efficiency of the base rate to which the discount is applied.

Tr. 34/18457.[26] As he further explained during oral cross-examination, ECP

---

[25] Prof. Sherman confirmed this point, and further noted that "Ramsey prices should only improve efficiency." Tr. 26/13802.

[26] As witness Bernstein elaborated in his POIR response, an (illustrative) efficient discount of six cents in First-Class letters would yield a cost-minimizing allocation of workload activity at a base rate of 33 cents and a discount rate of 27 cents, but would likewise have the same effect at a base rate of 43 cents and a discount rate of 37 cents. Clearly, however, the overall efficiency effects are quite different between the

analysis looks only at cost considerations, while Ramsey analysis automatically takes into account the trade off between cost (or supply) considerations and demand considerations. Because the objective of setting rates is not as simple as maximizing total surplus, however, Prof. Panzar believes that ratemakers should examine both ECP and Ramsey discounts. See Tr. 34/18465-66, 18480-84.

In summary, the record shows that there are some thorny issues involved when attempting to address efficiency concerns while setting discounts for mailers with potentially different demand situations, with potentially different user costs, and who present mail that may potentially cost the Postal Service different amounts to sort if they opt out of worksharing. Additional research remains to be done. Something along the lines of ECP may appear to be the simple solution, but ECP ignores demand considerations. It clearly is not the right answer in every situation. Although no party has directly tied these matters to its rate proposals, they are important, and the Commission is urged to keep an open mind as more light is shed on these issues.

H. Dr. O'Hara's Comprehensive Approach Is Consistent With The Postal Reorganization Act And Improves Upon Past Commission Practice

Traditionally, the Commission has assessed rate levels by comparing revenue to attributable cost, the latter defined as the sum of volume-variable cost and specific-fixed cost. For each subclass, the resulting cost coverage ratio was evaluated against the nine criteria of § 3622(b). Subsection 3622(b)(3) imposes the

---

first pair of ECP rates and the second pair of ECP rates. Tr. 9/5082.

requirement that revenues equal or exceed attributable costs, to prevent any cross-subsidy between subclasses. The remaining criteria provide guidance in determining how the burden of institutional costs is to be shared among the subclasses and special services, so that the result is fair and equitable and the rate schedule generates sufficient revenues to ensure financial breakeven. Traditionally, the ratio of revenue to attributable cost for each subclass has been used to accomplish both of these tasks.

As discussed above, the testimony of Dr. Panzar (USPS-T-11) explained why these objectives are better served if, for purposes of avoiding cross-subsidy, the appropriate test is whether revenue for a subclass is at least equal to its incremental cost. His testimony and that of witness Takis (USPS-T-41) fulfilled the Commission's Docket No. R94-1 objective that the Postal Service develop incremental cost estimates that would allow the Commission to perform the cross-subsidy analysis on that basis. *See* PRC Op. R94-1, Appendix F, at 24, ¶170. By ensuring that each subclass cost coverage satisfies the incremental cost test, Dr. O'Hara met the requirements of § 3622(b)(3).

Dr. O'Hara explained that cost coverage -- the ratio of revenue to volume-variable cost -- is the primary, and appropriate, measure of rate level. USPS-T-30, at 13-14; Tr. 2/155-57, 256. At pages 14-16 of USPS-T-30, he clarified why marginal costs provide a superior basis for the development of cost coverages, particularly in comparison to attributable or incremental costs.

As discussed in Section III of this Brief, the Postal Service presented

significant refinements in cost analysis. These improvements are important to the application of the § 3622(b)(3) requirement that each class of mail or type of service bear the direct and indirect postal costs attributable to that class. As described in the testimonies of Postal Service witnesses Bradley (USPS-T-14) and Brehm (USPS-T-21), the Postal Service has replaced the previous assumption of 100 percent volume variability with an analysis that measures actual volume variability. As Dr. O'Hara noted (USPS-T-30, at 17), a consequence of this breakthrough in the understanding of postal costing is that the percentage of costs found to be volume variable declines and the total amount of institutional costs to be assigned through the application of the remaining pricing criteria increases. The result is that the system-wide average cost coverage rises significantly.

In the last several omnibus rate cases, the Commission's practice has been to use markup indices as a starting point for analyzing proposed rate increases. The markup for each subclass represents the sum of the attributable plus institutional costs of that subclass, as a percentage of the attributable costs for a subclass. PRC Op. R87-1, Vol. 1, at 369, ¶4034. The Commission's markup index compares the markup for each subclass with the system-wide average markup. PRC Op. R90-1, Vol. 1, at IV-4, ¶4011.

The Commission has indicated that, in the absence of evidence indicating a need to vary the relative shares of institutional cost burden among the subclasses, the burdens should remain relatively proportionate. Accordingly, the Commission has found a markup index particularly valuable because

> it allows us to compare relative burdens from case to case, while case to case comparisons of cost coverages or unit contributions are misleading by variations in the amount of total and attributable dollars involved.

Id. Dr. O'Hara's testimony reflected the view that existing rates and cost coverages are critical points of reference in developing new rates. USPS-T-30, at 19-20; Tr. 2/232-33. However, he demonstrated that for setting rates based on the improved volume variability cost analysis, a rigid reliance on past markup indices and past markup relationships among subclasses would produce results which would be neither fair nor equitable. USPS-T-30, at 16-19; Tr. 2/229. Alternatively, he explained why the Commission would be better served by reliance upon a cost coverage index. USPS-T-30, at 19. He testified:

> [s]ince applying the cost coverage index results in the same revenue for each subclass as before, this is equivalent to unchanged rates (volume does not change). Therefore, there is no need for mechanical adjustments in response to higher-than-average cost coverage resulting from the change in costing methods; one can simply use existing rates as the starting point for developing new rates and rate levels under an increased revenue requirement.

USPS-T-30, at 19-20. He also observed:

> existing rates are only the starting point. In the light of the new costing information, rate levels may need to be considered afresh against the criteria of the Act. It should be noted, however, that the existing rates, when evaluated relative to the new costs, do preserve whatever trade-offs between economic efficiency and other objectives were reflected in their original selection. For example, if Product A's price was below the Ramsey price derived from the original costs, it will also be below the Ramsey price derived from the new costs. This is because the coverage index preserves the <u>relative</u> positions of various products in terms of their ratios of price to marginal cost.

Id. at 20.[27] (Emphasis in original.)

---

[27] With respect to Ramsey pricing, it should be emphasized that Dr. O'Hara recognized the importance of balancing all of the statutory pricing criteria and makes

The proposed cost coverage of each subclass is a summary index of the many considerations weighed to determine the proper share of institutional cost allocated to that subclass. By statute, all cost coverages must be reasonable, because they determine the portion of unattributable costs which the Postal Service allocates to each class or subclass. A discussion of why the specific cost coverages put forth by witness O'Hara warrant approval by the Commission will be facilitated by first describing the methodology used to arrive at the proposed cost coverages, and why such an approach is appropriate.

As the Postal Service's witness on rate policy, Dr. O'Hara determines how institutional costs should be allocated among the classes and subclasses of mail such that total revenues equal total cost. His approach to that task is spelled out in great detail in his direct testimony.

Dr. O'Hara began with the volume-variable costs identified for each subclass of mail. These costs are developed by Postal Service cost analysts in a process which is independent of his pricing exercise. Taking these costs, witness O'Hara then determined what percentage contribution over costs (cost coverage) would be required from each of the subclasses, so that, after adjustments are made for the volume (and subsequent cost) consequences of new rate levels, total proposed

---

no formal use of the Ramsey prices developed by witness Bernstein (USPS-T-31). Nevertheless, he found the relationship between Dr. Bernstein's Ramsey prices and his own cost coverage levels to be noteworthy, even if overshadowed by other Postal Service Docket No. R97-1 rate policies: keeping rate increases near the system-wide average, where possible and softening the impact of rate increases implied by the refinements in cost attribution. USPS-T-30, at 20-21.

revenues will equal total costs as nearly as practicable.

In setting cost coverages, Dr. O'Hara used the average or system-wide cost coverage as a benchmark. The system cost coverage may be calculated by subtracting appropriations and investment income from the total revenue, and dividing that result by the volume-variable cost. Other guidance in developing the rate levels was obtained from cost coverage determinations from prior Commission recommended decisions, court decisions, and previous Postal Service proposals. Relevant historical data, unit contributions to institutional costs, rate design considerations plus own- and cross-price elasticities provide important inputs to the process. Dr. O'Hara also relied on his own expert knowledge of mail classes and their costs, as well as his consultations with postal operations and costing experts. Using these reference points, he applied the criteria of the Act to each subclass to determine an appropriate cost coverage.

Witness O'Hara's process of determining rate levels was an iterative one. His early iterations involved preliminary volume and cost forecasts. Subsequent iterations included more refined cost and volume projections. After each iteration, witness O'Hara recalculated the system cost coverage and compared it with the before-rates system cost coverage. During this process, relative adjustments in cost coverage were made to take into account the differing volume responses of each subclass to rate changes, as measured by the own- and cross-price elasticity of demand in order to assure the achievement of financial break-even. Of necessity, the final iteration incorporated any last minute changes in any of the data and any fine-tuning in

witness O'Hara's assessments of subclass level cost coverages. The final cost coverage proposals were determined with a final detailed analysis of each of the non-cost criteria of section 3622(b), the pattern which is emerging for all other subclasses, and how each of these factors enters into the total revenue picture. As demonstrated by witness O'Hara, the relative weight given to each of the §3622(b) criteria can vary from subclass to subclass.

Dr. O'Hara's proposed rate levels are the product of a comprehensive process, covering all aspects of the various postal subclasses. He applied his expertise in a manner prescribed by the specific pricing criteria established by Congress, and the evolution of the interpretation of the Act through the Commission's recommended opinions, decisions of the Governors and judicial precedent. Dr. O'Hara made no pretense that his was anything other than a judgmental approach to pricing. His methodology is consistent with the Postal Reorganization Act. Judicial review of this approach confirms its validity. *See Direct Marketing Association v. United States Postal Service*, 778 F. 2d at 102.

I. The Cost Coverages Proposed By The Postal Service Reflect A Fair and Equitable Allocation Of Institutional Costs and Give Proper Consideration to All of the Applicable Ratemaking Criteria

In the preceding subsection, we described the basic approach taken by Dr. O'Hara and have demonstrated why it is the most appropriate method on record in this proceeding for fairly and equitably allocating institutional costs. Below, subclass-by-subclass, we will explain how the Postal Service's proposed cost coverages reflect the proper application of that methodology. Dr. O'Hara ensured that each subclass

meets the requirement of § 3622(b)(3). He applied his judgment to allocate institutional costs, based upon his consideration of the remaining § 3622(b) criteria. A summary of his analysis is presented below.

1. First-Class Mail -- Letters and Sealed Parcels

The Postal Service's proposed rates for First-Class Mail (letters and sealed parcels) reflect a cost coverage of 200 percent and an average 3.3 percent rate increase. USPS-T-30, at 22. For single-piece letters, the increase is 2.5 percent, taking into consideration the proposal of a one-cent increase in the basic rate, retention of the additional-ounce rate, and the proposals of new categories for Prepaid Reply Mail and Qualified Business Reply Mail. The overall proposed increase for workshared First-Class Mail is 4.5 percent. *Id.*

The proposed increase for First-Class Mail letters as a whole is below the rate of inflation and lower than the proposed system-wide average increase. *Id.* at 23.

The value of service of First-Class Mail, by any standard, is high. With the exception of Express Mail and Priority Mail, First-Class Mail receives the most expeditious transportation and delivery of all the mail classes. The existing collection network provides a major convenience to many First-Class Mail users. First-Class Mail is forwarded without additional cost. The contents of First-Class Mail pieces are normally free from any postal inspection, thereby providing privacy of communication. These factors clearly enhance its value from the perspective of senders and recipients. *Id.* at 22-23. The First-Class Mail letters subclass is also characterized by a relatively low price-elasticity. USPS-T-30, at 23.

The proposed rates ensure that the class continues to recover its attributable costs and that it makes a substantial contribution to institutional costs. At the same time, in accordance with 39 U.S.C. §3622(b)(5), the proposed coverage was moderated by the influence of the restrictions upon available alternatives which result from the application of the Private Express Statutes.[28] *Id.* at 23; Tr. 2/107.

In accordance with §3622(b)(6), Dr. O'Hara appropriately considered the degree of pre-mailing preparation and the impact of his rate proposals on the mail preparation industry in formulating the rates for various First-Class Mail presort and automation-related rate categories. USPS-T-30, at 23-24.

The Postal Service's proposed First-Class Mail letter rate structure is fair and equitable. It satisfies all applicable §3622(b) criteria and merits the approval of the Commission.

2. First-Class Mail -- Cards

The Postal Service's proposed rates for First-Class Mail cards reflect a cost coverage of 184 percent. Witness O'Hara analyzed cards in comparison to letters as part of determining the appropriate cost coverage for cards. *Id.* at 25.

After some analysis, Dr. O'Hara concluded that the intrinsic value of service for cards is less than it is for letters. *Id.* at 25. The Postal Service's proposed card rates will also ensure that the tradition of a lower per-piece institutional cost contribution for cards is maintained, reflecting the lower value of cards compared to letters.

Reviewing the impact of the proposed increase on mailers and competitors, Dr.

---

[28] 18 U.S.C. §1693-1699; 39 U.S.C. §601-606.

O'Hara testified that while the proposed percentage rate increase for cards (5.9 percent) is relatively higher than that for cards and for the system average, this is in part driven by the whole-cent rounding constraint. *Id.* at 25-26. The relative magnitude of his proposed increase for cards is, however, mitigated by the fact that the card rate increase since Docket No. R90-1 has been below average. *Id.* at 25.[29]

Witness O'Hara took account of the broader availability of alternatives for cards, in relation to letters. *Id.* at 26. The rate structure for cards is nearly parallel to the structure for letters, leading Dr. O'Hara to conclude that degree of preparation performed by the card mailers and the complexity of the schedule are at a similar, acceptable level as well, and consistent with § 3622(b)(6) and (b)(7). *Id.* at 26.

Witness O'Hara carefully considered the relevant pricing criteria of §3622(b). USPS-T-30, at 25. His First-Class Mail post card cost coverage deserves the concurrence of the Commission.

3. Priority Mail

Witness O'Hara proposed a 7.4 percent rate increase for Priority Mail, which reflects a 192 percent cost coverage. *Id.* at 26-27. At 7.4 percent, the proposed Priority Mail rate increase is well above the proposed system average of 4.5 percent.

In his testimony, as originally filed, Dr. O'Hara's proposed cost coverage was 198 percent. However, the resulting revenue from corresponding rates, when divided

[29] The Postal Service is not suggesting that because cards were subjected to lower percentage increases in recent cases, that a higher than average increase is necessarily called for here. The point is that judgments about percentage rate increases must be made with due consideration to rate history of a subclass.

by the revised volume-variable cost produced by witness Patelunas on September 19, 1998, resulted in a coverage of 192 percent.

As the name of the service implies, Priority Mail receives preference in handling and dispatch. It enjoys the same priority of delivery as First-Class Mail and receives even greater use of air transportation. Features such as special envelopes and flat rates for lighter-weight Priority Mail pieces permit and encourage more use of the Postal Service's collection boxes for the deposit of such mail. Tr. 2/117. Compared to First-Class Mail, Priority Mail enjoys expanded two-day service commitment zones. Tr. 2/118, 120. On the other hand, its price elasticity is considerably higher than that of First-Class Mail, indicating a lower value of service. *Id.* at 27; Tr. 2/119.

The proposed cost coverage, which is above the proposed system average, clearly ensures that Priority Mail covers its attributable costs and makes a significant contribution to institutional costs. This cost coverage also ensures that rates proposed by the Postal Service do not support the charge that they are designed to harm competition. USPS-T-30, at 27.

Priority Mail rates are based upon the weight of a package and (except where the rates are unzoned) the distance it will travel. In this regard, the rates are relatively simple for the public to use. With the approval of the Postal Service's proposal to eliminate the per-piece discount for presorted pieces, the rate schedule will be even simpler overall. Reasonable rate relationships are maintained between lighter-weight Priority Mail pieces and those mail pieces at the upper ounces of the

First-Class Mail rate schedule, demonstrating careful consideration of § 3622(b)(7).[30]

The Postal Service's Priority Mail cost coverage proposal, as revised, should be recommended by the Commission.

4. Express Mail

Dr. O'Hara proposed an Express Mail cost coverage of 204 percent, resulting in a 3.7 percent rate increase. He testified that Express Mail's value of service is very high, when intrinsic factors are considered. Express Mail receives the highest delivery priority, extensive air transportation, and a significant collection system, though not as extensive as the general collection system for First-Class Mail. USPS-T-30, at 28. It also benefits from a tracking capability. On the other hand, its price-elasticity indicates an extremely low economic value of service. The proposed increase will have a modest and acceptable effect on mailers. In view of Express Mail's relatively small market share and modest recent growth, the increase should not have an unfair effect on competition. Dr. O'Hara noted that a number of private sector alternatives are available to Express Mail users.[31] He also testified that the deposit or pickup of pieces at post offices and airports reduces postal costs and constitutes a form of mailer preparation recognized by separate rate schedules. *Id.* at 29.

Dr. O'Hara's application of the statutory criteria should be approved.

---

[30] The Postal Service proposed that the current 11-ounce First-Class/Priority weight/rate breakpoint be retained.

[31] For individuals and small volume business users, these alternatives may only be available at a higher price, with additional features. USPS-T-30, at 29.

5. Periodicals

a. Regular

The cost coverage proposed for the Regular Periodicals subclass is 107 percent, which results in an average increase of 3.5 percent for the subclass. *Id.*

Dr. O'Hara considered the value of service of Periodicals, taking into account intrinsic characteristics, as well as comparisons to other mail classes. He observed that the own-price elasticity translates into a high value of service. *Id.* at 29-30.

The educational, cultural, scientific and informational (ECSI) value is accounted for in the cost coverage. Because of the large increase in unit mail processing costs for Periodicals, witness O'Hara moderated his proposed cost coverage. He emphasized that the Postal Service is undertaking an analysis to understand what factors may have contributed to increases in mail processing costs. Rather than mechanistically reflecting the cost increases in rates, he explained that it is appropriate to first see whether these trends can be reversed as a result of operational changes referred to by witness Moden (USPS-T-4, at § II.B.). Dr. O'Hara also took into account the fact that smaller publications with geographically dispersed circulation had recently experienced significant rate increases as a result of Docket No. MC95-1. Another factor he analyzed was the availability of alternatives, noting that the degree to which they exist for different publications varies. *Id.* at 30-31.

Although Dr. O'Hara observed that the Periodicals rate structure is relatively complex, he noted that the proposed revisions to the definition of presort categories will help to conform them to the way Periodicals mail is processed. The changes are

expected to improve the degree to which there are understandable relationships between rates. *Id.* at 31.

The results of Dr. O'Hara's analysis should be embraced by the Commission.

b. Preferred Rate.

The Revenue Foregone Reform Act requires that, at full rates, Within County, Nonprofit, and Classroom Periodicals each have a mark-up equal to one-half that of Regular Periodicals, resulting in a proposed 103.5 percent cost coverage proposal from witness O'Hara. For the Test Year, Step 5 rates will apply, with a mark-up equal to five-twelfths that of the Regular subclass. *Id.* at 32. The resulting average rate increases proposed for Within County, Nonprofit, and Classroom are 3.4 percent, 3.9 percent, and 4.8 percent, respectively.[32]

6. Standard A Mail

a. Regular

Dr. O'Hara proposed a cost coverage of 154 percent for the Regular subclass, which results in an average increase of 4.1 percent. *Id.* He considered the value of service, taking into account such factors as delivery being subject to deferral, the use of ground transportation, and lack of access to the collection system. He observed that Postal Service attempts to satisfy mailer-specific delivery windows typically require advance coordination by mailers. Dr. O'Hara evaluated the price elasticity for Standard A Mail Regular as between First-Class Mail and Enhanced Carrier Route,

[32] For an explanation of why it is appropriate to apply Nonprofit rates to Classroom pending further analysis, see the testimony of witness Kaneer (USPS-T-35).

suggesting an intermediate economic value of service. *Id.* at 33.

The proposed 4.1 percent average rate increase for Standard A Regular is well below inflation and will have an acceptably small impact on users. Importantly, Dr. O'Hara noted that the proposed percentage increase is only slightly below the system-wide average. This factor combines with the proposed 154 percent cost coverage to establish that competitors are not being unfairly targeted. *Id.*

Dr. O'Hara discussed the availability of alternatives, particularly other demographically targeted communications media. He also compared the Regular subclass to Enhanced Carrier Route (ECR), which has more of a geographic focus. He testified that the Regular subclass has a substantial degree of mailer preparation, but less than ECR. *Id.*

Dr. O'Hara's cost coverage analysis should be affirmed by the Commission.

b. Nonprofit

Under the RFRA, at full rates, the Standard A Nonprofit subclass is required to have a mark-up equal to one-half of the Standard A Regular subclass, or a coverage of 127 percent. For the Test Year, Step 5 rates will apply, with a mark-up equal to five-twelfths of Standard A Regular. When this mark-up applied to Nonprofit costs, the result is a rate increase well above the system average, 15.1 percent. *Id.* at 34.

c. Enhanced Carrier Route

Dr. O'Hara proposed a cost coverage of 228 percent for the Enhanced Carrier Route (ECR) subclass, which results in a 3.2 percent average rate increase. This

moderate proposal reflects a desire to lower the very high cost coverage of this subclass. *Id.*

The proposed cost coverage reflects Dr. O'Hara's consideration of the intrinsic value of service for ECR, which is relatively low, since it lacks access to the collection system, receives ground transportation, and is subject to delivery deferral. He testified that, although the Postal Service is sometimes able to accommodate mailer requests for delivery within a specified window, this requires mailer preparation, coordination, and planning.[33] The price-elasticity of ECR indicated a relatively low economic value of service as well. *Id.* at 34-35.

As with First-Class Mail, the proposed average rate increase for ECR is below the rate of inflation, limiting the adverse effect upon mailers. The very high cost coverage undercuts any claim that the proposed rate increase results in unfairness to competitors. *Id.* at 35.

The availability of alternatives for ECR is relatively high. Due to the geographic concentration, alternative delivery firms and newspaper inserts provide alternate means of delivering the same hard-copy messages. ECR requires a high degree of mailer preparation. *Id.*

At page 36 of USPS-T-30, witness O'Hara testified that application of the statutory factors would suggest an even lower cost coverage, but that this would only impose greater institutional cost burden on other subclasses. A lower ECR cost

[33] For high-density and saturation mailings, this is also facilitated by the regularity with which many of these mailings occur. USPS-T-30, at 35.

coverage also would have made it more difficult to design rates in a manner which encouraged the movement of ECR Basic letters into the automation mailstream, an important goal of postal management.[34]

His proposed ECR cost coverage deserves the Commission's endorsement.

d. Nonprofit Enhanced Carrier Route

Under the RFRA, the Nonprofit Enhanced Carrier Route subclass is required to have a mark-up equal to one-half that of the commercial ECR markup at full rates, or a cost coverage of 1.64 percent. For the test year, Step 5 rates will apply, with a mark-up equal to five-twelfths that of commercial ECR. When the mark-up is applied to Nonprofit ECR and full Step 6 rates are imposed for those rate cells where Step 5 rates fall below the RFRA phasing period rate floor for nonletters,[35] the result is an average decrease in rates of 4.8 percent. USPS-T-30,at 36-37.

7. Standard B Mail

a. Parcel Post

Dr. O'Hara proposed a Parcel Post cost coverage of 103 percent, which corresponds to an average rate increase of 10.2 percent for the subclass. Parcel Post exhibits a low intrinsic value of service, low priority of delivery, and generally relies upon surface transportation. Because of security concerns, stamped Parcel Post no longer has access to the collection system. Its own-price elasticity indicates a low economic value of service. Though alternatives abound, they are more accessible to

---

[34] See the testimony of witness Moden (USPS-T-4, at § II.A.3.).

[35] *See* USPS-T-36 (Moeller), at §§ VII.B and VIII.

large-volume business mailers. Commercial package sending agencies, where accessible at the retail level, often charge a premium over competitors' rates. For many mailers in remote areas, there may be no alternative to Parcel Post. The proposed 10.2 percent average rate increase is one of the highest in this case. Dr. O'Hara testified that it is expected to have some adverse effect upon mailers who use the service, but is driven largely by the need to satisfy the requirement that the service cover its costs. Parcel post competitors are not expected to be adversely affected by the proposed rates. USPS-T-30, at 37-38.

The results of Dr. O'Hara's analysis should be affirmed.

b. Bound Printed Matter.

The proposed cost coverage for this subclass is 152 percent, resulting in an average rate increase of 5 percent. As with Parcel Post, the intrinsic value of Bound Printed Matter is relatively low. Conversely, its own-price elasticity suggests a moderately high economic value of service. Dr. O'Hara took into consideration the alternatives available to BPM users. For book mailers, the Special subclass is an alternative. Alternative delivery is available to some degree for catalogs and telephone directories, which are often mailed in this subclass. The proposed five percent rate increase, though higher than the system average, is below the rate of inflation and should not have an adverse impact upon users. The above-average proposed rate increase and the proposed 152 percent cost coverage establish conclusively that the Postal Service is not attempting to unfairly target competitors. *Id.* at 38-39.

Dr. O'Hara's cost coverage proposal merits the Commission's approval.

c. Special

The proposed cost coverage for this subclass is 137 percent. The result is an average rate increase of zero percent for the subclass. As with other Standard B subclasses, the intrinsic value of the Special subclass is relatively low. Its price elasticity suggests a moderately high economic value of service. Bound Printed Matter is available as an alternative for business mailers. For individuals, alternatives are more limited. The proposed increase will not adversely affect mail users and will mitigate the effect of the proposed rate increases for users of the Library subclass. Materials such as books, films, and sound recordings give the Special subclass a high ECSI value in Dr. O'Hara's judgment and he reflected this in his proposal. By operation of the RFRA, the Special subclass cost coverage directly determines the Library subclass coverage. Dr. O'Hara's proposal to hold the Special average rate increase to zero should help to mitigate the rate increase for Library. Nevertheless, as Dr. O'Hara testified, the new RFRA-driven Library rates will exceed Special rate. This should result in a significant migration of mail from the former subclass to the latter. *Id.* at 39-41.

Dr. O'Hara's application of the pricing criteria for Special should be approved.

d. Library

Under RFRA, at full rates, this subclass is required to have a mark-up equal to one-half that of Standard B Special, which would result in a cost coverage of 119

percent. Step 5 Library rates apply in the Test Year, at five-twelfths that of Standard B Special. Rates which correspond to the required mark-up generally exceed those for the Special subclass.[36] Dr. O'Hara's financial analysis[37] recognized that Library mail eligible to migrate to the Special subclass will indeed do so. When this is taken into account, the result is a coverage for what is now Library mail of 107 percent and the corresponding average rate increase is 14 percent. USPS-T-30, at 41.

J. Witness Chown's New Cost-Allocation Metric, Like Her Previous Commission-Rejected Proposal, Would Inject An Unnecessary And Unreasonable Additional Level Of Complexity In Postal Ratemaking, And Would Foster Irrational And Uneconomic Decisionmaking.

In this proceeding the Newspaper Association of America has again attempted to persuade the Commission to adopt a technical approach to costing and pricing that, not surprisingly, would tend to push upward the rates for advertising carried through the mail, advertising material coveted by newspapers. The vehicle chosen for this purpose is the testimony of witness Sharon Chown. The technique advanced is the proposed use of what Ms. Chown dubs a "weighted attributable cost metric." As will be shown below, while Ms. Chown's "metric" sports different packaging, her proposal, at its core and in its likely results, is not novel. It is a variation on unsound methods she has proposed in the past. Like her previous effort, the defects of which it shares, it should be rejected.

---

[36] See the testimony of USPS witness Adra (USPS-T-38).

[37] O'Hara Workpaper II, page 3.

1. *Old Wine in New Wineskins - The Current Chown Proposal*

In her direct testimony on behalf of the Newspaper Association of America, witness Chown recommends "an alternative metric - total weighted attributable costs - that will allow the Commission to better gauge the appropriate level of the institutional costs to be borne by each subclass of mail." Tr. 25/13263. She contends that the current method used by the Commission to assign institutional costs does not adequately reflect the relative mix of the different postal functions used by each subclass and the contribution of each of these functions to the total institutional costs of the Postal Service. Id. at 13265. She finds it problematic that under the Commission's traditional methods, "mailers that reduce the total attributable costs of a particular subclass by avoiding mail processing and transportation costs through presorting and dropshipping receive a reduced assignment of *all* institutional costs, not just the institutional costs associated with mail processing and transportation." Id. at 13270-71.

Her objection to this result appears to be rooted in notions of fairness, rather than economic notions of efficiency. For example, she states that it is "unfair to ask people with high mail processing and transportation costs to contribute large amounts to the institutional costs of the delivery function." Tr. 25/13430. According to witness Chown, her new metric has no underlying economic significance beyond the fact that it is a "better measure of how each subclass of mail benefits from institutional effort". Tr. 25/13384.

Back in Docket No. R90-1, witness Chown sought to address perceived

problems with institutional cost allocations with a proposal to assign institutional costs on an "unbundled basis." Under this method, the institutional costs associated with major cost functions be were to be assigned by marking up the attributable costs for that function only. Thus, the statutory factors in section 3622(b) of the Act were to be applied separately to each of the functions offered by the Postal Service to determine the appropriate markup for each function for each subclass. While the Commission appeared to be somewhat sympathetic to her argument that the traditional method of allocating institutional costs was problematic, it nevertheless rejected her proposal. PRC Op., R90-1, Vol. 1, at IV-16-17.

In the current case, witness Chown advocates "a refinement of the proposal [she] put forward in Docket No. R90-1." *Id.* at 13263. Instead of purporting to mark-up the attributable costs of discrete postal functions, she proposes, when assigning institutional costs to subclasses, that the attributable costs associated with each postal function "be weighted by a factor equal to the percentage of total institutional costs divided by the percentage of attributable costs for that function." *Id.* at 13275. In this way the "attributable cost for those functions with a large percentage of attributable costs but few institutional costs will be given far less weight when assigning institutional costs." *Id.* The weighted attributable costs for all functions are then summed to produce a weighted attributable cost metric for each subclass. "The Commission could then apply its judgmental assessment of the factors under Section 3622(b) of the Act to derive the appropriate markup for each subclass of mail" using the metric as the basis for the markups. *Id.* at 13280.

As the testimonies of several witnesses have shown, the new Chown method is not all that different from her former proposal. In fact, it is a restrictive form of witness Chown's Docket No. R90-1 proposal. Tr. 36/19676 (Andrew). This can be seen from the fact that both methods yield identical results when equal markups are applied to all subclasses in each method, an identity of results which Ms. Chown readily confirmed. Tr. 25/13306 (Chown). See also Tr. 36/19676, 721-23 (Andrew). It can also be seen from the fact that both methods would tend to allocate more costs to those subclasses which make relatively heavy use of the delivery function, such as ECR mail,[38] and would favor those that use relatively more of the transportation and mailprocessing functions. As Advo witness Crowder notes, this tendency to force ECR rates upward is hardly surprising, since Ms. Chown's testimony in both proceedings was on behalf of newspapers who compete with the Postal Service for carriage of advertising material. *See* Tr. 34/18347-50.

For the reasons discussed below, Ms. Chown's recommendations must again be rejected.

2. Ms. Chown's characterization of the ratemaking problem is based upon invalid and incoherent inferences of subclass responsibility for institutional cost causation.

In advancing her proposal in this case, Ms. Chown again uses a concept peculiar to her, that of "identified" institutional costs. *See, e.g.,* Tr. 25/13395.

---

[38] For ECR mail, the weighted attributable costs produced by the Chown method exceed unweighted volume variable costs by 65 percent; that is, they are the actual volume variable costs marked up by 65 percent, to which an additional judgmental markup would be applied. Tr. 34/18351.

Although she concedes that institutional costs are not causally related to any particular subclass of mail, (Tr. 25/13263), she nevertheless contends that "institutional costs can be related to the provision of a particular function of the Postal Service." Tr. 25/13263. Both her Docket No. R90-1 method and her current approach purport to "identify the attributable and institutional costs associated with the basic functions provided by the Postal Service." Tr. 25/13302. Through her proposed weighting procedure, and subsequent markups to be applied by the Commission, the institutional costs are ultimately linked to particular subclasses. Tr. 25/13332.

Although witness Chown may deny it (*See* Tr. 25/13323), implicit in the linkages she establishes between particular classes of mail and institutional costs are the twin notions that particular subclasses cause certain institutional costs to be incurred, and that some subclasses cause institutional cost incurrance to a greater degree than other subclasses. This can be seen in the conceptual linkages she makes between subclasses and institutional costs. Ms. Chown believes that cost functions cause institutional costs, including incremental costs, to be incurred. See Tr. 25/13265, 13272, 13275, 13398-99. For example, she contends that the Commission's "markup method can result in a low institutional cost assignment for a subclass of mail that primarily uses mail functions for which few of the costs are attributed, *even if the provision of these functions causes the Postal Service to incur substantial institutional costs.*" Tr. 25/13265. She completes the linkage by tying subclasses to functions: "Some subclasses use functions, a greater proportion of

functions that give rise to more fixed costs." Tr. 25/13436.

Sometimes she describes the linkage between subclasses and institutional costs in a related, but slightly different way. First, she contends that certain attributable costs cause particular amounts of institutional costs to be incurred. There can be no other rational interpretation of her assertion that "each dollar of attributable costs does not result in the same institutional cost effort."[39] Tr. 25/13311. See also Tr. 34/18350. Next, it is clear that she agrees with the well-established understanding that particular subclasses cause certain dollar amounts of attributable costs to be incurred. Tr. 25/13323. Putting these ideas together produces an inescapable conclusion: the proposition that individual subclasses cause differing amounts of institutional costs to be incurred. Such reasoning clearly underlies Ms. Chown's concern that "using the unweighted attributable costs as a markup base makes an implicit assumption that institutional costs are incurred to provide the different functions of the Postal Service in proportion to the attributable costs of these functions." Tr. 25/13326. Implicit in this statement is Ms. Chown's belief that institutional costs result from attributable costs, but in *varying* proportions depending on the functions related to the attributable costs.[40]

---

[39] Ms. Chown explained that she borrowed this phraseology from the Commission's Docket No. R90-1 Opinion. Tr. 25/13418.

[40] The correctness of this view of the relationship between functions and institutional costs is subject to debate. As witness Andrews correctly noted, "virtually all categories of mail use all of the cost functions identified by witness Chown, and the elimination of any function would mean that the USPS had decided to put itself out of business, i.e., stop any function and you stop the mail." *See* Tr. 36/19674 (Andrew).

Of course, Ms. Chown disputes that her method employs any such logic of causation. Tr. 25/13263, 13398, 13431. She is careful to employ other terms, such as "related to" (Tr. 25/13263), "indirectly assigned to" (Tr. 25/13431) or "give rise to" (Tr. 25/13329). Thus she states: "Some subclasses use functions, a greater proportion of functions that give rise to more fixed costs." Tr. 25/13436.

But what is the basis upon which she assigns to subclasses this responsibility for "giving rise to" institutional costs? Is it some undisclosed ethical or moral notion of responsibility? Is it the result of a particular philosophy or theology? Has Ms. Chown received a revelation? We do not know, for Ms. Chown never clearly articulates the basis for her claim.

One thing is certain. She will find no basis in logic or economics. As Professor Panzar has explained,

> The institutional costs are "identified" with particular subclasses of mail solely because Witness Chown has chosen to use a metric which arbitrarily implies responsibility for such costs without establishing any causal nexus whatever. Tr. 34/18451-52.

He continues:

> What is the significance of this exercise for ratemaking purposes? None, that I can see. Witness Chown has cleverly constructed a cost measure that is a *weighted* sum of component volume variable costs. One could construct many other such weighted sums, which would be equally arbitrary. The WAC in Witness Chown's proposal reflect the relative level of institutional costs in the various components. These weights appear meaningful, until one recalls that, by definition, the institutional costs in question are *common costs,* which are not caused by any single subclass. Therefore, just because a subclass incurs most of its volume variable costs in a cost component that has large institutional costs does not mean it is any more or less "responsible" for those costs than any other *single* subclass.

Id. at 18452.[41]

3. *The Chown Metric is an unnecessary solution to a misperceived problem.*

Ms. Chown's muddled notions of cost causation permeate her attempts to illustrate the nature of the problem she seeks to solve. In her testimony, she provides a number of simplistic scenarios intended to show that, left unmodified, the method traditionally used by the Commission to set rates that recover the total costs of the Postal Service will tend to produce unfair results. *See* Tr. 25/13270-74. She describes a world of three mail classes, A, B, and C, and two cost functions, 1 and 2. Class A is said to use both functions, while provision of service to Class B involves only function 1 and service to Class C involves only function 2. *Id.* After assuming equal markups for each class, Ms. Chown shows that under the Commission's method, Class B "would be assigned a share of the institutional costs of Function 2 although the class makes no use of this function." Thus, Class B is said to be overburdened, while Class C is said to escape paying a "reasonable share" of the institutional costs associated with Function 2. Tr. 25/13272.

While the example provided by witness Chown is carefully contrived to suggest a problem with the Commission's method of assigning institutional cost burdens, upon careful examination it can be seen that the nature of the problem is not quite what Ms. Chown would have the Commission believe. First, the hypothetical provided by

[41] Other experts on this record are in accord with Professor Panzar's assessment. *See, e.g.,* Tr. 34/18232 (Christensen), 34/18350-53 (Crowder), 34/18514-15 (Taufique), and Tr. 32/17296-99 (Haldi).

Ms. Chown does not reflect the way in which functional costs actually are incurred in postal operations. The key characteristic of Ms. Chown's scenario is the assumption that there are major cost components which are completely divorced from provision of service to at least some classes of mail. As witness Crowder has observed, this is not a realistic reflection of postal operations. With only two minor exceptions, costs from each of the four functional cost components defined by witness Chown are attributed to each of the subclasses in the DMCS (the exception being that Mailgrams and Nonprofit Periodicals do not receive any window service costs). Tr. 34/18348, *citing* Tr. 25/13287.

Moreover, as Professor Panzar has shown, the actual problem illustrated in the Chown hypothetical can be defined in well-established economic terms, without reference to peculiar notions of functionalized cost responsibility. Applying the same equal markup assumption used by witness Chown, a straightforward analysis of revenues and incremental costs reveals that Ms. Chown's example is characterized by significant cross-subsidy by Class B of the group comprised of Classes A and C. Tr. 34/18453-56. Thus, to the extent that witness Chown has raised any of issues of relevance to rational postal ratemaking, those issues lie in the area of cross-subsidy analysis. As Professor Panzar has shown, the simplified examples contained in witness Chown's testimony do not raise any issues that cannot be addressed with established methods to detect cross-subsidy, such as the incremental cost testing presented by the Postal Service in this docket. Tr. 34/18453.

Thus, even if, contrary to fact, situations existed in which a particular subclass

does not make use of all cost components, the sensible approach to avoiding unfairness and inefficiency would be to perform incremental cost tests on relevant groups of subclasses to make certain that no such group is receiving a cross-subsidy. *Id.* at 18453-56.

Ms. Chown concedes that the incremental cost test is the appropriate test to ensure that the rate schedule is free from cross-subsidy. Tr. 25/13337. Unfortunately, Ms. Chown ignores incremental costs in designing her method. See Tr. 32/17293. It is thus essential to recognize that *witness Chown's approach would provide no assurance that the cross subsidy entailed in her examples would be avoided.* Since, under her method, the Commission theoretically would be free to select differing mark-ups for each subclass, basing those markups on WAC (which can fall below or above incremental costs) does nothing to ensure that subsidy-free rates are established. The Commission would still need to perform any relevant incremental cost tests. Tr. 34/18456 (Panzar), Tr. 34/18347-48 (Crowder).

4. The Chown Metric is not merely unnecessary; it is also counterproductive

It has been established on this record that the Chown metric is unnecessary and irrelevant to dealing with the cross-subsidy issues suggested in her testimony. But the problem with the metric runs deeper: if used, it would actually introduce impediments to rational ratemaking.

Ms. Chown does not dispute that measures of marginal and incremental costs are essential to rational ratemaking. She agreed that marginal costs are relevant information for trading off costs and benefits at the margin, and stated that "it is

necessary to have information on both marginal costs and incremental costs when setting rate levels and determining rate structures." Tr. 25/13325.

However, by transforming volume variable costs (marginal costs) into "weighted attributable costs," witness Chown has combined marginal and incremental cost concepts in such a way that the usefulness of both concepts is destroyed. Tr. 34/18446 (Panzar). But these concepts are relevant and useful to the ratemaking process precisely because they are based on reliable causal connections between subclasses and the costs they cause.[42] As Professor Panzar and others have shown, because witness Chown's "identified" institutional costs have no reliable causal nexus to particular classes of mail, rendering them devoid of economic content, they would serve only to obscure and render unusable the economically relevant cost measures which the Postal Service has developed: marginal and incremental costs. Tr. 34/18446-53. Witness Chown's methods would also unnecessarily complicate the setting of discounts, and would make it impossible to pursue cost-efficient discount policies. Tr. 34/18458, 18466. Furthermore, if adopted without modification, her methods are virtually certain to result in a significantly higher cost coverage for Within County Periodical rates which would violate the requirements of the Revenue Foregone Reform Act. Tr. 34/18516-18.

---

[42] "Cost measures can be relevant for rational ratemaking only to the extent that they are causally related to the firm's decisions. Marginal costs play an important role in rate-setting because they reflect the costs that are *caused by* the (marginal) volume changes resulting from (marginal) rate changes. Incremental costs are important for both equity and efficiency because they measure the costs that are *caused by* the provision (of all units) of some service. The WAC concept proposed by Witness Chown reflects neither notion of causality." Tr. 34/18444 (Panzar).

The types of logically and economically perverse outcomes which would be encouraged by use of the Chown metric are best illustrated by its likely effect on Standard (A) ECR mail.[43] As Ms. Chown freely admits, one of her objectives is to provide the Commission with "an explicit method of accounting for the fact that ECR mail has very low attributable costs for some of the postal functions due to the heavily presorted and dropshipped nature of this mail; and that the attributable costs of ECR mail are predominately delivery costs -- a function that accounts for a large share of the institutional costs of the Postal Service." Tr. 25/13265. Unfortunately, the method Ms. Chown prescribes fails to recognize the existence of economies of scope and scale in postal operations. See Tr. 36/19678-79 (Andrew).

Or, to put it more accurately, Ms. Chown's method stands the proper recognition of such economies on its head. To use weighted attributable costs as the basis for markups is to deprive the Postal Service, and all of its customers, of the value of these economies. Tr. 34/18349-51 (Crowder).[44] Instead of recognizing that additional pieces of ECR lead to efficiencies and lower overall unit costs, that ECR pieces make large contributions to institutional costs, and that ECR volume thus benefits all other mailers, Ms. Chown recommends inordinately raising the base for ECR's institutional cost markups, and consequently, the rates for ECR. The only

---

[43] Witness Andrew has also noted how use of the metric produces unstable and unpredictable results. Tr. 36/19679-89.

[44] Indeed, the greater the efficiencies of scale and scope associated with additional volume of a subclass, the more the Chown metric would increase the attributable costs used to assign institutional costs to that subclass. Tr. 34/18351.

winners after such a choking off of beneficial growth in ECR volume would be the newspapers Ms. Chown represents. *Id.*

5. The Current Chown Method Introduces a Mechanistic Middle Step Into the Ratemaking Process, in Conflict With Commission Policy and Supreme Court Precedent.

Although Ms. Chown appears to contend that her revised institutional cost allocation method corrects the defects which caused the Commission to reject her prior approach (*See* Tr. 25/13318-19), this is far from correct. In Docket No. R90-1, the Commission expressed three main concerns with her analysis. First, the Commission expressed disappointment that Ms. Chown did not "address whether her methodology is likely to meet the goals for fairly distributing institutional costs" set out in Docket No. R87-1. PRC Op., R90-1, Vol. I, at IV-15. The current Chown proposal fares poorly when measured against this concern. Ms. Chown made no attempt in this case to address whether her proposal is likely to meet the goals for fairly distributing institutional costs set out in earlier dockets, as the Commission requires.

Second, the Commission concluded that "simply to break systemwide attributable costs into pieces" was not a solution to the problem she perceived. *Id.* at IV-16. Far from addressing this concern, Ms. Chown's revised method continues to rely on unbundled attributable costs. Both her Docket No. R90-1 method and her current approach purport to "identify the attributable and institutional costs associated with the basic functions provided by the Postal Service." Tr. 25/13302. The only significant difference is that now the unbundled attributable costs are weighted, rather than directly marked up. But, the slightly differing treatment of the unbundled costs

does not negate the fact that this unbundling fails to address the potential cross-subsidy problem inherent in Ms. Chown's examples. As Professor Panzar has shown, incremental cost tests would be the appropriate solution. See Tr. 34/18453-56.

Finally, the Commission was convinced that a mechanistic approach to allocating institutional costs burdens would encroach on the proper exercise of the Commission's judgement. Id. at IV-15. There is no doubt that Ms. Chown's current method is mechanistic, and would displace Commission discretion at a critical juncture in the ratemaking process, by mathematically distorting attributable costs via Ms. Chown's algorithm into "weighted attributable costs," and using such costs as the basis for markups. Ms. Chown would protest that her method is less mechanistic, as it explicitly requires the Commission to apply markups to the weighted attributable costs. *See, e.g.*, Tr. 25/13278. But, as Dr. Haldi has correctly observed, the fact that the Commission can undo or offset the cost allocation bias embedded in the weighted attributable costs[45] does not obscure the fact that Ms. Chown's method injects a mechanistic middle tier into the ratemaking process. *See* Tr. 34/17288-93.

Furthermore, the injection of a new intermediate step into the ratemaking process, whether to give added emphasis to fairness concerns, or to give weight to extended inferences of causation, would conflict with relevant Supreme Court

---

[45] Ms. Chown conceded that in reality, the Commission would likely need to significantly alter its usual markups for each class in order to offset the more extreme effects of inherent in her approach. See Tr. 25/13424. *See also* Tr. 34/18353 (Crowder).

precedent. In *NAGCP v. U.S. Postal Service*, 462 U.S. 810 (1983) ("NAGCP IV"), the Supreme Court ruled that, after attributing all costs possible based on reliable causal connections, the Commission was not to attempt to extend the attribution process by construction of a further attribution based on extended inferences of causation. 462 U.S. at 826-29. Because it is based on irrational and unreliable inferences of causation, construction and use of the proposed weighted attributable cost metric would do just that.

Even if the metric were to be viewed as not based on causal inferences, but on fairness concerns, it would still be an illegitimate intrusion on the statutory ratemaking scheme. As Dr. Haldi again correctly observes, the Act already specifies a variety of non-cost considerations that are to be applied in the allocation of institutional costs to classes, fairness being only one of these. To impose an intermediate step based solely on fairness considerations would be to elevate this one criterion to an unjustified and unbalanced degree, and give it primacy over all of the other non-cost factors. *See* Tr. 32/17290.

6. The Chown Metric Must Be Rejected.

For the reasons stated above, the Chown metric, like its predecessor, must be rejected. It is based upon invalid and incoherent inferences of subclass responsibility for institutional cost causation. It imposes an unnecessary solution to a incorrectly perceived problem. It would tend to produce ratemaking results that are irrational, uneconomic and unstable. Finally, it would inject a mechanistic middle step into the ratemaking process, in conflict with Commission policy and Supreme Court

precedent.

The Commission should again meet Ms. Chown's proposal with the following words:

> we are convinced that the method we use for the allocation of institutional burdens among the classes and subclasses, . . . is more fair in application and result than the method proposed by witness Chown.

PRC Op., R90-1, Vol. 1, at IV-15.

K. The Costing And Pricing Approach Suggested By Witness Henderson Is Economically Unsound; Would Lead To The Loss Of Essential Cost Information, And Fails To Consistently Apply Commission Precedent.

As shown previously in this section, the Postal Service has in this case not only provided the correct economic concepts to employ in rational ratemaking, it has also provided the marginal cost, incremental cost and demand data needed to implement such concepts. It was perhaps inevitable that, once such a comprehensive display of relevant economic information was made available, one or more parties to this proceeding would seek to misuse that set of information in such a way as to advance the ratemaking interests of those parties. One such example of misuse can be found in the testimony of UPS witness Henderson.

The major features of witness Henderson's testimony are as follows: He advocates that the newly-developed incremental costs of the Postal Service be employed as the cost basis for markups, on the basis that this would be consistent with Commission precedent and statutory interpretation. Tr. 25/13558. He also claims that a markup on incremental cost is necessary to overcome potential

measurement error which could produce cross-subsidies if incremental costs were to be used solely as a check against such cross-subsidy. *Id.* He further contends the incremental costs provide a better basis for markups because they purportedly reflect necessary "longer run" considerations. *Id.* at 13559. Additionally, in his direct testimony at least, he seems to dismiss the utility of Ramsey pricing for postal ratemaking. *Id.* at 13561-62. He also claims that the Commission should continue to use an assumption of 100 percent volume variability in analyzing mail processing costs. *Id.* at 13565. He advocates attributing Alaska Air costs to Parcel Post. *Id.* at 13620.

Based on these observations, and utilizing the Commission's relative markups from Docket No. R94-1, Dr. Henderson recomputes the revenue requirement, and produces average rates for 16 subclasses. *Id.* at 13566,13574. The only rates he examines under the Act's pricing criteria, however, are those for Express Mail, Priority Mail and Parcel Post. Following his review, he recommends average rates and cost coverages for each. *Id.* at 13567.

Dr. Henderson's average rate proposals are discussed elsewhere in this brief, as is his "on-again, off-again" treatment of Ramsey pricing. Since his position on Dr. Bradley's variability analyses is completely derivative of the work of other UPS witnesses, that position is also covered in a separate section. The focus of this section is his rationale concerning the proper use of incremental costs, and his adoption of Commission markups.

This is the first case in which the Postal Service has been able to provide an

incremental cost estimate for each of the subclasses of mail. Because these estimates differ significantly from the costs previously used by the Commission, witness Henderson's suggestion that the incremental costs developed in this case should be used as the basis for markups is more than trivial, and would lead to substantial changes in rate patterns. This can be seen from Mr. Henderson's proposed average rate increases of 32 percent for Priority Mail and 28 percent for Parcel Post. Tr. 25/13568-70.

Because of the important rate implications, it is imperative that the soundness of Dr. Henderson's proposals be thoroughly established before they are adopted. Unfortunately, Mr. Henderson's costing and pricing proposals have been shown to be far from sound. As has been explained elsewhere, by making incremental costs serve as the cost base for markups, Dr. Henderson has jettisoned from the process critical marginal cost information. As Dr. Panzar has explained, given the existence of a break-even constraint, the marginal costs of the various services are essential information for the implementation of any rational pricing policy. USPS-T-11 at 7. The Postal Service, the Commission, or any other entity concerned with meeting the break-even requirement, can appropriately and rationally evaluate the degree to which different rate changes may foster or undermine break-even in the test-year by analyzing the marginal cost and revenue changes associated with the proposed rate changes.[46] This is decisionmaking at the margin, and it can only be done appropriately based on information demonstrating how costs and revenues vary at

[46] This is best exemplified in the iterative roll-forward process.

the margin.

Equally important, as emphasized in prior sections of this brief, the degree to which different rate combinations deviate from economically efficient rates can be known only if the starting point for ratemaking is marginal costs. As Dr. Henderson agrees, the essence of economic efficiency is the avoidance of waste. Tr. 25/13597-98. If the Commission is to design postal rates that do not excessively waste society's resources, it must orient the ratemaking process so that the information necessary to avoid such waste is preserved and utilized. Unfortunately, by turning away from the use of volume variable (marginal) costs for purposes of markups, Dr. Henderson urges an approach which would foster such waste.

His advocacy of such an approach does not rest on any disagreement with the fundamental principles set out by Dr. Panzar. In fact, he concedes that "[e]conomic efficiency is a valid consideration" in postal ratemaking. Tr. 25/13554. He also agrees that Ramsey prices (which are based on marginal costs and demand elasticity measures) have a valid and useful role to play in the ratemaking function. Id. at 13669-70. The bases of his disagreement are his view of the Commission's interpretation of the ratemaking statute, and two technical arguments regarding potential measurement error in incremental cost measures, and the proper length of run to be considered when choosing a cost basis for ratemaking.

While Dr. Henderson's understanding of Commission precedent and the Postal Reorganization Act are interesting, it is ultimately the Commission which must decide what principles to use in exercising its discretionary authority in ratemaking. As has

been shown previously, the economic principles espoused by Dr. Panzar do not conflict with the ratemaking provisions of the Act, which surely allow the Commission the discretion to formulate rates consistent with economic efficiency, among other factors.

Moreover, as Professor Panzar has shown, witness Henderson's technical arguments lack merit. Dr. Henderson takes the position that because rates should exceed incremental costs, and because the estimated incremental costs, like all estimates, are subject to error, and may be underestimated, it is not sufficient for rates to be tested against incremental costs. Instead, the incremental costs should be marked up to ensure the absence of cross-subsidization.

As Professor Panzar explained, Dr. Henderson fails to consider that incremental costs may also be *over*estimated, and, if used as the basis for marking up rates, could produce rates which inefficiently encourage entry of competitors into the market, at significant social cost. Tr. 34/18459. Since error may occur in both directions, the best practice is to rely on the point estimate of incremental costs. *Id.* However, even if overestimation of incremental costs were to occur, and it were thought best to allow some "margin for error", that is "no reason to use average incremental costs as the cost basis to which mark-ups are applied. The correct way to implement such a policy would be at the subsidy testing stage." *Id.*[47]

---

[47] Regardless of the manner in which the Postal Service's incremental costs are employed, there is no question that the rates proposed by the Postal Service more than adequately cover incremental costs. Estimation error is thus unlikely to affect the outcome of the incremental cost test. *See* Tr. 34/18242 (Christensen).

Dr. Henderson's concerns regarding length of run are equally misguided. Dr. Henderson appears to believe that the Postal Service's incremental cost estimates are superior to its volume variability because the volume variable costs supposedly are based on a less realistic timeframe. See Tr. 25/13559-60. As Professor Panzar has explained, this argument proceeds from a false premise.[48] The incremental costing methodology presented by the Postal Service in this case is based on precisely the same costing system that is used to develop the unit volume variable cost estimates, and hence represent the same timeframe. There is thus no temporal reason to dismiss the Postal Service's estimates of marginal costs as inferior to incremental costs. Tr. 34/18460-61.

One final aspect of Dr. Henderson's analysis also bears mention. Throughout his testimony, Dr. Henderson purports to be following Commission costing and pricing precedent from prior proceedings. It can easily be seen that this is not the case, and that the radical rate adjustments he proposes are, in part, founded upon internally inconsistent findings and policies. First, as Dr. Christensen has noted, witness Henderson's proposed cost base, subclass incremental costs, has not been used by the Commission in prior proceedings, since this is the first case in which a complete set of such estimates was presented. Tr. 34/18241. Second, it is clear that witness Henderson incorporates PRC contribution levels from Docket No. R94-1 without any

[48] As Dr. Christensen shows, witness Henderson's testimony also reflects misunderstanding of the relevant economic concepts. Tr. 34/18242-46. In particular, Dr. Henderson implies that long run costs will be greater than short run costs, whereas, in actuality, a firm can be expected to be able to optimize its capacity in the long run so as to reduce costs. *Id.*

recognition that these levels *were calculated from a cost base much different from the one he now advocates.* If the Commission had marked up incremental costs developed in the manner now presented by the Postal Service (rather than marking up attributable costs consisting merely of volume variable and product specific costs, excluding Alaska Air costs), it would have been working with a much different cost base, and the cost coverage percentages it arrived at would have been correspondingly different. Thus, despite the fact that Mr. Henderson asserts that "markup relationships established in an omnibus rate case are a better general guide" to sound ratemaking than the rate relationships emerging from a given case," (Tr. 25/13555) he has utterly failed to base his rate proposals on markup relationships which are comparable to those the Commission has used. Since the costs witness Henderson would use are higher than the Commission's attributable costs, the cost coverages he cites are not comparable to the coverages used in past cases. His rate proposals are not consistently based on prior Commission methods, and, under his own standards, must be ignored.

L. Conclusion

The cost coverages proposed by the Postal Service represent a fair and equitable allocation of institutional costs. Witness O'Hara's approach is the only balanced and comprehensive application of the various statutory criteria to each subclass of mail. He takes into account the relevant statutory criteria while analyzing each specific subclass and ensures that the institutional cost contributions of the

various subclasses are fair and equitable in comparison to each other. The result of his analysis is an allocation of institutional costs which treats mailers and competitors fairly, takes into account the unique characteristics of each subclass, and best allows the Postal Service to meets the needs of the mailing public. The Postal Service urges the Commission to give full support to his proposals.

V. THE RATES PROPOSED BY THE POSTAL SERVICE WILL RECOVER THE NECESSARY AMOUNT OF REVENUE FROM EACH SUBCLASS IN A FAIR AND EQUITABLE MANNER

After the Postal Service determines the appropriate cost coverage for each subclass of mail, it must design rates for each subclass which generate sufficient revenue to ensure that the ratio of per-piece revenue to per-piece volume-variable cost equals the prescribed cost coverage. The revenue burden for each mail subclass or service must be spread across each rate category of that subclass or distinct element of that service offering in a fair and equitable manner. As is evident from the preceding chapter of this Brief, each subclass is accorded an independent application and weighting of the appropriate statutory policy considerations. Only a comprehensive subclass-by-subclass approach will ensure that all of the relevant costing and pricing criteria have been reasonably considered and fairly applied.

Such an approach has been taken by the Postal Service in this proceeding. The Postal Service has presented substantial record evidence which reflects a strict adherence to the fundamental principles of postal rate-making. The product of this effort is a comprehensive, integrated and harmonious rate schedule. The Postal Service's proposed rates for each subclass are discussed below and are contrasted with the pricing proposals of the intervenors. The record in this proceeding demonstrates that the Postal Service's rate proposals ensure that the Postal Service's revenue requirement will be met in a manner which is fair and equitable to mailers and competition. The rates proposed by the Postal Service are consistent

with the public interest and should be preferred by the Commission to those suggested by the various intervenors.

A. First-Class Mail

1. Proposals

For the letters subclass of First-Class Mail, the Postal Service proposed an average rate increase of 3.3 percent for First-Class Mail and a cost coverage of 200 percent. For the cards subclass of First-Class Mail, the Postal Service proposed an average rate increase of 5.9 percent and a cost coverage of 184 percent.

Specifically, the Postal Service proposed the following First-Class Mail rate changes for single-piece and nonautomated presort pieces:

The current rate for the first ounce of a First-Class Mail piece should be increased from 32 cents to 33 cents.

The current 2.5-cent rate differential from the basic rate for Nonautomated Presort letters should be reduced.[1/]

The current 23-cent additional-ounce rate should be maintained. This would increase the additional-ounce degression from the first-ounce rate from 9 to 10 cents.

The current 11-ounce weight limit for First-Class Mail should be retained.

The current surcharge for nonstandard size single pieces weighing 1 ounce or less should increase from 11 to 16 cents. In addition, the nonstandard surcharge for

---

[1/] While the Postal Service proposed reducing the discount to two cents, resulting in a 31-cent rate, a subsequent revision to the underlying cost data may suggest that more of the current discount should be retained. *See Section V.A.2.e.i. below.*

presort mail weighing one ounce or less should be increased from 5 to 11 cents.

For all properly presorted pieces weighing above two ounces, the Postal Service proposed that the current additional incremental discount of 4.6 cents be eliminated.

The current basic postal and post card rate should be increased from 20 to 21 cents. The current 2-cent rate differential from the basic rate for Nonautomated Presort cards should be retained, resulting in a 19-cent per-piece rate for such mail.

New categories of Prepaid Reply Mail (PRM) should be established. The rate of postage on the first ounce of an automation-compatible letter-shaped PRM piece should be 30 cents. The corresponding PRM card rate should be 18 cents.[2/]

Additional new categories of Qualified Business Reply Mail (QBRM) should be established. The rate of postage on the first ounce of an automation-compatible letter-shaped QBRM piece should be 30 cents. The corresponding QBRM card rate should be 18 cents.[3/]

[2/] The Postal Service also requests that the Commission issue a recommended decision on proposed changes to the Domestic Mail Classification Schedule (DMCS) relating to the establishment of and conditions of eligibility for these proposed new letter and card rate categories.

[3/] *Id.*

For the automated categories of First-Class Mail, the Postal Service proposed the following rate changes:

The Postal Service proposed reducing the current 5.9-cent rate differential for the first ounce of Basic Automation letters to 5.5 cents (resulting in a rate of 27.5 cents per piece).[4/] The current 3.4-cent rate differential for cards should be retained, resulting in a Basic Automation card rate of 17.6 cents.

The current 0.7-cent incremental rate differential (from the Basic Automation rate) for the first ounce of 3-Digit presorted letters should be increased to 1.0 cents, resulting in a cumulative discount for such letters of 6.5 cents and a rate of 26.5 cents. The current 0.7-cent incremental rate differential (from the Basic Automation rate) for 3-Digit presorted cards should be reduced to 0.6 cents, resulting in cumulative discount for such cards of 4.0 cents and a rate of 17.0 cents.

The current 1.6-cent incremental rate differential (from the 3-Digit rate) for the first ounce of 5-Digit presorted letters should be retained, resulting in a cumulative discount for such letters of 8.1 and a rate of 24.9 cents. The current 1.6-cent incremental rate differential (from the 3-Digit rate) for 5-Digit presorted cards should be reduced to 1.1 cents, resulting in a cumulative discount for cards of 5.1 cents a rate of 15.9 cents.

The current 0.8-cent incremental rate differential (from the 5-Digit rate) for the first ounce of Automated Carrier Route letters should reduced to 0.3 cents, resulting

---

[4/] A subsequent revision to the underlying cost data could be seen as providing a basis for retaining more of the current discount. See Section V.A.2.f.i.[4/] below.

in a cumulative discount for such letters of 8.4 cents and a rate of 24.6 cents.

The current 0.3-cent incremental rate differential for Automated Carrier Route cards should be retained, resulting in a cumulative discount for such cards of 5.4 cents and a rate of 15.6 cents.

The current 3.0-cent differential for the first ounce of Basic Automation flats should be retained, resulting in a rate of 30 cents.

The current 2.0-cent incremental rate differential for Automation 3/5-Digit flats should be retained, resulting in a cumulative discount for such flats of 5.0 cents and a rate of 28.0 cents.

The current surcharge for nonstandard size automated pieces weighing 1 ounce or less should increase from 5 to 11 cents.

For all pieces weighing above two ounces, the current additional incremental discount of 4.6 cents be eliminated.

The current 23-cent additional-ounce rate should be maintained.

The Postal Service proposed no changes in the Domestic Mail Classification Schedule conditions of eligibility for the current categories of First-Class Mail.

The rate proposals filed by the Postal Service and discussed above are depicted at pages 1 and 2 of Attachment A of the Request of the United States Postal Service For A Recommended Decision On Changes In Rates Of Postage And Fees For Postal Services (July 10, 1997) and at pages 4 and 5 of the Direct Testimony of David Fronk On Behalf Of The United States Postal Service (USPS-T-32).

2. *Discussion*

a. The Postal Service's First-Class Mail rate design for existing automation- and presort-based categories builds upon the Commission's Docket No. MC95-1 recommendations.

In Docket No. MC95-1, the Commission recommended discounts for the new First-Class Mail letter and post card subclasses based on studies which better reflected the impact of automated mail processing technology on costs. The Commission also reconfigured the rate categories within First-Class Mail in a manner which, in its view, sought to accommodate the Postal Service's operational plans and management objectives of maximizing the potential of automated barcode-based mail processing technology. PRC Op. MC95-1, at VI-16, ¶5035.

Concluding that the Commission's reclassification decision fell short of some of their expectations, the Governors, nevertheless, credited the Commission for recognizing that the value of mailer presortation had greatly diminished with the advent of the Postal Service's automation program. The Governors also approved of the Commission's reorientation of rate relationships to reduce the incentives for nonautomated presort, in keeping with the evolution in the operating environment and increasing automation incentives, where the mailer's worksharing has greater value. [5/]

The rates proposed by the Postal Service in Docket No. R97-1 for the First-

---

[5/] *Decision of the Governors of the United States Postal Service on the* Recommended Decision of the Postal Rate Commission on Classification Reform I, Docket No. MC95-1, at 7 (March 4, 1996).

Class Mail categories established in Docket No. MC95-1 are intended to build upon the Commission's work in that case. As emphasized by witness Fronk, "the Postal Service has been relying upon automation to control the costs of several mail processing and delivery functions" and to "work toward a mailstream that is as barcoded as practicable." USPS-T-32, at 21. In developing his rate proposals, witness Fronk took account of the importance of the Postal Service's automation program by developing discounts that not only recognize the need for continued bulk mailer participation, but also create opportunities for single-piece mailers to benefit from automation-based rate reductions. *Id.*

b. The Postal Service's automation- and presort-based discount proposals for the existing categories of letters and cards are based upon improved cost avoidance estimates.

Postal Service witness Philip Hatfield (USPS-T-25) has produced mail processing cost estimates for First-Class Mail which provide a solid basis for witness Fronk's proposed worksharing discounts for existing presort and automation rate categories.[6/]

Using a mailflow methodology similar to that employed by witnesses Smith and Takis in Docket No. MC95-1,[7/] witness Hatfield developed estimates of unit volume-variable mail processing costs for the various presort and automation rate

---

[6/] *See* Docket No. R97-1, Direct Testimony of Philip W. Hatfield On Behalf Of United States Postal Service, USPS-T-25.

[7/] Docket No. MC95-1, Direct Testimony of Marc Smith (USPS-T-10) and Direct Testimony of William Takis (USPS-T-12) On Behalf Of United States Postal Service.

categories of First-Class Mail.

Witness Hatfield's cost estimates benefits from analytical and methodological improvements made since Docket No. MC95-1. First, improved analysis of the volume variability of mail processing costs, introduced by Dr. Bradley (USPS-T-14), permits witness Hatfield to more accurately estimate mail processing benchmark costs and productivities. USPS-T-25, at 8-9.

Second, witness Hatfield was able to take advantage of the grouping of mail processing costs by Management Operating Data Systems (MODS) cost pools to address the Commission's Docket No. MC95-1 concerns[8/] about reliance upon the assumption that volume variable mail processing costs not reflected in the mail flow models were related to worksharing in the same proportion as modeled costs. By breaking down benchmark costs into the 46 different MODS cost pools, witness Hatfield was able to more accurately assess the degree to which non-modeled costs will vary proportionally with modeled costs. USPS-T-25 at 10-11. Witness Hatfield's analysis on this issue responded to the Commission's request[9/] that the 100 percent proportionality assumption be revisited in the next omnibus rate case. Witness Hatfield further improved upon the work of his Docket No. MC95-1 predecessors by developing new equipment accept and upgrade rate data, which were provided in USPS Library Reference H-130 and incorporated into his testimony.

[8/] PRC Op. MC95-1, at IV-44.

[9/] PRC Op. MC95-1, at IV-44, ¶4104.

In addition, witness Hatfield relied upon data which reflect the impact of classification reform presort mail entry requirements. USPS-T-25, at 12-15. He also made changes to the mailflow models to reflect non-machinable mail and the flow of mail from non-automated facilities to automated facilities. USPS-T-25, at 16-17. He presented an improved estimate of acceptance and verification costs for presort mail. *Id.* at 18. He modified the mailflow models to reflect the phasing out of Multi-Position Letter Sorting Machine (MPLSM) processing,[10/] as discussed by witness Moden (USPS-T-4 at 4-5).

Finally, witness Hatfield has more accurately reflected differences in the costs of processing First-Class Mail letters and cards. USPS-T-25, at 19-20. Witness Hatfield's analysis is consistent with the principle that the relevant mailstream be examined and that pertinent cost data be used in a manner appropriate to the characteristics of the mail being examined.[11/] Since prebarcoding and presorting are mailer worksharing activities, and related rates are proposed to recognize the avoided costs associated with that activity, the mail types discussed here are properly designated as rate categories. Consequently, the cost analyses presented by the Postal Service focus on the reasons for creation of those categories.[12/]

In addition to witness Hatfield's mail processing cost estimates, witness Seckar (USPS-T-26) provided mail processing costs for presort flats, and witness

---

[10/] *Id.*

[11/] *See* PRC Op., R84-1, Vol 1, at 361; PRC Op., R80-1, Vol. 1, at 288.

[12/] *See* PRC Op., R84-1, Vol. 1, at 363.

Hume (USPS-T-18) produced First-Class Mail delivery cost estimates. The sum of these mail processing and delivery cost estimates provided witness Fronk with a firm basis for developing his workshare discount proposals.

c. The Postal Service's use of the improved cost estimates is consistent with sound ratemaking practice.

The Postal Service's First-Class Mail rate category proposals seek to produce a rational allocation of resources through the rate design. In order that bulk users of the First-Class Mail stream can act with a high degree of economic rationality and efficiency in selecting among mail types and rate alternatives, it is imperative that the rates recommended by the Commission be based upon the properly measured cost differentials. In this regard, the selection of the appropriate benchmark from which to measure cost avoidance or cost differences is critical.

In Docket No. MC95-1, the Commission concluded that the bulk metered mail component of the single-piece First-Class Mail stream was the appropriate benchmark from which to base the price differentials for the First-Class Mail letter automation rate categories which emerged from that case. *See*, PRC Op. MC95-1,at IV-136, ¶4302. While the Postal Service also relates the nonautomated presort discount for letters to the bulk metered benchmark, this rate is based primarily on the practice that the discount be small enough that it does not present an obstacle to the Postal Service's goal of working toward a mailstream that is as barcoded as practicable. USPS-T-32, Appendix A, page 1.

Unfortunately, the record in Docket No. MC95-1 did not include an estimate of bulk metered mail costs, requiring the Commission to adopt a proxy for purposes of

its Docket No. MC95-1 rate design.[13] Following the Commission's Docket No. MC95-1 conclusion in Docket No. R97-1, witness Fronk has used the necessary estimate of the unit volume variable mail processing and delivery costs for bulk metered First-Class Mail.[14] This estimate provides a solid foundation from which the Postal Service and the Commission can design rates for purposes of this proceeding.

The Postal Service shares the view expressed by the Commission that the discounts should be based upon an appropriate benchmark cost from which the costs avoided by mail which migrates from that benchmark to various worksharing categories can be identified. In doing so, the objective should be to pass through approximately 100 percent of the costs avoided relative to the benchmark. See PRC Op. MC95-1, at IV-135, ¶4299.[15]

---

[13] With only the gross single piece cost available to serve as a benchmark (which included the costs of both stamped and metered single-piece mail), the Commission reduced the passthroughs implied by the use of that single-piece benchmark from 100 to 78 percent. PRC Op. MC95-1, at IV-136-37, ¶4301-02.

[14] *See* Exhibit USPS-29C, page 1 (as revised October 1, 1997). The First-Class Mail "bulk" metered single-piece cost, as used by witness Fronk, refers to meter bypass mail which is trayed by the mailer and, therefore, does not require the preparation that bundled metered letters would. Similarly, bulk metered mail does not require facing and canceling. This mail has the features commonly associated with metered First-Class Mail, such as a non-script address, often originating from businesses having a meter imprint or strip. *See* Tr. 4/1418 and Tr. 19E/9865. *See also*, USPS Library Reference H-106, page II-10, which is incorporated into USPS-ST-45; Tr. 19B/8811, 8814.

[15] Subject to deviations required by important management objectives or considerations of impact upon mailers. *Id.*

A particularly critical consideration in the development of First-Class Mail rate incentives is their relationship to each other. Setting discounts to compensate mailers only for the costs avoided by the Postal Service motivates the bulk mailer to presort or apply a barcode only if it can do so at lower cost than the Postal Service. USPS-T-32, at 20. As an example, if one form of worksharing results in a 1-cent greater cost savings than another, absent a compelling countervailing policy reason, the rate difference between the two should be 1 cent. Otherwise, if the rate difference is 2 cents, mailers would be encouraged to spend up to 2 cents to perform the latter form of worksharing, even though the actual cost savings to the Postal Service is only 1 cent.

As witness Fronk testified, in developing bulk presort and automation discounts for letters and cards, he focused on the costs avoided by successive degrees of presorting or automation capability. However, he did not blindly follow this approach in developing rates, since the statutory pricing criteria call for a balanced consideration of a number of factors, including fairness and equity, and simplicity in the rate structure. USPS-T-32, at 20.

d. The Commission should recommend the First-Class Mail basic single-piece rate proposed by the Postal Service.

Postal Service witness Fronk proposes a 33-cent basic rate for the first-ounce of single-piece First-Class Mail pieces. This rate, in combination with the various related rate differentials based upon such factors as weight, prebarcoding, presorting and size, allows the Postal Service to achieve the revenue requirement in a manner consistent with the policies of the Act. By every measure, the proposed

one cent increase in the basic First-Class Mail rate from 32 to 33 cents is the smallest since postal reorganization.

As explained by witness Fronk (USPS-T-32, at 22), in light of the modest revenue requirement requested in this proceeding, several factors combine to reinforce the fairness and equity of the proposed one-cent increase. First is the whole-cent constraint, which the Commission and the Postal Service have consistently agreed, makes it impractical for the basic rate used by the general mailing public to be anything other than rounded to a whole integer.[16/] Second is that the alternatives produce unfair and inequitable allocations of institutional cost. A 32-cent rate would unfairly and inequitably burden other mail classes and services with an inordinate share of institutional cost burden. A 34-cent rate would unfairly relieve other mail classes from having to bear equitable shares of institutional cost burden. It should be noted that the recommendation of the current 32-cent rate was based upon a balancing of similar considerations. *See* PRC Op. R94-1, at V-2-3.

e. The Commission's rate recommendations for the remaining First-Class Mail single-piece and nonautomation presort rate categories should conform to the Postal Service's proposals as closely as possible.

i. Nonautomated Presort Rate

Witness Fronk has proposed that the current 2.5 cent rate differential be reduced to 2.0 cents, resulting in a rate of 31 cents. In Docket No. MC95-1, the Commission was faced with cost evidence which signalled that the presort discount

---

[16/] *See*, PRC Op. R94-1 at V-2, ¶5005; PRC Op. R87-1 at 438, ¶5083.

should be reduced from 4.6 cents to 2.0 cents. However, because the Commission concluded that such a proposal[17] represented too drastic a change for small-volume presort bureaus and in-house presort mailers, it struck a compromise. The Commission opined that these mailers should be afforded time to adjust their capabilities and practices to the Postal Service's automation-driven priorities. Accordingly, the Commission moderated the impact of the reduction of this discount in Docket No. MC95-1 by recommending a 2.5-cent presort rate differential. PRC Op. MC95-1, VI-21, ¶5043.

The Postal Service considers that the more than three-year interval between its March 1995, Docket No. MC95-1 declaration of intent to align nonautomated presort rates with their costs and the ultimate implementation of Docket No. R97-1 rates will provide a generous grace period for small-volume presort bureaus and in-house presorters to adjust their capabilities to adapt to automation or to pay more cost-based rates. Accordingly, a reduction in the nonautomated presort discount from 2.5 cents should be recommended.

Although witness Fronk originally proposed a reduction of the discount to 2.0 cents, he made clear[18] that his proposal was based upon a cost estimate, which was superseded by the estimate ultimately reported in Exhibit USPS-29C (as revised October 1, 1997). He offered the Commission the benefit of his hindsight

---

[17] Coming on the heels of the decision in R94-1 to increase the discount from 4.0 to 4.6 cents.

[18] USPS-T-32 at 24, n. 4.

that, had he been able to rely on the revised Exhibit USPS-29C cost estimate, the discount he would have recommended would have been toward the middle of the range between the current 2.5-cent discount and the 2.0-cent proposal authorized by the Board of Governors. Tr. 4/1625-26, 1690. *See also*, USPS-T-32, Appendix A (October 8, 1997).

ii. Additional-ounce rate

Witness Fronk proposed the retention of the current 23-cent additional-ounce rate for single-piece and nonautomated presort First-Class Mail.[19] His testimony observed that the rate has not changed since Docket No. R90-1, resulting in an increase in the degression from the basic rate over time, as the latter has increased to 29 cents and then again to 32 cents. USPS-T-32, at 23.

In Docket No. MC95-1, the Commission reaffirmed what may be universally recognized as one of the "truisms" of postal ratemaking -- that the costs of handling additional ounces of First-Class Mail pieces are at some unquantified level less than those for the initial ounce. PRC Op. MC95-1, at V-51, ¶5112. It has been the practice of both the Postal Service and the Commission, in the absence of definitive cost evidence, to increase the degression over time. Accordingly, witness Fronk proposes that the degression be increased as a result of this proceeding from 9 to 10 cents. In the absence of definitive evidence suggesting an alternative approach, it also has been the practice of both agencies to maintain a uniform and universal additional-ounce rate for all First-Class Mail rate categories. As noted by witness

[19] And, as noted below, for the Automated First-Class Mail rate categories.

Fronk, such a practice promotes simplicity in rate design. USPS-T-32, at 23.

Witness Fronk noted that the additional-ounce rate continues to be an important source of revenue for the Postal Service, generating 13 percent of FY 1996 First-Class Mail revenue. USPS-T-32, at 23.

iii. Nonstandard Surcharge

The basis for witness Fronk's proposed increases to the nonstandard surcharges for single-piece and for the Presort and Automated rate categories of First-Class Mail is the cost study contained in USPS Library Reference H-112, Nonstandard Surcharge Cost Update, and in Exhibit USPS-43A.[20/] In general, this cost study presents an update of the incremental costs associated with the processing of nonstandard First-Class Mail pieces, using the same methodology employed by the Postal Service and approved by the Commission in the last several omnibus cases. An initial correction to the original USPS-LR-H-112 cost study reduced the unit cost estimate for the single-piece nonstandard surcharge from 15.08 cents to 14.95 cents, a decrease sufficient for witness Fronk to candidly acknowledge that if he had relied upon that corrected cost estimate, he would have recommended a 15-cent nonstandard surcharge for single-piece mail, instead of 16 cents. Tr. 4/1634.

However, the original 15.08-cent unit cost estimate and the above-referenced corrected estimate were superseded by the filing of USPS-ST-43. As noted at

---

[20/] Supplemental Testimony of Sharon Daniel On Behalf of the United States Postal Service (USPS-ST-43).

pages 2 and 3 of that supplemental testimony, incorporation of up-to-date nonstandard mail mix shape data results in a sharp, upward correction of single-piece nonstandard surcharge unit mail processing costs to 21.59 cents.[21/] The current surcharge is now 11 cents. As noted above, based upon the original USPS-LR-H-112 cost estimate, witness Fronk proposed an increase to 16 cents.

Similarly, as reflected at pages 2 and 3 of USPS-ST-43 and Tr. 14/7364, incorporation of current nonstandard mail mix shape data results in an upward correction of Presort and Automated nonstandard surcharge unit mail processing costs to 15.16 cents.[22/] The current surcharge is now 5 cents. Based upon the original USPS-LR-H-112 cost estimate, witness Fronk proposed an increase to 11 cents.

Implicit in witness Fronk's nonstandard surcharge proposals was his judgment that increases from 11 to 16 cents and from 5 to 11 cents did not trigger considerations of "rate shock" or whether it would be unfair to impose such increases in one increment. It was, and continues to be the Postal Service's preference that the surcharges, to the greatest extent possible, reflect the estimated additional mail processing and delivery costs incurred by nonstandard First-Class Mail pieces. This is consistent with the Commission's statement that "[h]istorically, the [nonstandard] surcharge has been imposed to recover the added cost of processing nonstandard pieces. PRC Op. R90, Vol. 1, at V-15, ¶5034.

[21/] Additional delivery costs are not included in this estimate.

[22/] *Id.*

Nevertheless, given the significant increases in cost which result from the improvements in cost measurement presented in witness Daniel's supplemental testimony, the Postal Service understands that surcharges which reflect the full impact of her most refined cost estimates might trigger considerations of "rate shock" sufficient to compel the Commission to soften the impact of the increases implied by the cost data. Accordingly, the Commission may want to consider reaching a compromise which coincides with the 16-cent and 11-cent surcharges originally proposed by witness Fronk.[23/] As noted by witness Fronk, such a compromise would pass through nearly three-fourths of the identifiable cost difference between standard and nonstandard single pieces. Similarly, such a compromise would pass through nearly three-fourths of the identifiable cost difference between standard and nonstandard presorted pieces. USPS-T-32, Appendix A, page 2. Such a compromise would be consistent with witness Fronk's testimony:

> In the nonstandard surcharge proposals, my intention was to better align prices with costs and signal this information to mailers. If the price is not generally aligned with costs and is artificially low, the Postal Service may encourage the overuse of nonstandard pieces.

Tr. 4/1504.

iv. Heavy-Piece Discount

The basis for the establishment of this discount has been overtaken by changes in mail processing over the last decade. Accordingly, witness Fronk

---

[23/] Notwithstanding the irony that his original proposal is based upon a cost estimate which has been superseded.

proposed that it be eliminated. In Docket No. R87-1, the Commission recommended and the Governors approved the adoption of an additional 4-cent heavy-piece discount for presorted pieces weighing over two ounces. At the time, the Commission made clear that it was motivated by a desire to spur further presortation First-Class Mail flats, having observed that the preponderance of First-Class Mail pieces over two ounces in weight were flats. In contrast, it was the Commission's view that letters, which dominated the First-Class Mail stream weighing up to two ounces, had sufficient rate incentives to encourage presortation. See PRC Op. R87, Vol 1, at 447-48, ¶5116-22. In Docket No. R90-1, the Commission affirmed that the driving force behind the discount was to avoid postal sortation of flats that incur additional costs by reason of size and weight. PRC Op. R90-1, Vol. 1, at V-13, ¶4050.

Witness Fronk advanced two principal reasons for eliminating the discount. First, he observed that, by keeping the additional-ounce rate the same since Docket No. R90-1 and progressively increasing the difference with the first-ounce rate, the Postal Service has already reduced the relative price for heavy pieces, making a special discount less necessary. Second, he observes that elimination of the discount would simplify the First-Class Mail rate structure. USPS-T-32, at 24-25.

At Tr. 4/1436-37, he also made several other keen observations. For instance, he noted that when the discount was originally implemented a decade ago, there was a much greater dependency on mailer presorting than in the current mail processing environment. A discount to encourage the presortation of flats had much

more value then than it does in today's barcoded environment. Moreover, as witness Fronk also observed, the weight increment to which the discount applies -- presorted pieces over 2 ounces -- is not dominated by flats to the extent that it was in 1988. In fact, there appears to be a 50/50 split between flats and letters.[24/] It also is important to observe that the very reason the Commission rejected intervenor proposals in Docket No. R90-1 to expand the eligibility of the discount was to "fence out" letters, a category which, in the Commission's view, had sufficient presort incentives built into the rate schedule. Extending eligibility to include letters would "undercut the necessary cost basis for the discount." PRC Op. R90-1, at V-14, ¶5033.

The Postal Service respectfully submits that the very mail pieces the Commission sought to "fence out" have crept in. Given the shift to barcode-based sortation, given the substantial proportion of letter-shaped pieces above two ounces which now qualify for the heavy piece discount, contrary to the premise underlying its adoption in the first place, one thing is clear: the discount is an anachronism which should be eliminated.

v. Basic Card Rate

Witness Fronk's proposal to increase the basic card rate from 20 to 21 cents would retain the current 12-cent difference between the basic letter and cards rates and maintain the traditional approximately 2:3 relationship with the basic letter rate. For the sake of simplicity and convenience for the general mailing public, the

---

[24/] *See* USPS-T-32 Fronk Workpaper II, at 3.

proposed increase also reflects an application of the whole-cent constraint. The proposed increase works to narrow the gap between the cost coverages for letters and cards resulting from Docket No. R94-1 and imposes upon card mailers no more than a fair and equitable contribution to the First-Class Mail revenue requirement. USPS-T-32, at 30-31.

vi. Nonautomated Presort Card Rate

The Postal Service proposes an 19-cent rate for nonautomated presort cards. This proposal, in conjunction with the proposed 21-cent basic card rate, maintains the current 2-cent card discount and parallels the proposed 2-cent discount for nonautomated presort letters discussed above. USPS-T-32 at 31.

f. The Commission's recommendations should conform as closely as possible to the Postal Service's proposals for existing automated First-Class Mail categories.

As discussed above, in the development of First-Class Mail worksharing rate incentives, the Commission has enunciated certain guiding principles. Among them is the notion that the relevant mailstream be examined and that pertinent cost data be used in a manner appropriate to the characteristics of the mail being examined. *See*, PRC Op. R84-1, Vol. 1 at 361; PRC Op. R80-1, Vol. 1 at 288. Since mailer prebarcoding and presorting are worksharing activities, and related rates are proposed to recognize the additional costs associated with such activity for the various rate categories, the cost analyses supporting the rates for these rate

categories should focus on the reason for the creation of those categories.[25] In the absence of overriding policy considerations, the Commission has held that cost differentials should reflect costs avoided by worksharing alone, since the primary purpose of the discount is to maximize productive efficiency within postal markets. PRC Op. MC95-1, at IV-95, ¶4210.

For rate categories within a subclass, combined cost (the mailer's internal cost plus the Postal Service's costs) is the appropriate focus for rate design. The mailer's purchasing decisions are based on their internal costs, plus postage.[26] The most meaningful market signal sent by the price of rate categories is one that accurately indicates their cost relative to other worksharing categories through which essentially the same delivery service can be obtained. It is appropriate to calculate the rate for these and other worksharing categories as discounts from the basic subclass rate. PRC Op. MC95-1 at IV-96, ¶4212.

The rate design of witness Fronk for the presorted and automated letter and card categories reflects an attempt to be as faithful as possible to these principles, while being mindful of the impact of the rates upon mailers. In developing discounts, he focused on the costs avoided by successive degrees of presortation or automation compatibility. Setting discounts to compensate mailers only for the costs avoided by the Postal Service provides the bulk mailer an incentive to apply a

---

[25] *See* PRC Op. R84-1, Vol. 1, at 363.

[26] While any perceived differences in delivery service provided do not play a significant role.

barcode or presort only if it can do so at a lower cost than the Postal Service. USPS-T-32, at 20. He testified:

> The specific benchmark I used in setting the discounts for bulk automation letters is the sum of mail processing and delivery costs for bulk metered mail. As the Commission stated in Docket No. MC95-1 (¶4302 at IV-136), "the single-piece mail most likely to convert to the automation categories is limited to the bulk metered mail component." I focused on the mail processing and delivery cost aspects of this benchmark because these are the costs that will be affected by presorting and prebarcoding. Transportation and "other costs" are not likely to be avoided by these worksharing activities. The Commission reached the same conclusion about transportation and "other costs" in MC95-1 (¶4273 at page IV-123).

USPS-T-32, at 20-21.

i. The Automation Letter Rate Categories

A significant development of Docket No. MC95-1 was the establishment of the four rate categories for prebarcoded letters: Basic, 3-Digit, 5-Digit, and Carrier Route. To be eligible for the 3-Digit and 5-Digit categories, letters must be properly barcoded and part of a mailing of at least 500 pieces. To qualify for either the 3-Digit or the 5-Digit rate, the mailing must have at least 150 pieces destined to the same 3-Digit or 5-Digit ZIP Code, respectively. USPS-T-32, at 25. Pieces that do not meet the 150-piece minimum qualify for the Basic Automation rate.[27] The Carrier Route rate is available for delivery point sequenced (DPS) letters destinating in zones specified by the Postal Service. Pieces qualifying for this rate must be one of at least 10 pieces destined for a particular carrier route.

In developing his letter automation rates, witness Fronk treated the 3-Digit

[27] One could view this rate as the bulk residual barcoded rate.

letter rate as the "key" from which the other letter automation rates were developed because this rate applies to the largest volume (60 percent) of automated letters. Unit cost differences for the 3-digit and basic automation rates were calculated in terms of the bulk metered benchmark, while the 5-digit and carrier route cost differences were calculated in terms of the previous automation tier (for example, 5-Digit difference in terms of 3-Digit automation). USPS-T-32, at pages 26-27. The goal was to establish discounts that would pass through approximately 100 percent of the measurable cost differences, subject to various policy constraints.

Because the bulk metered benchmark cost was revised after the Postal Service rate design was complete, witness Fronk recomputed the automated letter cost differences and implicit cost passthroughs using the revised benchmark. Tr. 4/1406-07. In doing so, he noted that there were no changes to the costs differences or cost passthroughs for Automated 5-Digit letters or Automation Carrier Route letters. The passthroughs for the 5-Digit category and the Carrier Route category remained 100 percent and 150 percent, respectively. For Carrier Route, he had originally increased the discount over and above what a purely cost-based approach would suggest, in order to moderate the reduction in the incremental Carrier Route discount from 0.8 to 0.3 cents, while still recognizing the extra mailer preparation needed to make Carrier Route trays and packages. USPS-T-32, at 29.

The Basic Automation letter and 3-Digit letter cost differences did change as a result of the revised benchmark, however. As witness Fronk indicates:

> Using the revised cost difference data, the percentage passthrough of the cost differential for the 3-digit category changes from approximately 118% to

> 100%. The percentage passthrough of the cost differential for the basic automation category changes from approximately 118% to 97%."

Tr. 4/1407. When his direct testimony was filed on July 10, 1997, witness Fronk justified the 118 percent passthrough for 3-Digit letters on the grounds of avoiding "rate shock" and maintaining incentives to automate. He justified the 118 percent passthrough for Basic Automation letters on the basis of avoiding "rate shock," maintaining incentives to automate, and helping maintain the general rate relationship with 3-digit letters. He also noted that his Basic Automation rate proposal increased the gap between Basic Automation and 3-Digit rates from its current 0.7 cents to 1.0 cents, thus reducing the risk that large 3-Digit mailings would be fragmented into numerous smaller mailings, unnecessarily raising acceptance and mail processing costs. USPS-T-32, at pages 27-28.

In the supplemental Appendix A (filed October 8, 1997) to his direct testimony, witness Fronk cited the recomputed Automated letter cost differences and implicit cost passthroughs using the revised benchmark (all of which now appear at Tr. 4/1406-07) and acknowledged the effect that the revision in the bulk metered benchmark had on the implicit cost passthroughs for Basic Automation and 3-Digit letters. By coincidence, the 3-Digit letter passthrough ended up at 100 percent, the level needed to send the appropriate price signal to mailers.

To achieve an implied passthrough of 100 percent for Basic Automation letters, the Basic Automation discount would need to be increased by 0.2 cents. Decreasing the Basic Automation rate to 27.3 cents would still increase the gap between the Basic Automation and 3-Digit rates from 0.7 cents to 0.8 cents.

ii. Automation Rate Category Flats

Witness Fronk proposed modest one-cent increases in the rates for both bulk Automation rate categories for flats: Basic and 3/5-Digit. He proposed that the Basic Automation rate for flats increase to 30 cents and the 3/5-Digit Automation rate for flats increase to 28 cents. This rate design preserves the appropriate rate relationships between the various rate categories of Automation letters and flats. It also establishes simple, identifiable relationships among rates, in accordance with 39 U.S.C. § 3622(b)(7). USPS-T-32, at 29-30.

iii. Nonstandard Surcharge

The current nonstandard surcharge for Automation rate category pieces is 5 cents. Based upon cost data originally submitted in USPS Library Reference H-112, witness Fronk proposed that the surcharge be increased to 11 cents, to track cost incurrence. Exhibit USPS-43C ultimately demonstrated that the handling of nonstandard size Automation rate category pieces generates an additional 15.16 in costs, far in excess of the surcharge originally proposed by witness Fronk. Accordingly, for the reasons discussed above in V.A.2.e.iii. in relation to the nonstandard surcharge for single-piece and nonautomation presort, the Postal Service proposed that the current 5-cent surcharge which applies to nonstandard Automation rate category pieces be increased to 11 cents.

iv. Heavy-Piece Deduction

For the reasons discussed above in section V.A.2.e.iv., witness Fronk proposed that the incremental 4.6-cent discount for automation pieces weighing

more than two ounces be eliminated.

v. Additional-Ounce

For the reasons discussed above in section V.A.2.e.ii., the Postal Service proposed that a uniform additional-ounce rate be applied to all First-Class Mail pieces, including those in the Automation rate categories.

vi. Automated Card Rate Categories

Docket No. MC95-1 classification reform established four rate categories for prebarcoded cards: Basic, 3-Digit, 5-Digit, and Carrier Route. The eligibility requirements for cards are consistent with those for letters, as generally described above in section V.A.2.f.i., and at USPS-T-32. 31-32. Witness Fronk's proposed 17.6 rate for Basic Automation cards retains the current 1.4-cent rate differential between this category and the nonautomated presort rate of 19.0. The proposed 17.0 3-Digit Automation card rate is 2 cents below the Nonautomated Presort rate and reflects a 100 passthrough of the cost difference. Witness Fronk's proposal of a 15.9 rate for 5-Digit Automation rate cards reflects a 100 percent passthrough of the cost difference between Automation rate cards presorted to this level and those presorted to the 3-Digit level. The proposed 1.1-cent rate differential between the two categories is a half-cent less than the current differential, but tracks cost incurrence. Witness Fronk proposed a 15.6 rate for Automation Carrier Route cards. This proposal preserves the current 0.3-cent differential between 5-Digit and Carrier Route cards, notwithstanding cost data which might suggest a larger differential. Witness Fronk cautions against relying on those data to increase the

differential, alluding to the relatively small volume in this category and the resulting volatility of the data underlying any cost differential estimate. He proposed the conservative route of matching the card differential to the letter differential (between Automated 5-Digit and Carrier Route). USPS-T-32 at 33.

g. The Commission should recommend the adoption of the proposed Prepaid Reply Mail and Qualified Business Reply Mail classifications and rates.

The Postal Service proposed two additions to the First-Class Mail rate and classification schedules in this proceeding. Both are consistent with the policies of the Act and merit recommendation by the Commissioners to the Governors for approval. Each is intended to extend the cost-savings benefits of automated mail processing to specified reply mail letters and cards designed to take advantage of such processing, for which the postage is paid by the recipient.

The first proposed new category is Prepaid Reply Mail (PRM), for which witness Fronk proposed a rate of 30 cents for letters and 18 cents for cards.[28/] The second is Qualified Business Reply Mail (QBRM), which witness Fronk proposed as a new First-Class Mail rate category for mail which currently is within the Prebarcoded category of Business Reply Mail.[29/] Witness Fronk also proposed

---

[28/] The recipient pays a monthly fee of $1000 to cover Postal Service administrative and accounting costs. USPS-T-32, at 35.

[29/] Commonly referred to as BRMAS -- Business Reply Mail Accounting System.

a 30-cent rate for each QBRM letter and 18 cents for each QBRM card.[30/]

Pre-printed, barcoded, FIM-tagged reply envelopes and cards are used daily by households and small businesses. On average, they incur less mail processing costs than similar nonbarcoded pieces.[31/] Both PRM and QBRM would be clean, prebarcoded mail with these characteristics.

In Docket Nos. R87-1, R90-1, and MC95-1, the Commission recommended the establishment of rate categories within First-Class Mail which were designed to permit the senders of certain reply mail letters to pay a discounted rate of postage. In those cases where the Commission recommended a Courtesy Envelope Mail (CEM) "shell" classification with no rate attached, [32/] the Governors rejected the proposals.[33/]

In opposition to these Docket No. R87-1, R90-1, and MC95-1 CEM proposals, the Postal Service raised a number of issues on the record in each case which, in

---

[30/] To be paid by the recipient, which also pays a per-piece fee of 6 cents. *See* USPS-T-39, at 13.

[31/] PRM and QBRM mail pieces would be pre-approved by the Postal Service, much in the same manner that Business Reply Mail pieces are today. Tr. 4/1527.

[32/] *See* PRC Op. R87-1, at 416-31, ¶¶5034-59; Docket No. MC95-1, at 33-37, ¶¶5075-84.

[33/] Decision Of The Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Mail Classification Changes, Docket No. R87-1 (May 2, 1998). *See also*, Decision of the Governors of the United States Postal Service on the Recommended Decisions of the Postal Rate Commission on Courtesy Envelope Mail and Bulk Parcel Post, Docket No. MC95-1, at 1-6 (March 4, 1996). In Docket No. R90-1, the Commission rejected the OCA's CEM proposal in favor of an amalgamated "Public's Automation Rate" (PAR) category, the fate of which is reflected in PRC Op. R90-1 On Remand (September 27, 1994).

summary, related not only to the enforcement and administration of such a mail category, but to the fairness and equity of such a proposal.

Central to the Postal Service's opposition to CEM were its concerns about what, in shorthand, is referred to as the "two-stamp problem" -- the adverse consequences of administering a postal system in which the public would be expected to differentiate its 1-ounce letter mail on the basis of whether it was qualified for either the full basic rate or the discounted CEM basic rate and to affix proper postage.[34/]

Against this backdrop, the Postal approached the task of designing rates for Docket No. R97-1 with the objective of trying to strike a balance between two objectives: the first being the

extension of some the cost-savings benefits of automation through a discounted First-Class Mail rate on reply mail generated by households and small businesses; the second being avoidance of the "two-stamp problem" which had prompted its opposition to CEM. As witness Fronk testifies, PRM "has the advantage of not burdening and confusing the public with two different stamps" and of "avoiding the serious Postal Service administrative and enforcement problems associated with what would happen if the general public were expected to use differently rated postage stamps for its First-Class Mail correspondence and transactions." USPS-T-32, at 37. PRM avoids the "two-stamp problem" because, like existing Business

---

[34/] A summary of the Postal Service's concerns related to past versions of CEM may be found in the March 4, 1996, Decision of the Governors referenced above.

Reply Mail,[35] it does not require that the sender affix postage at all. Witness Fronk testified:

> PRM is intended to benefit the customers of large-volume business mailers, such as utility companies or credit card companies. Households and others would be provided with PRM envelopes . . . by the PRM account holder for which no postage would need to be affixed for mailing. The envelope provider, a PRM account holder, would pay the postage (and applicable fees).

USPS-T-32, at 34.[36]

The Postal Service's PRM proposal was further buttressed by quantitative market research which demonstrates a strong positive public reaction to the concept. USPS-T-32 at 38.[37] Over two-thirds of those surveyed considered the product either "very" or "somewhat" attractive. Over 60 percent considered the added extra convenience of not having to affix postage either "extremely" or "somewhat" important. Eight out of every 10 persons surveyed indicated that inclusion of a PRM envelope with a billing statement would have either a "strong" or "somewhat strong" positive influence on the level of their satisfaction with the envelope provider, leading witness Fronk to testify that businesses could generate significant goodwill through the use of PRM. USPS-T-32 at 38. The survey also demonstrated PRM could have a significant positive impact on expediting the entry

---

[35] Or, for that matter, QBRM.

[36] PRM envelopes and cards would be pre-approved by the Postal Service. They would need to meet Postal Service automation standards and bear a Facing Identification Mark, a proper barcode, and indicia signifying they were PRM-eligible pieces on which no postage need be paid. See USPS-T-32, at 34, n.7 and 8.

[37] Conducted on a statistically valid cross-section of the American public. *See*, USPS Library Reference H-200, Prepaid Reply Mail: Household Weighting Study (April 17, 1997).

of reply pieces into the mail stream and converting some customers from their current practice of making in-person bill payments. *Id.* This research also demonstrates that the key factor when respondents determine how to pay a bill is convenience, not price. Reply mail recipients who expressed an interest in PRM were not influenced by the price, but by the level of convenience -- the not having to buy and affix postage stamps -- associated with PRM. Tr. 4/1571-72.

Invoices and bill payments are the largest component of the First-Class Mail stream. USPS-T-32, at 35. With the growth in electronic alternatives to the mail stream, it is clear that electronic diversion poses a threat to through-the-mail bill payment. By not requiring that the senders affix postage, PRM provides an opportunity to enhance the convenience of using the mails in a manner which can help to stem the threat of electronic diversion. USPS-T-32 at 35-37.

By recognizing some of the cost differences associated with this mail, witness Fronk has further enhanced the appeal of PRM. Proposed in conjunction with a reduced rate of postage, PRM offers an opportunity for household and small business mailers in search of a more convenient way to transact business to do so in a manner which creates an opportunity for them to share in the cost savings associated with automation, without reviving the "two-stamp" problem associated with earlier CEM proposals.

PRM creates an opportunity for businesses, utilities, and other reply envelope providers and their correspondents to resolve whether remittances will continue to be mailed under the current system at the full rate of postage paid by the senders or

whether the recipient will arrange to pay a reduced rate of postage on such reply mail. Witness Fronk observed that if a business funds PRM or QBRM by explicitly billing its customers for the cost of the postage, then the 3-cent savings would be passed directly on to the customer. Conversely, if the business treats PRM or QBRM postage as a cost of doing business and recovers the cost through its product or service prices (similar to current BRM), then the 3 cents could be divided between the business and its customers. Tr. 4/1412.

PRM is not intended to be a panacea. It is another option to help improve the reply mail stream, for those reply mail recipients who determine that it satisfies their needs. Tr. 4/1545. As witness Fronk testified, whether an organization is interested in PRM or QBRM will depend on a number of factors, including its willingness to prepay postage and whether it finds a monthly fee or a (QBRM) per-piece fee more advantageous financially. USPS-T-32, at 7.

As witness Fronk stated, "It is important to recognize that mailers are under no obligation to offer PRM. Mailers may participate in PRM if they feel it meets their needs and if they meet Postal Service requirements for participation." Tr. 4/1536. As he further testified, "For example, in the intensely competitive bank card industry where card issuers compete on the basis of interest rate, annual fee, grace period, and the like, it is conceivable that one card issuer could offer PRM as a means of gaining a competitive edge." Tr. 4/1521.

In the end, a business will presumably offer PRM if it makes business sense to offer it based on a complete assessment of costs, customer preference and

acceptance, and intangibles like goodwill. In the bank card industry, does the fact some card issuers offer cards with no annual fee force everyone to do the same? No. If customers convince a business to adopt PRM, it will presumably be because those customers value PRM enough to want to pay the postage and the administrative costs built into the mailer's product or service.

Since PRM is especially targeted at the billing/remittance portion of the mailstream, the Postal Service anticipates that participating organizations will already have in place sophisticated automated payment systems that maintain a high degree of quality control due to their financial nature. Tr. 4/1584. Such systems typically capture and report a significant amount of data on pieces processed and customer payments. These features lead to PRM systems that are "easily audited" in that records can be routinely created and maintained as part of the business that the Postal Service can later compare against the number of pieces the mailer actually paid for. Tr. 4/1511.

Witness Fronk testified that pieces which qualify for and convert to PRM will come principally from two sources: existing courtesy reply mail and high-volume prebarcoded Business Reply Mail. USPS-T-32, at 42. He developed his Test Year estimate of PRM volume in two steps. First, he used data on prebarcoded BRM volumes and fees to estimate the Business Reply Mail volume that will migrate to PRM. Second, he started with the number of courtesy reply pieces in the mailstream, and then adjusted it (using Household Diary Study data and Postal Service experience in introducing a barcode discount in the late 1980s) to develop

his estimate of courtesy reply pieces switching to PRM in the Test Year. His total estimate of PRM volume in the Test Year was 847.8 million pieces. USPS-T-32 at pages 42-44. *See also* Tr. 4/1516-19.

Witness Fronk also testified that QBRM in the Test Year will come from current Business Reply Mail. He estimated that up to 179.9 million letters and cards that are prebarcoded and meet the requirements for the current 2-cent per-piece Prebarcoded BRM fee will qualify for this new rate. He developed this estimate by computing a break-even BRM volume needed to make the monthly fee of PRM more expensive than the per-piece fee of BRM. USPS-T-32, at 46.

The 30-cent per-piece rates for both PRM and QBRM are based upon a cost study performed by Postal Service witness Michael Miller (USPS-T-23). Mr. Miller's testimony measured the mail processing cost differences between a pre-approved, prebarcoded reply piece and a handwritten reply mail piece. USPS-T-23, at 16-18. This is the appropriate benchmark because households that are not provided with pre-approved, prebarcoded reply mail pieces must generate mail pieces that are not postal certified (e.g., hand-addressed mail pieces). *Id.* at 2. His study showed there to be a 4.0-cent unit cost difference between his benchmark mail and PRM/QBRM pieces. Taking a conservative approach often employed by the Commission in recommending conservative discounts for new rate categories, witness Fronk proposed a 3-cent PRM/QBRM rate differential from the proposed 33-cent basic rate for First-Class Mail letters and the proposed 21-cent basic rate for First-Class Mail cards.

The most significant difference between PRM and QBRM will be in the postage payment methods and the accounting or auditing requirements for each category. USPS-T-32, at 7. Witness Fronk described the PRM postage payment requirements, auditing methods, and related costs. USPS-T-32, at 40-42; Tr. 4/1527. See also, Tr. 4/1582-83, 1585-86. For a description of the proposed QBRM postage payment and accounting methods and costs (which are identical to the current methods for Prebarcoded (or BRMAS) Business Reply Mail), see the testimony of Postal Service witness Leslie Schenk (USPS-T-27, at 4-6, 8-14, Appendix A and Exhibit USPS-27C).[38/]

Witness Fronk concluded his discussion of the PRM and QBRM proposals with a discussion of how the proposals meet the classification criteria of § 3623(c) of title 39. The proposed new categories promote fairness and equity by establishing rates that are more closely aligned with costs. By recognizing some of the costs savings associated with this mail, the Postal Service is able to permit a broader base of customers to more directly share in the benefits of automation. In addition, by facilitating the invoice/remittance mail cycle and making bill payments more convenient, the Postal Service is able to enhance the value of this important component of the mail stream. Also, these services can enhance commerce by facilitating access to services offered by firms. Moreover, both mail categories have been developed to recognize the importance of speed of delivery by allowing the

---

[38/] The direct testimony Postal Service witness Susan Needham (USPS-T-39) explained the basis for the per-piece QBRM accounting fee.

PRM or QBRM recipient to receive its mail as expeditiously as possible. USPS-T-32, at 47-48.

3. Intervenors' proposals

Numerous intervenors have proposed First-Class Mail subclass and rate proposals which they prefer that the Commission recommend to the Governors. With limited exceptions noted below, none of their proposals has sufficient merit to warrant recommendation to the Governors. The inherent weaknesses of their proposals are explained below.

a. The Commission should reject the alternative intervenor First-Class Mail basic rate proposals.

i. MMA witness Bentley refrains from proposing his own preference

MMA witness Bentley's expressed his "preference" that the first-ounce rate for First-Class Mail be kept at 32 cents (Tr. 21/11155), but he refrained from proposing that the Commission recommend that rate. Tr. 21/11229. While Mr. Bentley estimated that a revenue loss of $809 million would result from keeping the basic First-Class Mail rate at 32 cents, he offered no means of making up for this revenue loss, stating that he cannot speculate what the Commission would do in terms of rate increases or revenue requirement adjustments.

Thus, while Mr. Bentley backed away from proposing what he hints the Commission might consider doing, it is important to recognize the importance of the 33-cent basic First-Class Mail rate in the Postal Service's overall rate request. As

witness Fronk testified, "a proposal not to change this rate would impose unreasonably large increases in other classes of mail." USPS-T-32, page 22 at lines 13-14. A 32-cent rate would significantly upset the balance in cost coverages among mail classes. Also, the proposed increase in the first-ounce rate of 3.1 percent is already below the proposed increases for the automated First-Class Mail rate categories, for example, a proposed 4.3 percent increase for 3-Digit presorted letters. Exhibit USPS-32A. A 32-cent rate would likely shift the burden of meeting the First-Class revenue target to bulk First-Class mail users.

ii. Greeting Card Association witness Erickson provides no basis for a re-evaluation of ECSI value

On behalf of the Greeting Card Association, witness Erickson testified, from the novel perspective of a cultural anthropologist, about the cultural value of mail and greeting cards in particular. Tr. 25/13151-213, 13217-31. Dr. Erickson's primary message seems to have been that greeting cards have a high level of cultural involvement that the Commission should be aware of when recommending rates. *Id.* at 13200 (concluding paragraph of GCA-T-1).

While his testimony certainly amplified the common sense understanding that greeting cards can send important messages, and may constitute a worthwhile academic work, Dr. Erickson's testimony was otherwise a compendium of cultural observations in the context of an omnibus rate case. He variously informed the record that all mail has cultural value, Tr. 25/13228, and that greeting cards which lack addresses on the outside still carry cultural value, *id.* at 13231. Moving to a more general level, he was unable to identify things that have no cultural value,

since once they are discussed they gain cultural value, *id.* at 13234-35, and "It is likely that any item in material culture would have an important role to play in human culture ...." *id.* at 13236. Indeed, with only a little equivocation, Dr. Erickson agreed that only the extent, but not the nature, of his observations were a surprise. *See, e.g., id.* at 13236-38.

The Postal Service acknowledges the effort and thought embodied in Dr. Erickson's testimony. Nevertheless, in the context of the instant proceeding, it really tells us only that if you study something – in this case greeting cards, you know more afterwards. While all mail has cultural value, he has only studied the greater value associated with greeting cards. There appears to be no barrier to studying other parts of the mailstream to identify attributes of their cultural value.

His testimony provides no basis for the Commission to conclude that First-Class Mail has more § 3622(b)(8) ECSI value than is already reflected in the current rate design.

b. *The Commission should reject the intervenor alternative* First-Class Mail presort and automation letter proposals.

i. ABA/EEI/NAPM *witness Clifton's result-oriented* cost analysis wilts under the slightest scrutiny

Testifying on behalf of a coalition of First-Class Mail users,[39/] Dr. Clifton proposes his own set of rates for the various presort and prebarcoded First-Class Mail rate categories. As will be demonstrated in a summary below, his rate design

---

[39/] Direct Testimony of James Clifton On Behalf Of American Bankers Association, Edison Electric Institute, and National Association of Presort Mailers (ABA/EEI/NAPM-T-1); Tr. 24/12458 *et seq.*

and underlying cost analysis are a result-oriented mish-mash and deserve no consideration by the Commission.

Dr. Clifton proposes a 0.5 cent increase in the Nonautomated Presort rate, from 29.5 cents to 30.0 cents, instead of the 1.5 cent increase to 31.0 cents originally proposed by Postal Service witness Fronk. Tr. 24/12506. In terms of letter automation rates, Dr. Clifton proposes keeping the Basic Automation rate at its current level, reducing the 3-Digit and 5-Digit automation rates by 1.0 cent from their current levels, and reducing the Automation Carrier Route rate by 0.5 cents from its current level. In sum, his automated letter rate proposal are:

Letter Rate Category	Current Rate	Clifton Proposed Rate	USPS Proposed Rate
Basic Automation	26.1 cents	26.1 cents	27.5 cents
3-Digit Automation	25.4	24.4	26.5
5-Digit Automation	23.8	22.8	24.9
Carrier Route	23.0	22.5	24.6

As indicated in this table, Dr. Clifton proposes a 3-Digit rate that is 3.9 percent below its current level and a 5-Digit rate that is 4.2 percent below its current level.

At Tr. 4/1410, witness Fronk testified that 3-Digit and 5-Digit letters are the largest categories of workshared mail, accounting for about 75 percent of workshared letters in the Test Year. While he acknowledged that his proposal calls for modest, 0.1-cent reductions in the 3-Digit and 5-Digit discounts, he pointed out that discounts have increased significantly when compared to the last omnibus rate

case. In comparison to Docket No. R94-1, the 3-Digit discount is increased from 5.6 cents to 6.5 cents in his proposal. Similarly, the 5-Digit discount is increased from 6.2 cents to 8.1 cents in his proposal. In fact, these 5-Digit mailers would still pay less than they did in 1995, even after this rate increase. Mailers at the 3-Digit Rate would pay only 0.1 cent more than they did in 1995. *See* USPS LR-H-187. Unlike MMA witness Bentley, who rejects the mail processing volume variability cost analysis proposed by the Postal Service in this proceeding, Dr. Clifton accepts the Postal Service's improved costing methodology. However, Dr. Clifton obtains discounts radically different from those proposed by witness Fronk by means of his unique brand of cost estimation and ratemaking.

The primary basis for Dr. Clifton's rate proposals is his recasting of First-Class Mail letter processing and delivery costs more to his liking. First, he adjusts the work of witnesses Hatfield (USPS-T-25) and Hume (USPS-T-18) for presorted First-Class Mail, as summarized in his Table 14 (Tr 24/12496). This reduces unit costs for each category by over 10 percent. He performs these adjustments by devising his own mail processing cost rollforward model and by reducing delivery costs, based upon an overstatement of the impact of the Move Update requirements, as described below. Second, he disregards the bulk metered benchmark costs used by witness Fronk (USPS-T-32, at 26) in favor of the cost for single-piece letters (Tr. 24/12485-88, 12497-98.) Cobbling together these elements, he launches into his rate design. Tr. 24/12496-98. As shown below, his methods are misguided and contrived.

ii. Dr. Clifton prefers his own personal rollforward model

Not pleased with costs projected by the Postal Service's Docket No. R97-1 rollforward model, Dr. Clifton decided to turn back the clock to the FY94 to FY96 time frame. He pointed out that the original 7.1 percent increase projected by the Postal Service for First-Class presort mail processing unit labor costs for the base year to the test year is inconsistent with the 13.8 percent decline that occurred between FY94 to FY96. Tr. 24/12477, 12479. He claimed that much of the decline in unit labor costs between FY94 and FY96 resulted from the growth in prebarcoding by First-Class presort mailers. Tr. 24/12481.[40/] Based on this assertion, he concluded that the FY94 to FY96 trend should be projected into the Test Year, since the Postal Service projected continued growth in the percentage of prebarcoded mail between FY96 and FY98. Tr. 24/12481.

Dr. Clifton's assertion that much of the decline in unit labor costs between FY94 and FY96 resulted from the growth in prebarcoding by First-Class presort is based upon what he claims to be an "empirical" measure of the manner in which changes in nonautomation share affect unit costs. Tr. 24/12515. His measure, an elasticity which purportedly measures the impact of nonautomation share on unit cost, is flawed. And, this flaw becomes apparent when one observes that, within the FY94 to FY 96 period, unit cost declined before the change in nonautomation share.

[40/] When asked to explain the basis for this assertion, he was non-responsive. Tr. 24/12626, 12653-55.

The decline in the nonautomation share is the same in each year (about 6 percent -- Tr. 24/12515, column [2]), while Dr. Clifton reports that the mail processing labor unit cost declined 12 percent between FY94 and FY96, and 1.1 percent decline in the period FY95 to FY96. See Tr. 24/12654. In developing his direct testimony, Dr. Clifton did not look at the relationship between nonautomation share and mail processing labor unit costs prior to FY94, since he questioned the relevance of such "old" data. Tr. 24/12661. But when asked to compute elasticities which measure the impact of nonautomation share on unit cost with data from FY90 to FY94, he conceded that the resulting elasticities would be very different than those he reported at Tr. 24/12515. *See* Dr. Clifton's response to USPS/ABA/EEI/NAPM-T1-41 (filed 3/6/98 and designated 3/23/98). *See also* Tr. 24/12748-51.

Dr. Clifton agreed that the Postal Service's automation program could have led to mail processing labor unit cost decline, but said he did not explore that possibility. Tr. 24/12751-52, 12626. It should be observed that much of the automation equipment for letters described by witness Moden (USPS-T-4, at 4-8) was deployed in the period between FY90 to FY95. Dr. Clifton ignores the labor savings associated with the substitution of automated sorting for mechanized and manual sorting. Instead, he ascribes these savings to growth in prebarcoding. Not only did Dr. Clifton not examine the period prior to FY94, he also did not examine the trends in <u>total</u> mail processing costs. Instead, he assumed in his cost projections that the piggybacked non-labor mail processing costs would have the

same downward trend as he projects for labor costs.[41/] He provides no basis for this counter-intuitive assumption.

Dr. Clifton rejected the Postal Service's rollforward model and mail volume mix adjustment simply because they do not make use of FY94 to FY96 cost trend data. Tr. 24/12481. He then developed his own rollforward costs based upon this earlier cost trend; however, he uses the same inputs that are employed in the Postal Service rollforward and mail mix adjustment that he rejects.

Employing four different scenarios, Dr. Clifton used his rollforward to roll back the 4.61 cent First-Class non-carrier route presort mail processing unit cost (labor and piggybacked costs) used by Postal Service witness Hatfield (USPS-T-25A, page 2 and LR-H-106, page II-5). Dr. Clifton estimated this cost to be either 3.21, 3.66, 4.06 or 3.98 cents, depending on the scenario. He uses these numbers as a base to obtain his own estimates of mail processing costs for each First-Class Mail rate categories estimates, all of which he favors over the estimates provided by USPS witness Hatfield (USPS-T-25, Exhibit A). Tr. 24/12483. Dr. Clifton's derivation and use of each of these scenarios demonstrate the contrived nature of his result-oriented methodology.[42/]

[41/] This flaw shows up in each of the four scenarios in which he calculates mail processing unit costs estimates. *See* Scenario 1, Technical Appendix B1 (Tr. 24/12516-28; Scenario 2, Technical Appendix B2 (Tr. 24/12529-40); Scenario 3 (Tr. 24/12637-48; and Scenario 4 (Attachment to revised response to USPS/ABA/EEI/NAPM-T1-4, filed 2/12/98) which revises Scenario 3.

[42/] At Tr. 24/12480, Dr. Clifton tries to discredit the Postal Service's calculation of the 4.61 cents in LR-H-106, page II-5, when he characterizes its calculation and labels the inputs as "assumed." *See also* Tr. 24/12740-2. Instead, he undermines his

iii. Dr. Clifton's estimate of the impact of the Move Update requirements has no foundation

Dr. Clifton's proposed discounts for workshared First-Class Mail are further exaggerated by 0.262 cents,[43] because of his reliance upon NAPM witness MacHarg's "conservative" estimate of the impact that the recently implemented Move Update requirements for First-Class Mail will have in reducing the quantity of workshared mail that gets forwarded in the Test Year.[44]

Based upon discussions with other presort bureaus managers and equipment manufacturers, Mr. MacHarg estimated that at least 25 percent of all First-Class workshared mail will be run through the FASTforward Move Update system and that other workshared volume will comply with other Move Update options, resulting in at least a 25 percent reduction in the volume of workshared First-Class Mail that gets forwarded in the Test Year, relative to the Base Year. Tr. 27/14956-57.

Dr. Clifton relied upon Docket No. MC95-1 USPS Library Reference MCR-76[45] to estimate that the average unit cost of handling forwarded First-Class Mail

---

credibility when he erroneously represents the calculation of 4.61 cent cost at Tr.24/12480, by claiming that the first term, 2.5 cents, is the mail processing direct unit labor cost from the FY96 CRA (Tr. 24/12479, 12742-43). The calculations of the 4.61 cents in LR-H-106 did not rely on the FY96 CRA, but instead relied on the base year mail processing costs, as contained in LR-H-146, part III. *See* LR-H-106, page II-1.

[43] Tr. 24/12477-78.

[44] For a description of these Move Update requirements, see Tr. 33/17649-50, 58-64.

[45] *Volumes, Characteristics, and Costs of Processing Undeliverable-As-Addressed Mail* (February 14, 1995)

is approximately 39 cents and that 2.69 percent of First-Class Mail is forwarded. On this basis, Dr. Clifton calculated that the projected 25 percent reduction in the forwarding of workshared mail will lead to a reduction in delivery costs for such mail of 0.262 cents per piece. Tr. 24/12512.

As demonstrated by the testimony of Postal Service witness Michael Murphy,[46/] Dr. Clifton's very elaborate analysis implodes for a very simple reason: Mr. MacHarg's "conservative" 25 percent estimate is an utterly unfounded overstatement of the impact of the Move Update requirements. Mr. Murphy's testimony cut to the quick. He invited the Commission's attention to the fact that Mr. MacHarg's 25 percent Test Year estimate fails to account for the degree to which bulk First-Class Mail users were voluntarily employing Move Update requirements before they were made mandatory. Tr. 33/17651-53. He demonstrated the unreasonableness of the 25 percent estimate by explaining the technical limits of Move Update technology. Tr. 33/17653-56. He explained why delays in the implementation of the FASTforward program have given it very little chance to be effective in the Test Year to any degree near that projected by Mr. MacHarg. Tr. 33/17650-51. Using First-Class Mail Computer Forwarding System (CFS) volumes as a proxy for First-Class Mail UAA volumes (Tr. 33/17656, 17668), Mr. Murphy showed that the Move Update requirements have yet to produce any reduction in

---

[46/] Rebuttal Testimony of Michael Murphy On Behalf Of United States Postal Service, USPS-RT-18; Tr. 33/17643 *et seq.*

CFS volumes.[471] Mr. Murphy demonstrated that it is premature to draw any conclusions about the impact of the Move Update requirements on the volumes of forwarded First-Class Mail in the Test Year. Tr. 33/17657.

Even if there were a 25 percent decline in forwarding of workshared mail in the Test Year, Dr. Clifton's 0.262-cent per piece cost savings would still be an overstatement. The 2.69 percent and 39-cent figures from Docket No. MC95-1 USPS-LR-MCR-76 relate to both forwarding and return-to-sender (RTS), as he acknowledged at Tr. 24/12512. However, witness Murphy's rebuttal testimony made plain that the Move Update requirements will have little impact on return-to-sender mail, since RTS stems from mail pieces having bad addresses, not from persons moving from one address to another. Tr. 33/17707-13. Dr. Clifton's calculations should have been based upon the cost associated with forwarding alone, 23.16 cents per piece and 1.88 percent. *See* Tr. 24/12655; USPS-LR-MCR-76, page 5-5 (line 2), and pages 4-3 and 4-7.

iv. Dr. Clifton is in denial concerning the bulk metered benchmark

Showing an apparent lack of understanding, Dr. Clifton made further "corrections" to the Postal Service's mail processing and delivery cost models by applying the Commission's Docket No. MC95-1 methodology for calculating discounts. Tr. 24/12459. In his Table 16 (Tr. 24/12498), he abandoned the Commission-recommended bulk metered benchmark used by witness Fronk in favor

[471] *See also*, Tr. 33/17691-92, 17706-07.

of the methodology the Commission relied upon in Docket No. MC95-1, notwithstanding the fact that the Commission relied on that methodology solely because "the cost of the bulk metered component of single-piece mail . . . [had] not been provided on . . . [that] record." PRC Op., MC95-1, at IV-136-37, ¶4302. Dr. Clifton's decision to apply the same 78 percent passthrough (of the cost difference between single-piece and basic automation letters) that the Commission used in Docket No. MC95-1 is arbitrary and unnecessary, since the Docket No. R97-1 record includes bulk metered mail costs. Tr. 24/12664, 12753-54.

Witness Clifton declared that there is not a sufficient volume history available for bulk metered mail to test the Commission's assertion that it is the most likely candidate for conversion to worksharing. Tr. 24/12488. He missed the point. The benchmark represents a pricing reference point to appropriately identify workshare cost savings and is not meant to imply that every piece that converts to worksharing comes from a pool of bulk metered pieces. Tr. 4/1413.

Dr. Clifton's prestidigitation is not over at this point, however. Because he does not like the cost coverages implied by his Table 16 discounts (Tr. 24/12498), he made some judgmental adjustments in his Table 22 to produce his rate proposals. Tr. 24/12506.

Any analysis of witness Clifton's rates is further clouded by the approach he has taken in developing the revenue consequences of his increased discounts. In measuring the volume and revenue impacts of his letter rate proposals, he left flat rates and workshared card rates at their current levels, rather than using the rates in

the Postal Service's proposal. Tr. 24/12666-67. He stated that leaving these rates at their current levels is not part of his formal proposal. However, in effect, they become part of his proposal, because the unchanged rates affect the First-Class Mail rate relationships and, thus, the forecasted volumes and revenues by rate category in his analysis. This makes it extremely difficult to isolate the financial impact of his letter rate proposals.

The impact of Dr. Clifton's letter rate proposals, including his additional-ounce rate proposal, as set forth in ABA&NAA-T-1, is a significant increase in the Standard Mail A cost coverage from 167.0 percent to 177.5 percent. Tr. 24/ 12509. While he makes no formal rate recommendation for Standard Regular and Enhanced Carrier Route (ECR) mail, Dr. Clifton's Appendix D analysis (in ABA/EEI/NAPM-T-1) presents automated letter and flat rates that are uniformly 1.6 cents higher than those in the Postal Service's proposal. This more than doubles the rate increase for these Standard A mailers.

While witness Clifton's automated letter proposals should be rejected in their entirety, one aspect of his Nonautomated Presort proposal warrants some discussion, as discussed above in IV.A.2.e.i. Witness Fronk proposed reducing the Nonautomated Presort discount from 2.5 cents to 2.0 cents, in part to increase the incentive for mailers to prebarcode their mail and thus further the automation goals of the Postal Service. USPS-T-32, page 24. The revision to the bulk metered benchmark discussed above reduced the implicit cost passthrough for this rate from close to 90 percent of the measured cost avoidance to 59 percent. USPS-T-32,

Appendix A page 2, at lines 1-3.

In his colloquy with Commissioner LeBlanc, witness Fronk stated that this implicit passthrough of 59 percent is "pretty low" and as a result, he would have considered retaining more of the discount, perhaps recommending a discount of 2.2 or 2.3 cents, had the revised benchmark been available at the time of his rate design. Tr. 4/1690-91.

c. Witness Bentley's proposed basic automation letter rate has merit, but the remainder of his automated letter proposals should be rejected.

MMA witness Bentley (Tr. 21/11168) proposed letter automation discounts that are 0.2 cents greater than those proposed by the Postal Service, resulting in MMA recommended rates that are 0.2 cents below those proposed by the Postal Service. The differences are highlighted below:

Letter Rate Category	USPS Proposal	MMA Proposal
Basic Automation	27.5 cents	27.3 cents
3-Digit Automation	26.5	26.3
5-Digit Automation	24.9	24.7
Carrier Route	24.6	24.4

As noted above, to determine the discounts for bulk automation letters, witness Fronk used the sum of mail processing and delivery costs for bulk metered mail as the benchmark for measuring cost savings. In developing the bulk presort/automation discounts, he then focused on the costs avoided by successive degrees of presorting or automation compatibility. Setting discounts to compensate mailers only for the costs avoided by the Postal Service provides the bulk mailer an

incentive to presort or apply a barcode only if it can do so at lower cost than the Postal Service. USPS-T-32 at 20.

In developing his automated letter rate recommendations, witness Bentley used the same categories of cost — namely, mail processing and delivery - that witness Fronk used in developing the Postal Service proposal. Tr. 21/11234. He also used bulk metered mail as the benchmark for measuring automated letter cost savings, as did witness Fronk. Tr. 21/11235. Indeed, Mr. Bentley testified that he "can confirm that the only reason my derived unit cost savings differ from those provided by USPS witness Fronk is that they assume that labor costs vary 100% with volume." Tr. 21/11236. In other words, had witness Bentley chosen to use the improved cost methodology set forth by the Postal Service in this docket, he would have obtained the same measured cost savings as witness Fronk.

Since witness Bentley recognized the cost savings from automation in the same manner as witness Fronk, it is puzzling that he would characterize the Postal Service proposal as sending an inconsistent price signal to mailers. Tr. 21/11171. What could be more consistent than sending a price signal that compensates mailers only for costs avoided by the Postal Service?

Because the bulk metered benchmark cost was revised after the Postal Service rate design was complete,[48/] the MMA rate recommendation to increase the discount by 0.2 cents for Basic Automation letters deserves attention. Because of their reliance on the wrong cost methodology, Mr. Bentley's remaining letter

---

[48/] As described above in section V.A.2.f.i.

automation rate proposals are without merit, however.

d. NAPM witness MacHarg uses the wrong benchmark for flats.

NAPM witness MacHarg used a single-piece benchmark to calculate cost differences for Automation flats and argues that the discounts for Automation flats should be increased, though he makes no specific rate recommendations. NAPM-T-1, at 4; Tr. 27/14966. There are a number of problems with his suggested approach.

First, the Commission has concluded that "cost differentials should reflect costs avoided by worksharing alone, since the primary purpose of the discount is to maximize productive efficiency within postal markets." PRC Op. MC95-1 at IV-95, ¶4210. Postal Service witness Fronk echoed this conclusion in his testimony:

> Discounts for bulk automation categories based in part on "dirty" rather than the "clean" mail most likely to be candidates for automation overstate the benefits of worksharing and can create the wrong incentive for mailers. Setting discounts to compensate mailers only for the costs avoided by the Postal Service provides the bulk mailer an incentive to presort or apply a barcode only if it can do so at lower cost than the Postal Service.

USPS-T-32, at 20.

Mr. MacHarg testified that single-piece costs are the appropriate benchmark in measuring cost differentials for worksharing purposes, notwithstanding his confirmation that such single-piece mail includes everything from "clean" mail (uniform pieces featuring typewritten or pre-printed addresses and often mailed in bulk) to "dirty" mail (pieces featuring handwritten and incorrect or incomplete addresses). Tr. 27/14966. Thus, Mr. MacHarg would have the Commission adopt

an approach that is inconsistent with its own recommendation and with economic efficiency.

Mr. MacHarg also confirmed that the single-piece benchmark he uses includes parcels as well as flats. *Id.* Since parcels are more expensive to process than flats, this overstates single-piece costs.

At Tr. 4/1490, witness Fronk discussed the appropriate ratemaking approach for flats:

> As Exhibit USPS-29C (cited at Tr. 4/1487) shows, flats are significantly more expensive to process than letters. Once the rate proposal for automated letters was developed based on the bulk metered benchmark and cost differences, the automated flat pricing proposal was developed to reflect the fact that flats are more expensive to process than automated letters. With the proposed rate relationships, barcoded flats pay more postage barcoded letters, and barcoded flats pay less postage that nonautomated presort flats.

e. Witness MacHarg fails to acknowledge that the heavy piece discount has become obsolete.

In his haste to oppose Mr. Fronk's proposal to eliminate the now-obsolete heavy piece discount, witness MacHarg mischaracterized Mr. Fronk's testimony. Mr. MacHarg summarily claimed that Mr. Fronk testified that the heavyweight incentive should be eliminated because: (1) heavyweight mail has benefitted significantly since 1990 from an increased gap between the first-ounce rate and the additional ounce rate, reducing the relative price for heavyweight pieces, and (2) elimination of the discount would simplify the rate structure. Tr. 27/14959.

Mr. MacHarg conveniently ignored the additional information which is referred to at Tr. 4/1415. It emphasizes that

the heavy piece discount was implemented in 1988 as a result of Docket No.

> R87-1. The discount was specifically targeted at flats, which incurred additional presort cost due to size and weight (see Docket No. R90-1 Opinion and Recommended Decision, paragraph 5050 at page V-13). Since this discount was instituted approximately 10 years ago, three things have happened which affect the original rationale for the discount.
>
> First, barcodes were in their infancy in 1987. Since then, the increasingly widespread use of barcodes has reduced the value of presorting alone. Second, while the discount may have been originally targeted at flats, it appears that a significant percentage of the pieces qualifying for the discount are now letters. Using data for Postal Quarters I and II of FY 1997 (from USPS-T-32, Workpaper II, page 3 of 9), about half of the automated presorted mail pieces eligible for the discount were letters. Third, the difference between the first-ounce rate and the additional-ounce rate has increased significantly since Docket No. R87-1, reducing the relative price for heavy pieces and making a special discount less necessary. In 1988 the difference was 5 cents. At present the difference is 9 cents, and the Postal Service is proposing to increase the difference to 10 cents (twice the amount of the 1988 difference).

Tr. 4/1436-47.

f. Relaxation of the sortation requirement for 3/5-Digit presort flats should not be recommended without the attendant rate consequences.

Witness MacHarg also recommended dropping the 5-Digit sortation requirement for the second (3/5-Digit) tier of the First-Class Mail Automated flats rate category, so that the category is simply for automated 3-Digit flats. Tr. 27/14960. Witness MacHarg confirmed that if this recommendation were adopted, it would reduce the amount of worksharing performed by mailers, shifting it back to the Postal Service. Tr. 27/14967. Such a change in mail preparation requirements cannot be considered without a careful examination of its impact on worksharing and the resultant level of the discount offered to mailers. Mr. MacHarg provided the Commission with no basis for doing so.

g. The intervenor additional-ounce proposals should be rejected.

As alternatives to the additional-ounce rate structure proposed by Postal Service witness Fronk, two intervenor witnesses have proposed additional-ounce rate structures designed to benefit First-Class Mail presorted or prebarcoded rate category additional-ounce pieces in the range between 1 and 3 ounces. *See*, Direct Testimony of James Clifton On Behalf of American Bankers Association and Newspaper Association of America (ABA/NAA-T-1), Tr. 21/10851 *et seq.*; Direct Testimony of Richard Bentley On Behalf of Major Mailers Association (MMA-T-1), Tr. 21/11173-76, 11180-82. As explained below, neither intervenor witness advocates a sufficient basis for deviating from the sound practice of both the Postal Service and the Commission of maintaining a universal, uniform additional-rate structure for all First-Class Mail pieces. Moreover, they have not presented any rationale for the Commission to reconsider its opinion about the establishment of an overly complex additional-ounce rate structure. *See* PRC Op. R84-1, at 328. For the additional reasons discussed below, each of their proposals should be rejected.

i. Dr. Clifton set out in a different direction, but ends up where the Postal Service started

Dr. Clifton proposed the balkanization of the First-Class Mail additional-ounce rate structure for the benefit of bulk presorted and prebarcoded pieces weighing between one and three ounces. For such pieces, he proposed that a 12-cent rate be applied to the second ounce and the third ounce of any First-Class Mail piece qualifying for a worksharing discount. For each ounce beyond the third for such

mail, he proposed that the same 23-cent additional ounce rate be applied as would be applied to each additional ounce of single-piece First-Class Mail. He calculated that his proposal would result in a reduction in First-Class Mail revenues of $138 million. Tr. 21/10832.

Given the nature of the coalition on whose behalf he is testifying, it comes as no surprise that he would propose that a compensating increase in revenue burden be imposed on Standard A Mail. Tr. 21/10833. The surprise comes in the rationalization that he offers in support of getting to his position:

> the Standard A Mail rate schedule imposes one basic rate for pieces weighing up to 3.3 ounces;
>
> which means that the Standard Mail A basic rate is imposed only on the first ounce of such mail and that no portion of the rate is charged to that portion of any Standard Mail A piece weighing between 1 and 3.3 ounces;[49/]
>
> however, because there is not a zero incremental cost of additional ounces, the second and third ounces of Standard Mail A must be charged something;[50/]
>
> but because the Postal Service imposes "no charge" for any portion of the weight of a Standard Mail A piece between 1 and 3.3 ounces, this mail is apparently cross-subsidized by other mail classes;[51/]

In reaching his conclusion, Dr. Clifton used his own definition of cross-subsidy, since he admits that he has not compared the revenues to the incremental costs of Standard A pieces between 1 and 3.3 ounces. Tr. 21/10823, 10914-16, 10982-87.

Brushing aside the reservations expressed by the Commission each time it

---

[49/] Tr. 21/10823.

[50/] Tr. 21/10822.

[51/] Tr. 21/10820, 10823, 10896.

has declined to rely upon USPS Docket No. R87-1 Library Reference F-177 as a basis for determining a unit cost estimate for First-Class Mail additional ounces,[52] Dr. Clifton extracted data from the Library Reference to calculate an estimate of approximately 2.5 cents as the volume variable cost of processing the second and third ounces of workshared First-Class Mail pieces. ABA/NAA-T1-1, Technical Appendices A and B; Tr. 21/10837, 10850. In this calculation, Dr. Clifton applied a "single-multiplying factor" to the Test Year 1989 cost (FY 1986 Base Year) from Docket No. R90-1 USPS Library Reference F-177 to account for intervening cost level, methodological and operation differences to obtain Docket No. R97-1 Test Year costs. Tr. 21/10859. From this, he inferred a "cost coverage" for First-Class Mail additional ounces of 920 percent (32/2.5) Tr. 21/10831. Dr. Clifton reduced this "extremely high coverage" to a "still very high 480%" with his proposal of a 12-cent additional-ounce rate for workshared First-Class Mail (12/2.5). Tr. 21/10831.[53]

Under Dr. Clifton's proposal, a bulk metered 2.5-ounce First-Class Mail letter which did not qualify for presort discount would be charged 79 cents (33+23+23), while that same letter, if presented as part of a presort mailing, would be charged 57

---

[52] PRC Op. MC95-1, at V-47-52; PRC Op. R94-1, at V-8-9; PRC Op. R90-1, at V-7-13; PRC Op. R87-1, at 438-445.

[53] Dr. Clifton would have the Commission undertake the practice of implying a distinct cost coverage for every rate cell in every subclass in order to make judgments about fairness and equity and cross-class subsidization. Even if such "coverages" could be calculated, the innumerable comparisons that parties would draw between rate cells would turn rate design into an infinitely more byzantine process.

cents (33+12+12). The implication of Dr. Clifton's rate proposal is that the presorting saves the Postal Service 22 cents per piece. The reality is that this 22 cents goes well beyond any measured cost avoidance. The difference in his rates would have nothing to do with the worksharing, but everything to do with the status of the latter piece as "workshared." Dr. Clifton's proposal to extend the concept of worksharing cost savings beyond its intended scope raise issues of fairness, as well as the identifiability of rate relationships, within the meaning of § 3622(b)(7). See PRC Op. R90, Vol. 1, at V-13, ¶5029.

The Postal Service respectfully submits that notwithstanding Dr. Clifton's manipulations of Docket No. R87-1 USPS-LR-F-177 and Docket No. R97-1 Exhibit USPS-44B, there are still not definitive or precise evidence of the costs associated with additional ounces of First-Class Mail, whether workshared or not. Despite this concern, the Postal Service observes that when Dr. Clifton applied his methodology in an effort to determine a universal additional-ounce rate for all First-Class Mail, he estimated the average incremental cost per First-Class Mail additional ounce and an implied additional ounce rate of 24 cents, a penny above the rate proposed by the Postal Service. Tr. 21/10960. Thus, if the Commission has any faith in Dr. Clifton's data manipulations and remains persuaded that a universal additional-ounce rate within First-Class Mail is appropriate, it can get there by adopting his 24-cent additional ounce rate. Alternatively, in the absence of persuasive and reliable data on the costs associated with additional ounces of First-Class Mail, the Commission should continue to recognize that the costs of handling additional ounces are at

some unquantified level less than those for the initial ounce and continue its policy of increasing the degression between the initial ounce and the additional-ounce rate as part of the process of ensuring that the class, as a whole meets, the revenue target established as a result of the cost coverage proposed by witness O'Hara (USPS-T-30). The Commission is able to do this by increasing the degression, as proposed by Postal Service witness Fronk.

ii. MMA witness Bentley's modification of his previously rejected proposal gets him nowhere

MMA witness Bentley proposed that the Commission reduce the rate paid for the second ounce of a First-Class Mail letter. However, he does not specify what that reduced second-ounce rate should be. Tr. 21/11173. At Tr. 21/11180, he compared the MMA Docket No. MC95-1 additional-ounce proposal rejected by the Commission with the MMA proposal in this proceeding. He stated that in Docket No. MC95-1, MMA made a proposal to reduce the additional ounce rates for letters weighing between 1 and 2 ounces and letters weighing between 2 and 3 ounces. Rejecting that proposal in Docket No. MC95-1, the Commission expressed a number of concerns, including its view that the proposal could complicate existing rate relationships. PRC Op. MC95-1, V-51, ¶5113.

In this proceeding, MMA has limited its proposal to letters weighing between 1 and 2 ounces only. According to witness Bentley, this limitation resolves the Commission's MC95-1 concern about complicating existing rate relationships. Tr. 21/11180. However, simply dropping one of the two weight increments from the MMA proposal this time does not address the Commission's concerns about over-

complication. For example, witness Bentley's revised proposal would apply only to letters, not to flats or any other First-Class Mail pieces.[54]

Moreover, he confirmed, at Tr. 21/11247, that whatever rate the Commission adopts for the second ounce of an additional ounce letter, it would apply only to letters that did not exceed 2 ounces in weight. Thus, a 2-ounce letter would pay, for example, 22 cents for the second ounce. On the other hand, a 3-ounce piece would pay 23 cents on each of the two additional ounces under the Bentley proposal.

It may be true that Mr. Bentley's proposal does not wreak havoc with the First-Class Mail/Priority Mail breakpoint where there is relatively little volume, but the second and third ounces are where the First-Class Mail additional-ounce action is. How will the Postal Service and the general mailing public distinguish between additional-ounce reduced rate 2-ounce letters and additional-ounce non-reduced rate 2-ounce flats? Mr. Bentley does not say. When queried about possible confusion that such a rate structure could generate, Mr. Bentley asked the Commission to shrug it off. He testifies that "even if that possibility might exist, the overriding criterion of offering rates that are fair and equitable makes the result worth the risk." Tr. 21/11249. The Postal Service questions the fairness of such a proposal, as should the Commission. There is no sufficiently credible basis for charging the second ounce of a 2-ounce letter a different rate than the second ounce of a 3-ounce letter. The Bentley proposal is fraught with inexplicable complication, promotes the establishment of rate relationships which lack any identifiable basis,

---

[54] *See* Tr. 21/11239, 11246.

and only serves to highlight the virtue of the universal, uniform additional-ounce rate.

h. NDMS witness Haldi's nonstandard surcharge proposals should be rejected.

Testifying on behalf of a consortium of film processors (Nashua Photo, District Photo, Mystic Color Lab, Seattle Filmworks, hereinafter, NDMS) who receive bulk quantities of nonstandard Business Reply Mail pieces, witness Haldi proposed the elimination of the nonstandard surcharge for both single-piece and presort First-Class Mail. Tr. 24/12918. In the alternative, he proposed that the Commission reject the Postal Service's proposed increases and reduce the single-piece surcharge from 11 cents to 4 or 5 cents. *Id.* at 12918-20.

Dr. Haldi testified that the elimination of the nonstandard surcharge would materially simplify the First-Class Mail rate structure, with negligible loss of revenue and, perhaps more importantly, would reduce the arbitrariness of this part of the rate structure. Tr. 24/12918. Eliminating the surcharge would arbitrarily shift the burden of the extraordinary processing costs (associated with nonstandard 1-ounce parcels containing such items rolls of film) to the mailers of clean, automation-compatible mail. Elimination of the surcharge also would reverse the trend of rewarding mail piece design which results in utilization of the most efficient mail processing technologies and would provide no incentive for mailers to engineer pieces to maximize use of efficient technology.

At Tr. 24/12893-94, Dr. Haldi attempted to link the nonstandard surcharge to the proposed elimination of the heavy-piece presort discount. His rationalization was that, since the Postal Service was eliminating a discount which affected a

relatively small volume of presorted First-Class Mail, why not eliminate a surcharge that affects a relatively small volume of nonpresorted First-Class Mail? He went so far as to assert that witness Fronk's proposed elimination of the heavy-piece presort discount was based, in part, on the relatively small volume of mail affected. This claim is contradicted by witness Fronk's actual testimony. *See* USPS-T-32, at 24-25 and Tr. 4/1436-37. Next, Dr. Haldi tried to criticize the USPS-ST-43 cost study underlying Mr. Fronk's proposed nonstandard surcharge rate increases. That study, first reported in USPS Library Reference H-112 and then in the Supplemental Testimony of Sharon Daniel (USPS-ST-43),[55] begins with the assumption that nonstandard one-ounce pieces (all nonletter-shaped pieces, including flats and parcels) cannot be processed on letter automation equipment. That study uses a formula to measure the cost differences between nonstandard pieces and average letter costs.

Pieces that meet the Domestic Mail Manual definition of a letter, yet fail automation compatibility criteria (such as aspect ratio), are defined as nonmachinable letters and are assumed to be handled manually in the cost model. Tr. 14/7447-49. Witness Haldi showed in LR-NDMS-1 that it is possible for letters failing the aspect ratio specifications to get processed on letter automation equipment. Tr. 24/12885[56] However, in the absence of more than anecdotal

---

[55] Discussed above at IV.A.2.e.iii.

[56] What is not evident from his Library Reference, however, is whether or not these pieces were successfully processed on automation equipment at every handling through delivery point sequencing. It is possible that the problem of "tumbling"

information on the effect of aspect ratio on automated handlings and potential jamming they may cause, it is still reasonable to assume, as witness Daniel's cost models do, that letters with poor aspect ratio are handled manually. It should be noted that letters, however, only comprise less than 20 percent of all nonstandard pieces. Exhibit USPS-ST-43C.

Pieces failing to meet the DMM definition of a letter, such as flats that weigh less than one ounce, are also subject to the nonstandard surcharge because they definitely cannot be handled on letter automation equipment. Thus, witness Haldi's statement that "[s]pecifications for pieces that can be sorted on the FSM 1000 indicate that flats under one ounce ('flimsies') are well within its limitations"[57/] is irrelevant. Furthermore, according to the flats models presented in USPS Library Reference H-134 (Section 1 page 19), the cost of *just one pass* on an FSM 1000 is 6.4 cents. This is obviously more expensive than processing letters to delivery point sequence on letter automation equipment where the total mail processing cost for First-Class Basic Automation letter is 5.3 cents (Exhibit USPS-29C, at 1).

The Postal Service cost model for computing the nonstandard surcharge recognizes this by subtracting the total mail processing cost of letters from the total mail processing cost of flats. Witness Haldi criticized the cost model for using the cost of processing an average flat and not using the cost of processing just under-

---

occurred in subsequent handlings after the application of the barcode, causing the piece to reject and be sorted manually in later handlings. Tr. 33/17377.

[57/] Tr. 24/12885.

one-ounce flats. Notwithstanding the fact that no reliable estimate of costs by ounce increment is available in this docket for First-Class Mail pieces (USPS-ST-43), Dr. Haldi argued that "[u]sing average weight First-Class flats and parcels as proxies for under-one ounce flats and parcels, respectively, is indefensible." Tr. 24/12900.

Obviously, parcel-shaped pieces containing rolls of film cannot be processed on letter automation equipment. Weight is less likely to affect the throughput on the Small Parcel & Bundle Sorter, compared to letter automation equipment. Thus, the use of the proxy of an average parcel processing cost, in the absence of data by ounce-increment, is reasonable. This is especially the case when on considers that parcels comprise less than ten percent of nonstandard pieces. Exhibit USPS-ST-43C.

It is not unexpected that the cost of handling nonstandard pieces has risen dramatically in comparison to the cost of handling machinable letters. The Postal Service has made great strides in lowering the cost for the automated letter mailstream. The improvements in mail processing also have lowered the delivery cost of automatable letters because of delivery point sequencing.[58/] As the Postal Service make progress in more efficient handling of flat and parcel-shaped pieces, the rate of increase in the difference in handling costs for standard and nonstandard pieces grows may diminish. However, it highly unlikely the Postal Service could

[58/] Which is not recognized in the Postal Service's calculation of the additional costs of handling nonstandard letters. Tr. 14/7457.

ever process and deliver standard and nonstandard pieces at the same cost and a surcharge will always be justified.

Postal Service witness Sheehan further described and affirmed the operational reasons why the nonstandard surcharge continues to be imperative to achieving the Postal Service's automation goals. Tr. 33/17376-79. Mr. Sheehan also identified the fundamental flaw in witness Haldi's call for the elimination of the surcharge. Witness Haldi testified:

> Automatability is not static. While the DMM definition of "non-standard" may not have changed for many years, the capabilities of mail processing technology have changed dramatically.

Tr. 24/12813. In response, Mr. Sheehan explained that what witness Haldi fails to recognize is that this very same equipment and any new equipment requirements are based on the current DMM nonstandard mail piece definition; the definition is not obsolete, as witness Haldi suggests. Tr. 33/17376. As noted by Mr. Sheehan, witness Haldi's anecdotal evidence concerning the 10 nonstandard, square greeting cards he mailed to himself does suggest that the Postal Service might want to re-evaluate the automatability of pieces with low aspect ratios. However, any informative analysis would need to test the full range of nonstandard criteria – height, length, thickness,[59/] and aspect ratio – and not be limited to one facet of the definition, as witness Haldi has done. Tr. 33/17378.

[59/] The Commission can no more draw any definitive conclusion about the future of the surcharge by examining the 10 greeting cards Dr. Haldi selected for mailing to himself than it can by examining 10 nonstandard, one-ounce envelopes, each of which contains a roll of unprocessed 35mm film, addressed to a through-the-mail film processor.

i. The APPA postcard proposal should be rejected.

American Public Power Association witness Eugene Threadgill (APPA-T-1) testified that the current 20-cent single-piece First-Class Mail postcard rate should be reduced to 18 cents and that the current 18-cent nonautomated presort card rate should be lowered to 15 cents. Tr. 20/10263-64.

Mr. Threadgill grasped at a number of possible reasons why the Commission should adopt his proposal. First, he claimed that the current postcard rates are excessive by the statutory standards established by the Postal Reorganization Act. Tr. 20/10248. He provided a comprehensive recitation of the First-Class Mail basic letter and cards rates since 1886 (Tr. 20/10250) for the purpose of asserting that, throughout most of postal history, "the postcard rate was 50% or less of the letter rate" and that an "18 cent post card rate would restore this historical relationship." Tr. 20/10253.

Boiled down to its essence, Mr. Threadgill's pricing philosophy is this:

1. For every year between 1886 and 1951 (except 1918-19), Congress used to dictate that the rate for postcards was a penny and the rate for letters was two cents or three cents, establishing an "historical" postcard/letter rate ratio.

2. The pricing criteria of § 3622 should be interpreted as requiring that this historical ratio be preserved.

3. The Commission should ignore what the rate relationships set by Congress may have been between 1952 to 1970.

4. The Commission should especially ignore what the rate relationships

have been as a result of any of its applications of the § 3622 criteria since 1971.

The fault in this approach is self-evident.

Mr. Threadgill also testified that public utility postcard billers "will be severely impacted by the proposed increases in post card rates." Tr. 20/10246. However, he confessed to having no idea what percentage of their total operating costs are consumed by postage on outgoing postcard bills and conceded that all he knows is that "a number of them were concerned about the prospect" of paying the Postal Service's proposed rate increases. Tr. 20/10279-80.

At Tr. 4/10258, he testified that "the Commission should show its concern for the public by requiring a reduction in postcard rates" to soften the severe impact of "dramatic increases in the postcard rate, from the traditional 'penny' post card to the present 20 cent card". But he presented no evidence of any adverse impact suffered by the public on account of the fact that postcard rates have increased as much as they have since 1886. Nor did he offer any compelling basis for Docket No. R97-1 serving as a forum for the distribution of reparations for 112 years of "wrong" endured by postcard mailers.

Mr. Threadgill pleaded that some bulk First-Class Mail postcard mailers which used to pay the pre-reclassification Carrier Route discount deserve rate relief because they are unable to qualify for post-reclassification Automation Carrier Route and have experienced "dramatic" rate increases as a result of reclassification. Tr. 20/10247-48. He points to technical challenges associated with making Carrier Route cards automation compatible (Tr. 20/10261-63). But he concedes that any

postcard biller using the old standard postcard format could convert to the new format,[60] and the problem is that some small utility companies simply are "not up to" hiring computer experts to re-do their billing programs or reconfigure or replace their printers. Tr. 20/10281.[61] In fact, he admits to not having studied the costs associated with converting cards to make them automation-compatible or to having had "any direct discussion with most of these people about what the problems are." Tr. 20/10284-85. He even concedes that other pre-reclassification Carrier Route mailers have been able to convert to the Automated Carrier Route category. Tr. 20/10281-82.

He suggested that the Postal Service could alter automation standards to make it easier for postcards (used for billing purposes) with vertical perforations to become automation-compatible, by either allowing cards which are seven inches in length cards or which only have partial barcodes. Tr. 20/10261. He presented no analysis of the feasibility or potential impact on mail processing of such changes.

Mr. Threadgill compared the proposed penny increase in the basic First-Class Mail letter rate (1/32 = 3.1 percent) with the proposed penny increase in the basic First-Class Mail post card rate (1/20 = 5 percent) and declares the latter to be unfair. Tr. 20/10255. The Postal Service willingly concedes that equal percentage increases might have been ideal, but such increases are difficult to execute as long

---

[60] Tr. 20/10281.

[61] For the one utility company he specifically identifies in his testimony, he is unable to say why converting their postcard bills to an automation-compatible format was too great a burden. Tr. 20/10282.

the Postal Service and the Commission continue to be guided by the whole-cent constraint when changing basic First-Class Mail rates paid by the general public.

Mr. Threadgill compared postcards to letters and comments on the former's relative lack of privacy. While it is true that letters are sealed against inspection, it seems at least an exaggeration to characterize postcards as "open to public view"[62] or to suggest that "[a] competitor of a mailer could gain access to a post card users bills and use that information for competitive purposes." Tr. 20/10256, 10287-88.

In an effort to widen the card/letter price gap, he also compared the quantity of information that can be conveyed by a postcard vs. a one-ounce letter. Tr. 20/10256.

There is no evidence that the level of privacy of postcards (relative to letters) has diminished over time or to any degree since Docket No. MC95-1 which would justify increasing the current basic card/letter 12-cent price difference to 15 cents. The same is true about the physical difference between cards and letters and the relative amount of information that each can transmit.

Finally, Mr. Threadgill asserted that the Commission should take into account the relative weight of postcards and letters in setting rates. By his estimate, letters weigh 10 to 12 times as much as post card bills. Tr. 20/10257. He appeared to argue that the Commission should take this into account because the Postal

---

[62] Tr. 20/10255-56. As the mailstream becomes increasingly automated and the proportion of manual piece handlings diminishes, the level of privacy within the mailstream would seem to increase.

Service, in 1991, made available a half-ounce letter rate for international mail to Mexico. Id. at 20/10257-58. In the Postal Service's view, weight would seem to be a driver only in determining the volume variable mail processing and delivery costs associated with First-Class Mail postcards or, for that matter, any other subclass or rate category of mail. Moreover, any attempt to analogize between domestic postcard prices and international letter rates to Mexico would seem, at best, to be a *manzanas a naranjas* comparison.

j. Douglas F. Carlson's proposal for a lower stamped card rate is based on a flawed approach to classification policy and an inadequate cost basis.

Intervenor Douglas F. Carlson proposed a bifurcation of the existing classification for cards to create a separate category, with a lower rate, for stamped cards. Tr. 24/12798. The Postal Service opposes this change. From the standpoint of classification policy, Mr. Carlson's proposal is inconsistent with established principles and embodies fundamental deficiencies. Furthermore, the Postal Service does not believe that the cost foundation advanced by Mr. Carlson to justify and develop a separate rate for stamped cards is adequate and supported on the record of this proceeding.

Mr. Carlson's apparent goal is to create a lower rate for stamped cards to reflect cost savings arising from a greater automation compatibility. He purports to create the vehicle for this separate treatment in the form of a rate category for stamped cards, while eliminating the classification and fee structure recommended by the Commission in Docket No. MC96-3. Carlson Trial Brief at 1. However, he

has not established the cost savings that would underlie such a rate category. No cost study estimating such cost savings has been presented, nor has any particular passthrough been proposed.[63/]

Instead, Mr. Carlson apparently, and inconsistently, gave stamped cards subclass treatment.[64/] He developed a rate based on what he asserts are the total costs for stamped cards, including the manufacturing costs underlying the separate fee contemplated in the Docket No. MC96-3 recommendation. Tr. 24/12802. He also analyzed the statutory rate criteria in support of an overall stamped card cost coverage, in order to justify a proposed rate of 20 cents. Tr. 24/12802, 12804-05.

However, Mr. Carlson has not established the uniformity of cost and demand characteristics needed to justify stamped cards as a separate subclass.[65/] In fact,

---

[63/] When asked about particular characteristics that some private cards might have, and that might cause processing problems, Postal Service witness Miller affirmed the lack of any data or analysis concerning the relationship of such characteristics to any processing problems. Tr. 3/775, 777, 794-95.

[64/] In Docket No. MC95-1, the Postal Rate Commission defined subclass as follows:

> As the Newspaper Association of America (NAA) correctly states on brief, '[i]n postal ratemaking, a subclass is a grouping of mail across which attributable costs are measured and averaged, and to which the Section 3622 ratesetting factors are applied for purposes of assigning a share of the Postal Service's institutional costs.' NAA Brief at 24 (footnote omitted).

PRC Op. MC95-1, at I-3. In line with this definition, Mr. Carlson takes the FY 1996 CRA attributable costs for stamped cards, and applies the Section 3622 ratesetting factors. Tr. 24/12801-02, 12804-05.

[65/] In particular, Mr. Carlson has not shown that stamped cards and private cards are "different products which serve different markets." PRC Op. MC95-1, at I-4.

some private cards meet the same automation compatibility and reflectance requirements as stamped cards. Tr. 24/12850. Mr. Carlson also acknowledged that some private postcards may incur costs as low as the costs for stamped cards. Tr. 24/12862. In response to Mr. Carlson's interrogatories, moreover, Postal Service witness Miller could not distinguish between stamped and private cards in terms of their automation compatibility.[66] Tr. 3/778-79.

Mr. Carlson also confirmed that the cards within a stamped card classification would have widely varying characteristics. Tr. 24/12851. For example, some stamped cards have handwritten addresses, while some have typewritten addresses. Tr. 24/12853. Other than manufacturing costs, therefore, stamped card costs exhibit too much variation to justify pricing them as a separate classification.

The cost basis for Mr. Carlson's proposed separate rate treatment of stamped cards also suffers from serious weaknesses on the current record. He relied principally on the separately reported costs for postal cards[67] in the FY 1996 CRA Report. The FY 1996 CRA costs for postal cards, however, were not based on a full year of data. Witness Alexandrovich explained:

---

[66] Mr. Carlson has not considered an alternative proposal that would group all automation compatible cards (either stamped or private) in one classification. Tr. 24/12866. While the Postal Service does not endorse such an alternative, it would appear to be preferable to Mr. Carlson's proposal, which creates two groups, each with some automation compatible cards.

[67] In this brief the terms "postal card" and "stamped card" are used interchangeably. The term "postal card" was changed to "stamped card" in the DMCS and DMM during 1997, at the implementation of Docket No. MC96-3. This brief discusses postal/stamped cards both before and after that change.

> The distinction between postal cards and private postcards is eliminated in the Base Year. During Fiscal Year 1996, most data collection systems were modified to combine these categories into a single line item designated as Single Piece Cards.

USPS-T-5 at 6-7. The Postal Service stopped collecting data separately for postal cards on July 1, 1996, well before the end of the FY 1996.[68]

The Postal Service eliminated separate cost estimates for stamped cards because it concluded that such costs were likely to be understated.[69] This was based in part on the assessment that IOCS data collectors tended to misidentify postal cards, mistaking them for the more common private cards. Tr. 13/6992; Tr. 19E/9622, 9626-27; Tr. 24/12849. Because of the relatively small number of cost tallies, such misidentification was expected to have an impact primarily on costs for postal cards, rather than on volumes. As a result, unit costs for postal cards would be underestimated. Tr. 31/16430-31.

In trying to discredit this conclusion, Mr. Carlson's Trial Brief, at page 3,

---

[68] Tr. 13/6991-92; *see* LR-H-13 at 79-80. As reference to LR-H-13 makes clear, witness Alexandrovich's response incorrectly refers to July 1, 1997, rather than July 1, 1996.

[69] Mr. Carlson suggests that separate data collection for postal cards was terminated in order to "obscure the large cost differential" between postal and private cards. In this regard, it should be noted that this data collection change was under consideration during 1995, well before Mr. Carlson or any other intervenor had focused attention on the large cost differential, by trying to use it to justify a lower rate for postal cards. *See* January 18, 1996 letter from Frank Heselton to Dan Foucheaux and Ashley Lyons, concerning In-Office Cost System enhancements "discussed over the past few months." Tr. 13/6994. In any case, the large differential was a consideration in determining that the postal card cost figure was not reliable, since such a large cost differential, repeated over many years, could not be justified by operational reasons. *See* Tr. 24/12849.

focuses on witness Alexandrovich's confirmation that "no studies or analyses have concluded that the reliability of the [FY 1996 CRA] cost data . . . has been affected in any significant way by the misidentification of stamped cards and other cards by IOCS data collectors." Tr. 19E/9621. However, in light of Mr. Alexandrovich's other testimony -- namely, that one reason the Postal Service terminated separate data collection for postal cards was the likelihood of data misidentification -- this response can only refer to formal written studies or analyses. In other words, the confirmation does not lead to Mr. Carlson's conclusion that the Postal Service's explanation regarding data collection errors is "pure speculation." Carlson Trial Brief at 3. Pure speculation did not induce the Postal Service to terminate separate data collection that had gone on for many years.[70/] Instead, its decision was based, in part, on expert opinion that data collectors have difficulty distinguishing between stamped and private cards, because these cards have similar shape and weight, and are nonpresorted First-Class Mail.[71/] Tr. 13/6992. Furthermore, the conclusion that

---

[70/] Rather, Mr. Carlson's conclusion that "the automation compatibility of stamped cards *explains* the cost differential reflected in Postal Service cost data" is itself pure speculation, not based on any cost study showing that the claimed greater automation compatibility of postal cards than private cards could reduce costs from 18.7 cents to 7.6 cents, as reported in the FY 1996 CRA. For other types of mail, automation compatibility alone has never been shown to have such a large impact on costs. *See, e.g.,* Exhibit USPS-29C, page 1, comparing non-automation presort with automation presort cost results.

[71/] A second justification for the termination of separate costing for stamped cards was to treat stamped cards similarly to stamped envelopes. Tr. 13/6992. Thus, mail processing and delivery costs will be combined for all types of nonpresort cards, as currently done for all types of nonpresort letters. Additional costs for stamped cards are identified like the additional costs for stamped envelopes, and

data collection errors have existed is reinforced by the unusually low levels of stamped card costs reported by the data systems over a number of years. *See* Tr. 24/12849.

The FY 1996 CRA costs, moreover, show that the costs for nonpresort postal cards are only 7.6 cents, just 0.2 cents more than the FY 1996 CRA costs for presorted private cards. Tr. 13/6993. Since the postal card costs include manufacturing costs of about 1 cent,[72] moreover, the CRA reports only about 6.6 cents of processing and delivery costs for postal cards, nearly a penny less than the processing and delivery costs for presort cards. In light of the testimony questioning the accuracy of cost reporting for stamped cards, the incompleteness of the data reported for this category in the FY 1996 CRA Report, and the fact that the Postal Service has stopped collecting these data separately, the FY 1996 postal card costs should not be used as the basis for developing a separate rate of postage for stamped cards.[73]

As discussed in more detail below (Section VI), Mr. Carlson's proposal also would reverse the Commission's recommendation of less than a year ago establishing a shell special service classification for stamped cards to reflect the manufacturing costs that the Postal Service incurs for stamped cards, but not for other cards.

---

used as the basis for a special service fee.

[72] USPS-T-39 at 88-89.

[73] While the Postal Service reported separate postal card costs until the current rate proceeding, these costs were not used separately for ratemaking purposes.

For all these reasons, the Commission should reject Mr. Carlson's proposal to create a separate rate for stamped cards.

k. The OCA CEM proposal should not be recommended.

As in Docket Nos. R87-1, R90-1, and MC95-1, the OCA has proposed the establishment of a Courtesy Envelope Mail (CEM) rate category for First-Class Mail letters weighing less than one ounce. OCA witness Willette[74/] proposed that qualifying courtesy reply envelopes be pre-printed and self-addressed envelopes, that they bear a proper barcode and ZIP Code, a corresponding Facing Identification Mark (FIM) designated by the Postal Service, and indicia signifying that the piece is eligible for the discount. She also proposed that the upper right hand corner of each mail piece bear a postage affixation block informing senders that "a First-Class discount stamp may be used." Tr. 21/10685. She describes CEM as "a very simple concept." Tr. 21/10688.

Ms. Willette relied upon the unit mail processing cost avoidance estimate of Postal Service witness Michael Miller (USPS-T-23, at 11) for Prepaid Reply Mail (PRM) and Qualified Business Reply Mail (QBRM) as the basis for her proposal that the CEM rate be established at three cents less than the proposed 33-cent basic rate for First-Class Mail letters. *Id.*

Referring to Docket No. MC95-1 USPS Library Reference MCR-88, witness Willette asserted that there is historical evidence that about half of households

---

[74/] *See* Direct Testimony Of Gail Willette On Behalf Of The Office Of The Consumer Advocate (OCA-T-400); Tr. 21/10679 *et seq.*

would purchase a discounted stamp, if it were available. *Id.* at 10694. She projects a maximum Test Year CEM volume estimate of 7.3 billion pieces, resulting in a maximum revenue loss of $219 million. *Id.* at 10692.

Witness Willette tried to explain[75] how one might conclude that the CEM proposal is consistent with the requirement in § 3623(c) that classification changes:

(1) promote a fair and equitable classification system for all mail;

(2) reflect the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;

(3) the importance of providing classifications with extremely high degrees of reliability and speed of delivery

(4) the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;

(5) the desirability of special classifications from the point of view of both the user and of the Postal Service; and

(6) such other factors as the Commission may deem appropriate.

Witness Willette emphasized that the Commission should not recommend CEM as a substitute for either PRM or QBRM. Tr. 21/10695. On this final point, the OCA and the Postal Service are in full agreement. However, for the reasons presented below, the Postal Service goes one step further and strongly urges the Commission not to recommend CEM at all.

In response to the CEM proposal in this proceeding, the Postal Service presented the testimony of four witnesses who demonstrated a broad range and

[75] At Tr. 21/10701-04.

depth of expertise on a number of issues relevant to the CEM proposal:

Postal Service witness Robert Sheehan (USPS-RT-16), an expert in postal operations and customer relations, explained how "simple" concepts like CEM are not so simple to the average postal customer. He demonstrated why the "two-stamp" system which would result from CEM implementation would require a major shift in short paid postage enforcement practices on the workroom floor, contrary to the trend in mail processing of decreased reliance on manual operations. He also indicated how CEM short paid enforcement would introduce undesirable levels of complexity in customer relations and generate unnecessary ill will with customers.

An expert in retail pricing trends, Dr. Carl Steidtmann (USPS-RT-15) testified that complicating the household mailer's most fundamental postal transaction -- mailing a one-ounce letter -- by offering two prices for essentially similar services, is contrary to the growing trend of keeping retail pricing structures simple in order to enhance customer satisfaction.

The testimony of Timothy Ellard (USPS-RT-14) revealed the results of a statistically valid sample of the bill payment mailing public. Putting an end to a decade's worth of speculation about what the public might want, his survey unambiguously and irrefutably demonstrated that, by an overwhelming majority, the bill payment mailing public strongly prefers not to have a two-stamp system imposed upon them.

Finally, the testimony of witness Michael Miller (USPS-RT-17) estimated the administrative and enforcement costs associated with implementing a two-stamp

postage system. Mr. Miller demonstrated how these system costs potentially could exceed any reasonable estimate of the benefit obtained by CEM users. He explained how CEM would unfairly and inequitably distribute costs and benefits, and pointed out that the OCA offered no explanation for how the revenue loss associated with a reduction in postage for CEM would be recovered. Finally, he demonstrated how the CEM proposal fails to satisfy the statutory classification criteria of § 3623(c).

In summary, the Postal Service testimony established that the CEM proposal does not comport with the policies of the Postal Reorganization Act and is inconsistent with management's operational objectives. Accordingly, it should not be recommended to the Governors.

In evaluating the Docket No. R97-1 CEM proposal, it is instructive to review the resolution of the CEM issue in Docket No. MC95-1. In that proceeding, the Governors rejected the Commission's "shell" classification recommendation, emphasizing their skepticism about the perceived benefits of creating a CEM category, their concerns about enforcement and administration, and the issues of equity and fairness.

In its review of the OCA's Docket No. R97-1 CEM proposal, the Postal Service was mindful of the Governors' standards for judging previous CEM proposals. It is the Postal Service's view that OCA Docket No. R97-1 CEM proposal does not meet those standards. CEM is undesirable to the overwhelming majority of its supposed beneficiaries. It would represent a step in the wrong

direction in an increasingly automated mailstream and interfere with efficient operation of the postal system. The Commission should defer to postal management on this issue and reject the proposal.

i. The Commission should not recommend a two-stamp system that the mailing public decidedly does not want.

As fundamental a change as CEM would represent to the mailing practices of the general public, it would seem imperative that the Commission and the Governors have a very high level of assurance that its adoption was something the public actually wanted. Thus, one would anticipate that a proponent of CEM would present for examination some measure of the public's current attitudes toward such a rate category. In this case, the OCA concedes that it has done little more than engage in "informal discussion with consumers." Tr. 21/10751.

Instead, witness Willette's pointed to a 1991 survey[76] which measured whether, assuming CEM were implemented, consumers would be likely to use discounted CEM postage stamps. That survey revealed that only 54 percent were likely to use CEM stamps.[77] Moreover, when survey respondents were told that the savings were possibly only $5.00 per year, less than half of the total respondents indicated that they were likely to use the stamps. Tr. 21/10748. It was apparently on these grounds that the OCA expected the Commission to conclude

---

[76] Docket No. MC95-1, USPS Library Reference MCR-88, Rate Change Telephone Survey (1991).

[77] A thorough history of market research on CEM through the years is presented in the testimony of USPS rebuttal witness Miller (USPS-RT-17); Tr. 33/17457-59.

that there was public support for their Docket No. R97-1 CEM proposal. Witness Willette testified that the Commission should not ignore the preferences of household mailers in considering the proposed two-stamp system. Tr. 21/10774-75. The OCA apparently holds itself to a different standard.

Witness Willette testified that low-income households, as well as those on low fixed incomes, might find saving between four and five dollars a year attractive, as a result of their use of CEM. Tr. 21/10693. Presumably, this CEM benefit is another reason why the Commission and the Governors should line up behind the OCA.

In response to witness Willette's Docket No. R97-1 CEM proposal, the Postal Service employed Opinion Research Corporation to conduct a survey of a representative cross-section of the American public to determine attitudes about the CEM proposal. The results of that survey are reflected in the rebuttal testimony of Postal Service witness Ellard (USPS-T-14). Tr. 35/19058 *et seq.* Mr. Ellard's survey methodology and sample design are explained at Tr. 19064-69, 19091-97, 19173-78. The survey tests the very rates implied by the OCA's CEM proposal. Tr. 35/19072, 19179-82.

The survey was designed to take into account of the individual mailing practices of each individual respondent, and the financial implications of CEM for each of them, based upon their individual mailing practices. Tr. 35/19074.[78/] As demonstrated by USPS rebuttal witness Miller (USPS-T-17), the survey results

[78/] As opposed to asking them to step into the shoes of hypothetical "typical" household mailer.

make clear that Ms. Willette's projections about how much low-income families might save are grossly exaggerated. Tr. 33/17460-62.[79]

Mr. Ellard's survey shows that 61 percent of the bill payment mailing public (as represented by the survey respondents) say they would use a two-stamp system if it were in place. These results are not out of line with the aforementioned 1991 survey on which Ms. Willette relies.

However, Mr. Ellard's survey went beyond merely asking whether, if CEM were available, the public would expect to use it. It asked them, point blank: Do you want a two-stamp system? And for a substantial majority, 60 percent, the answer was resoundingly in the negative. This implies that a substantial majority regard the two-stamp system as an imposition, rather than a benefit. Tr. 35/19076.

The survey went a step further and asked the 40 percent who favored the two-stamp system whether they would prefer a one-stamp system or a two-stamp system, if the latter contributed to an increase in the basic (non-CEM) First-Class Mail rate. An overwhelming majority of these respondents, 66 percent of them abandoned their support for the two-stamp system.[80]

When the 60 percent of survey respondents who are opposed to CEM were combined with those whose opposition was based upon concerns about a potential push-up effect on the basic First-Class Mail rate (66 percent of the remaining 40

---

[79] It is noteworthy that the same low-income households (on whose behalf the OCA purports to champion its CEM proposal) exhibited the strongest preference for the one-stamp system in the Ellard survey. Tr. 33/17460.

[80] Tr. 35/19128.

percent), the opposition to CEM rose to 86 percent of all survey respondents.

Through Mr. Ellard's survey, the public has spoken. And the largest part of the public does not want a two-stamp system foisted upon it. These results are telling and, by themselves, put an end to speculation which may have informed earlier Commission preferences for earlier CEM proposals.

ii. CEM would complicate the nation's mail system for all parties involved.

As noted earlier, witness Willette described CEM as "a very simple concept." She testified that "CEM proposals have been around for some years." Tr. 21/10703. But, the real questions are: Simple to whom? Around where? The answers are provided by Postal Service witness Sheehan (USPS-RT-16).

Concepts like differentially-rated Courtesy Envelope Mail are familiar to those who frequent the Postal Rate Commission hearing room, but not to members of the general public.[81/] Based upon his nearly three decades of experience dealing with postal customers in different parts of the nation, at every level of the organization,[82/] Mr. Sheehan provided insight into the typical household customer's relationship with the Postal Service.

As Mr. Sheehan put it: Regardless of income or education, being a postal

---

[81/] For the most part, they obtain information about CEM through their limited participation in CEM-related market research.

[82/] Mr. Sheehan has ably served as a Letter Carrier, Clerk, Bulk Mail Center Engineer, Sectional Center Director of Customer Services, Sectional Center Manager, Regional Commercial Accounts Manager, Area Manager of Processing and Distribution, Headquarters Manager of In-Plant Operations, and now as District Manager of Customer Services and Sales in Atlanta.

customer is not the dominant activity in the lives of most people. They tend not to focus on technical postal matters, even things that "insiders" might consider to be very simple and straightforward. They are preoccupied in an increasingly fast-paced world with things that are not related to the Postal Service, to the point where implementing seemingly simple postal matters as address or ZIP Code boundary changes presents confounding challenges to postal managers. Tr. 33/17372-73. Based upon his innumerable interactions with postal customers over the years, he observed:

> With other things on their minds, the general public tends to prefer that we keep things simple, and they prefer to avoid having to deal with change in their basic relationship with the Postal Service.

Tr. 33/17373. These same customers have lives beyond their postal transactions, in part, as customers of other retail organizations competing for the opportunity to satisfy customers' needs. Postal Service witness Carl Steidtmann (USPS-T-15) provides valuable insights about the growing trend toward simpler retail pricing schemes by retail goods and service providers seeking to improve customer satisfaction. In view of Mr. Ellard's compelling survey results, the depth and breadth of Mr. Sheehan's postal customer relations and experiences, and the trend in pricing to which Dr. Steidtmann refers, the Postal Service invites the Commission to join it in retaining postal retail customers' satisfaction in the form of a unitary basic rate for their most common and fundamental postal transaction -- the mailing of a one-ounce letter.

iii. That CEM would be voluntary does not alleviate the confusion it would generate.

At various times, witness Willette testified that CEM would be voluntary. Tr. 21/10740, 10756. Those courtesy reply envelope providers which did not want to generate CEM envelopes would not have to. Those of their correspondents who were provided CEM envelopes would not have to affix CEM postage and could pay the full, basic rate. Ms. Willette characterized the transformation of current courtesy reply envelopes to a CEM format as "simple." Tr. 21/10688. However, as pointed out by witnesses Sheehan and Miller,[83/] what witness Willette ignored was the degree to which the nonstandardization of existing courtesy reply envelopes would delay conversion to CEM and leave the public confused about which envelopes qualify for the "bill payer" rate and which do not.

Moreover, the issue of early voluntary conversion to a CEM format aside, whether conversion of courtesy reply envelopes to the CEM format is mandatory is a critical issue. As witness Miller explained, if the Postal Service sought to make the CEM format mandatory, it could face resistance from envelope providers, many of whom just made significant investments to satisfy recently imposed Domestic Mail Manual requirements for enclosed reply envelopes and who perceived that they were being asked, yet again, to bear a burden for which they received no benefit. Tr. 33/17453. And, if the requirement was not made mandatory, households would receive similar looking prebarcoded envelopes -- and be faced with prebarcoded

---

[83/] Respectively, Tr. 33/17373; and Tr. 33/1750-54 and Exhibit USPS-RT-17 (Tr. 33/17486-90).

reply letters with and without CEM indicia. Presumably, most of the former would bear CEM postage and most of the latter would bear full postage. The current reply mail stream consists of a mix of similar envelopes, all bearing the same postage. In a CEM environment, the reply mail stream would consist of a mix of two barely distinguishable types of prebarcoded reply envelopes -- CEM and non-CEM -- to which would be affixed postage stamps representing the public's varied mailing practices, depending on what stamps were on hand and how much attention was being paid at the time of mailing: (1) full postage on non-CEM envelopes, (2) CEM postage on CEM envelopes, (3) full postage on CEM envelopes, and (4) CEM postage on non-CEM envelopes. A mixture of postage rates on a mixture of envelopes would be an enforcement challenge, indeed. Tr. 33/17450-54.

iv. CEM would require an extensive public education program.

Mr. Sheehan expressed concern that, based upon his past experience with implementing other household-oriented initiatives, and notwithstanding the best efforts of the Postal Service to educate the public about CEM, there would be many customers who would not take the time to determine which reply envelopes CEM stamps should be affixed to, and that there would be significant misunderstanding and misuse of CEM postage. *Id.* The Postal Service is a customer-oriented service agency. Understandably, witness Sheehan was concerned that, in a two-stamp environment, in order to reinforce proper postage application of CEM postage, the Postal Service would be required to enforce proper application of CEM postage in a manner that was sure to risk harm to relations with large-volume recipients of reply

mail and the individual customers who misapplied CEM postage. Tr. 33/17374. In a CEM environment, the Postal Service,[84/] would regard visible enforcement as a necessity. Witness Miller testified that any enforcement program would be coupled with an education program designed to educate the public about CEM.

In determining what the costs of such an education program could be, Mr. Miller relied upon two public relations firms employed by the Postal Service. Cohn & Wolfe was asked to design a multimedia campaign with the specific objective of educating the general public about CEM. Young & Rubican was employed to estimate the cost of producing a saturation direct mail piece and point-of-purchase brochures which would inform the public about CEM. Tr. 33/17494. As reflected in Exhibit USPS-RT-17B (Tr. 33/17492), it is estimated that the Postal Service would need to spend over $33 million to advertise, promote, and educate the public.

v. CEM short paid enforcement would require a step backwards in postal operations.

During the past five years, the Postal Service has invested heavily to extend the reach of automated letter mail processing. Notwithstanding the technological advances brought about by increased reliance on automated piece handling, automated mail processing equipment, for all its virtues, cannot detect the amount of postage affixed to a mail piece. Tr. 33/17374, 17512-14. Revenue protection activity for CEM would require the involvement of postal clerks, the deployment of whom is described in the testimony of witness Miller. Tr. 33/17470. By making it necessary

[84/] Like OCA witness Thomas in Docket No. R90-1, Tr. 30/15357-58.

to increase manual involvement in mail processing, the implementation of CEM would represent a significant mail processing step backward. Tr. 33/17369.

Current policy for handling short paid mail directs the carrier or box clerk to attempt to collect from the recipient. Delivery point sequencing increasingly puts the carrier in the position of having to make a decision about a short paid piece while out on the street, since that is where the carrier will first encounter DPS'd mail. *Id.* See also, Tr. 33/17470. Witness Sheehan explained that, in a CEM environment, short paid enforcement could most efficiently be accomplished at origin, as CEM pieces were trapped by the Advanced Facer-Canceler System (AFCS). Tr. 33/17374. As witness Miller explained, revenue protection clerks would need to be deployed to identify short paid pieces at the AFCS operation. Tr. 33/17470-72.

Available data show that short payment on one-ounce First-Class Mail pieces is relatively low -- 6 out of every 10,000 pieces. Tr. 33/17358. The reason is simple. Knowing how much postage to affix to a one-ounce letter is a "no-brainer." You know the rate, you affix the stamp, you get on with your life.[85/] It is hard to make a mistake. On the other hand, data show that when the public has to determine how much postage to affix to a letter, such as when additional-ounce postage is required, short payment occurs on one in every 14 letters. *Id.* at 17359. In a CEM environment, the public would be expected to have to make postage

---

[85/] Similarly, with Business Reply Mail, because of the combination of the standardized mail piece design (which current courtesy reply mail lacks), the public clearly understands that "No Postage Necessary" on a BRM piece means NO POSTAGE NECESSARY, and they act accordingly.

determinations on considerably more letters than in the current environment, which is dominated by a unitary one-ounce rate. How much short payment on one-ounce pieces would occur in a CEM environment cannot be precisely determined. The CEM environment would no longer be one in which a mailer seeking to use the rate could, without thinking, affix a stamp and move on. Witnesses Sheehan and Miller testify that there will be confusion and mistakes that no postal education program can eradicate. While it would be hoped that considerably fewer than seven percent of CEM stamps would be misapplied, there is no basis for assuming that short payment would be anywhere near as low as it currently appears to be for one-ounce letters. According to Dr. Ellard's survey, 40 percent of the public would not purchase and use CEM stamps at all. However, it is reasonable to infer that, based on Postal Service short payment experience with additional-ounce postage, the *remaining 60 percent could make short payment mistakes in a CEM environment at* a rate approaching 120 times as frequently as they do in a unitary rate environment. Because there are limits on the degree of precision which can be applied to estimates of First-Class Mail short payment through misapplication of CEM stamps, witness Miller calculated CEM enforcement costs, using a range of short payment percentages. Exhibit USPS-RT-17D; Tr. 33/17500. Assuming postal CEM education efforts could prevent CEM stamp misapplication form approaching current additional-ounce short payment levels, witness Miller demonstrated that -- at a conservative two percent short paid level, the Postal Service would incur approximately $96 million in CEM enforcement costs. He noted that the cost of

identifying and returning short paid mail always outweighs the corresponding revenue loss. Nevertheless, enforcement would be the only effective means of reinforcing proper payment of postage, consistent with the view of OCA witness Thomas in Docket No. R90-1. Tr. 33/17472.

vi. CEM enforcement would generate other costs.

Witness Miller also testified that CEM could increase postal window transaction costs, since more customers may have to make additional trips to post offices to purchase stamps. In his Exhibit USPS-RT-17C, he estimates an additional $17 million in CEM-related window transaction costs. Tr. 33/17496-98. Whether grocery stores and other alternative outlets would be willing to stock more than one denomination of stamp is a great unknown.[86/] In addition, limitations in current vending machines and Automated Teller Machines that sell stamps would prevent the use of these alternative outlets to sell anything other than one basic stamp denomination. The basic stamp? The CEM stamp? Which one would be anyone's guess. These factors could contribute to there being more and longer window transactions.

vii. The cost of administering CEM would outstrip the benefit it would be designed to redistribute.

Just factoring in education, enforcement, and window transaction costs, witness Miller estimated that the Postal Service would incur $146 million in the first

---

[86/] And consignment outlets which did not or could not offer both stamps could be faced with unanticipated customer inquires and dissatisfaction. Tr. 33/17450.

year alone. Tr. 33/17475. Witness Willette estimated a maximum potential CEM volume large enough to generate a revenue loss of $219 million. Tr. 21/10692. Witness Ellard's survey showed that only 60 percent of mailers would purchase CEM stamps, if they were available. Taking this into account, witness Miller testified that a CEM revenue loss of $134 million would be more plausible. Tr. 33/17475. OCA witness Willette testified that the purpose of the CEM proposal was to provide a direct benefit to the mailers of courtesy reply mail letters. Tr. 21/10714. The question the Commission and the Governors should ask is: Why would postal management spend $146 million to redistribute more directly $134 million in benefits, when those same benefits already are being enjoyed by the intended beneficiaries indirectly through averaged rates on all their single-piece First-Class Mail?

viii. The administrative burdens overwhelm the benefits of de-averaging a mailstream whose costs are converging.

The CEM proposal, now in its fourth presentation before the Commission, is more than a decade old. Mr. Miller demonstrated that equipment deployments and technological improvements since then have contributed to the convergence of mail processing costs for the different types of single-piece mail, and that future changes will contribute to that trend. Tr. 33/17479. His testimony established that, from a cost standpoint, a separate CEM rate classification would be less appropriate in tomorrow's environment than it may have been at the time CEM was initially proposed.

One who might be tempted to argue that his testimony is undercut by the proliferation of de-averaged rates[87] within First-Class Mail would be ignoring a critical distinction between bulk workshared mail and single-piece mail. Postage is verified and paid before the former enters the mail stream. The mailer pays permit fees to cover these additional costs of this enforcement and administration.

One might also argue that what is good for the CEM goose is good for the PRM/QBRM gander, since the Postal Service proposes de-averaging the rates of these latter categories. However, the Postal Service has proposed that PRM/QBRM recipients pay significant accounting fees and/or per piece fees to cover administrative costs associated with PRM/QBRM. Moreover, the de-averaging of rates for PRM and QBRM would not generate significant new administrative or enforcement or education costs not covered by such fees. The elimination of postage on PRM pieces all but eliminates enforcement burdens that would be associated with CEM. For PRM, there would be no need for a massive public education program, because it would be isolated to distinct business/customer relationships and would operate like BRM does today.[88] Existing accounting practices and auditing procedures are either in place or available to handle the postage payment. The PRM/QBRM recipient would pay fees -- over and above postage -- to cover administrative accounting and auditing costs. De-averaging

---

[87] Many rate differentials are considerably less than three cents.

[88] With standardized envelope designs for those reply mail recipients opting to use PRM.

makes sense for bulk First-Class Mail categories and for PRM/QBRM, because of the very features that distinguish these categories from CEM.

ix. The revenue loss associated with CEM would have to be recovered.

Witness Willette testified that CEM would generate a potential loss of $219 million in revenue (Tr. 21/10692), but she has "not taken a formal position" as to where that revenue loss should be recovered in order to reach statutory breakeven. Tr. 21/10735. Instead of identifying rates she would propose to adjust upward to compensate for this revenue shortfall and justifying such adjustments, however, she merely assumes that the shortfall could be offset by the year-to-date surplus being reported at the time her testimony was prepared. *Id.* Such a proposal patently fails to conform with sound ratemaking practice. CEM mailers have no greater claim to the benefits that could accrue by virtue of an unexpected surplus than all other mailers. The statute requires postal rates that allow the Postal Service to breakeven over time. The OCA did not make even a superficial effort to comply with this requirement.

x. The CEM proposal is patently inequitable.

As discussed by witness Miller at Tr. 33/17476, household mailers presently enjoy the benefit of having their high-cost letters, often handwritten, averaged with low-cost CEM reply mail and low cost business mail. What the OCA is proposing is to provide a discount for their CEM mail. Under the OCA's proposal, household mailers still would come out ahead only because they would receive both

the benefits of averaging with respect to their high cost mail, and the benefits of deaveraging with respect to their low cost mail. The Postal Service continues to regard this proposal as patently inequitable. The inequity is highlighted when one realizes that it is those large business mailers who provide the CEM envelopes, thereby making much of the cost savings possible, who would also be penalized with higher rates for their own mail. For households, the reduced rate would be a complete windfall, because in reality they would do nothing more than continue to mail the envelopes that someone else has provided them. Equity suggests that households should not receive the benefit of their low-cost CEM mail unless and until they are asked to pay a surcharge to cover the costs of their high-cost mail. And, while such a proposal may be equitable, it is hard to imagine that anyone would consider it to be wise. The status quo is much to be preferred, in which household mailers have some mail of above-average costs, some mail of below-average costs, but are not bothered with the complexities of a rate scheme that discriminates so finely to the benefit of no one.

xi. The record lacks substantial evidence that the statutory classification criteria justify CEM

At the beginning of this CEM discussion, the Postal Service invited the Commission's attention to the criteria in § 3623(c) which are intended to guide recommendations to the Governors regarding the establishment of new classifications of mail. The Postal Service submits that the record evidence in this case clearly establishes that CEM fails to meet these criteria.

As discussed in the preceding section, the testimony of witness Miller made clear how distinctly inequitable and unfair the CEM proposal is. Accordingly, CEM fails to satisfy subsection (c)(1).

The record does not reflect that the public would value courtesy reply envelopes with CEM indicia any more highly than it would regard courtesy reply envelopes or any other First-Class Mail letters without such indicia. There is nothing on the record which suggests that the public finds a CEM rate category desirable. To the contrary, the testimony of Postal Service rebuttal witness Ellard stands as uncontroverted and compelling evidence that the public desires the retention of the traditional one-stamp system. Accordingly, CEM fails to satisfy subsection (c)(2).

There is no evidence that CEM would promote the objective of establishing a new classification with an extremely high degree of reliability and speed of delivery, when compared to other portions of the First-Class Mail stream, within the meaning of subsection (c)(3). In fact, OCA witness Willette conceded that, in relation to other stamped, automation-compatible First-Class Mail, CEM would not have an extremely high degree of reliability of speed and delivery. Tr. 21/10788.

There is no basis for considering the application of subsection (c)(4), which relates to the establishment of classifications which do not require an extremely high degree of reliability of speed and delivery.

With regard to subsection (c)(5), which calls upon the Commission to consider the desirability of special classifications from the point of view of the user and the Postal Service, the Postal Service respectfully invites the Commission to

give due weight to the views of the public, as reflected in the CEM survey conducted by witness Ellard. The Commission also is encouraged to give due consideration to the testimony of Postal Service rebuttal witnesses Steidtmann, Sheehan and Miller.

With respect to the consideration of "such other factors as the Commission may deem appropriate" within the meaning of subsection (c)(6), the Postal Service observes that none has been advanced by the OCA in favor of its proposal. The Postal Service agrees that there are none.

It bears repeating that if one were to examine the contents of the corner mailbox in any American neighborhood, one would find a wide variety of letters deposited by households. Some would be bill payments, some would be greeting cards, some would be charitable donations, some would be personal letters, some would be completed application forms, some would be job resumes. The Commission has noted:

> Literally billions of pieces pay the current single piece First-Class Mail rate of 32 cents. They are sent to different distances; they are sent in different parts of the country; they are to be delivered to rural or urban areas; they are addressed in different ways; the paper used is different; the mail piece[s are] . . . shaped differently; the list goes on and on. It is accepted that for practical reasons, however, there is a single rate applicable to most First-Class pieces weighing one ounce or less.

PRC Op. MC95-1, at III-25, ¶3064. The record in this proceeding shows that the system of a uniform rate for nationwide coverage is one with which every American is familiar, and one which works. It is also one which a substantial majority want to see preserved. The Commission should defer to the preferences of the American

public regarding the manner in which they conduct their most fundamental postal transactions -- the mailing of one-ounce letters.

I. Niagara Telephone Company's "local" mail proposal is deficient.

In this proceeding, Niagara Telephone Company (Niagara) has revisited its proposed recommendation of separate rates for "local" mail. The testimony of its witness, Sidney Peterson, the President of Niagara Telephone Company, is very similar to the presentations he has made in previous Postal Rate Commission proceedings (i.e., R90-1, R94-1, and MC95-1). Unfortunately, Niagara's current proposal suffers from deficiencies that mirror those in the testimony's earlier manifestations.

Niagara seeks a discounted rate for First-Class mail which is deposited into "local only" mail receptacles or is otherwise submitted "for delivery in the local area as determined by the local post office." Tr. 21/10650. However, Niagara has provided no record evidence upon which the Postal Rate Commission may base a recommended decision on the implementation of the proposal.

Witness Peterson's testimony fails to furnish even basic information regarding the operation of his proposed discount. For instance, he leaves to the Postal Service the definition of what it would consider to be included within the very definition of "local" mail, Tr. 21/10671, and would have different Postal Service facilities determine their own unique applications of his discount. *Id.* Although "Niagara believes that 'local only' mail volume is significant," Tr. 21/10665, Niagara's

testimony does not give the Postal Service or the Postal Rate Commission any way to calculate the specific volume of mail that would be likely to qualify or take advantage of the discount. *Id.*

Witness Peterson advocates the recommendation of a discount level equivalent to "the combined discount for the first ounce received by first class pre-barcoded and presorted (5 digit) mail using those rates which are effective after implementation of the rates proposed in the instant proceeding." Tr. 21/10652. This is the same cost avoidance analogy urged by Niagara in Dockets No. MC95-1 and R94-1. *Opinion and Recommended Decision, Docket No. MC95-1*, at V-40. The Commission, in its MC95-1 Opinion and Recommended Decision, indicated that, as it had found in Docket No. R94-1, "the detailed mailflow analysis upon which the costs of the suggested proxy are based would not necessarily be equally applicable to 'local only' letters. . . . [and that] the Commission will not be equipped to recommend a specific rate for local mail until more detailed processing information is made available." *Id.* (footnote omitted.) Such processing information has not been supplied in Niagara's current testimony.

Witness Peterson does not provide any calculation of the cost savings underlying the discount he proposes. In fact, the testimony is silent upon the consequences of the "local" mail proposal on Postal Service finances, other than to assert, without quantitative support, that they "should be neutral." Tr. 21/10666. Without such information, the Postal Rate Commission cannot determine how "local" mail would affect the Postal Service's ability to comply with the break-even

requirement of the Postal Reorganization Act.

In Docket No. MC95-1, the Postal Rate Commission's Opinion and Recommended Decision commended witness Peterson for a proposal very similar to the one raised by Niagara in this proceeding, but pointed out specific areas that required attention before the Commission could actually recommend it. *Opinion and Recommended Decision, Docket No. MC95-1,* at V-39. Specifically, the Commission indicated that "specific and reliable estimates of cost avoidance would be prerequisites to quantifying an appropriate rate differential with respect to other First Class letters." *Id.* at V-40. As noted above, Niagara has not provided such estimates.

Finally, in Docket No. MC95-1, the Commission stated that, even armed with record evidence for developing an appropriate rate differential for local mail, Niagara had failed to furnish any information on the feasibility of the implementation and administration of its proposal. *Id.* Niagara's proposal in this proceeding is similarly silent on these issues.

Because of the lack of specific information with which to support the discount urged by Niagara Telephone Company, the "local" mail proposal cannot be recommended at this time. There is no evidence indicating the amount of mail that would be affected by the discount, and there is therefore no way to calculate the costs that may be avoided in the handling of such mail. Without this information, the Postal Service and the Postal Rate Commission cannot ascertain whether the

proposed discount is appropriate, or what its impact would be on the Postal Service's revenues.

m. The Brooklyn Union Gas Company modifications to PRM are not welcomed.

Brooklyn Union Gas Company (BUG) is the only party other than the OCA to address the Postal Service's Prepaid Reply Mail proposal. BUG witness Bentley (BUG-T-1; Tr. 21/11078 *et seq.*) generally supports the proposal, but suggested changes to it. The Postal Service appreciates the support, but prefers that the proposal not be modified as suggested by BUG.

Witness Bentley suggested that the PRM proposal,[89] be modified to permit the recipient to perform the accounting function by means of weight averaging. Tr. 21/11086, 11126. In response, the Postal Service invites the Commission's attention to the testimony of witness Fronk which emphasized that the Postal Service eliminated weight averaging as an option, because it would not leave an audit trail or create the types of reports and documentation that a manifest system would. Tr. 4/1509-10.

Witness Bentley observed that reply mail received in bulk quantities is almost always addressed to a post office box. Tr. 21/11082. Accordingly, he proposed that post office box delivery be a required element of PRM. *Id.* The Postal Service invites the Commission's attention to Mr. Bentley's choice of words: almost always.

---

[89] An essential element of this proposal is that the recipient maintain a manifest system through which the piece counting, rating and billing function would be performed, subject to audit by the Postal Service.

There could be circumstances where alternative mail exit points provide for a suitable point from which to tender mail to a PRM recipient. Imposition of a rigid post office box delivery requirement now could result in an unnecessary limitation that would require significant regulatory process to change later.

B. Priority Mail

1. Proposals

The Postal Service proposes a moderate overall increase in Priority Mail rates of 7.4 percent. This increase corresponds to a test year after rates cost coverage of 192 percent.[1] As explained by witness Thomas M. Sharkey, the important two-pound-and-under rate, which applies to 80 percent of projected test year volume, is proposed to be raised from $3.00 to $3.20, an increase of 6.7 percent. Mr. Sharkey moderated the impact of his rate increases on all other Priority Mail users by constraining the proposed increase in any given rate element to no more than 16 percent. USPS-T-33 at 26.

The Postal Service proposes to keep in place the basic features of the Priority Mail classification scheme. Rates for the 2-, 3-, 4- and 5-pound pieces will remain unzoned. The flat rate envelope is also to be retained as part of the basic classification structure.

The Postal Service is, however, proposing to introduce two significant changes to the Priority Mail classification scheme. First, in recognition of the fact that the Postal Service is continuing to deploy equipment that will enable delivery

[1] This cost coverage is slightly lower than that initially used by Postal Service witness Thomas M. Sharkey in deriving his rate increases. Mr. Sharkey was initially provided by witness O'Hara with a target cost coverage of 198 percent, which was subsequently adjusted downward to reflect a correction to test-year Priority Mail costs. Although the resulting cost coverage is somewhat lower than the initial target, witness Sharkey did not believe that the change required an adjustment to his proposed rates, which remain cost-based, and still make a large contribution to institutional costs. *See* Tr. 4/2138-39.

confirmation service to be provided to Priority Mail customers, and cognizant that features such as electronic delivery confirmation are becoming expected basic service components in the expedited delivery market, the Postal Service proposes to offer an electronic delivery confirmation service as part of basic Priority Mail service.[2] Based on market research contained in Library Reference H-166 and costs developed by Postal Service witness Treworgy (USPS-T-22), Mr. Sharkey made final adjustments to revenues, volumes and costs associated with Priority Mail delivery confirmation. USPS-T-33 at 27 and Exhibit 33-R.

Second, the Postal Service also proposes to eliminate from the classification schedule the existing Priority Mail presort discount category. As Mr. Sharkey explains, Priority mail presort volume has never comprised more than one percent of the total Priority Mail volume, and has declined as a percentage since FY 1995. USPS-T-33 at 31. Given this lackluster reception in the marketplace, and the fact that presorting will have a diminished value in the test-year mail processing environment, it is appropriate to discontinue this classification at the present time.

Beyond these classification changes, the Postal Service also proposes to significantly adjust the pickup fee for Priority, Express and Standard (B) parcels, raising the current fee of $4.95 to $8.25. This large increase of 67 percent is necessitated by the results of an updated cost analysis performed and presented by

[2] A more labor-intensive retail version will also be available at retail counters, for an additional charge that reflects additional retail costs. The testimony of witness Plunkett (USPS-T-40) addresses the details of the Priority Mail delivery confirmation special service.

Postal Service witness Michael A. Nelson, which indicates weighted average test year cost per pickup far in excess of the current pickup fee. *See* USPS-T-33, Exhibit J, USPS-T-19, Exhibit E. Witness Sharkey concluded that the relatively low implicit cost coverage of 102 percent, which corresponds to the proposed $8.25 fee, is justified in order to ameliorate the impact of this significant fee adjustment. USPS-T-33 at 33. In addition, it should be noted that the pickup fee is charged once, regardless of the number of pieces picked up at each location. As witness Sharkey points out, because multiple pieces are typically received at each pick up, the average cost per piece picked up is very low: $0.01 per piece for Parcel Post, $0.03 per piece for Priority Mail, and $0.30 per piece for Express Mail. USPS-T-33 at 33, note 9. Thus, even though the per pickup fee has increased by 67%, the resulting average charge per piece picked up is only an additional $0.03, or less than one percent of the proposed two-pound Priority Mail rates ($0.03/$3.20 = 0.94%).

Witness Sharkey's rate design incorporates witness Haldi's recommendation from Docket No. R94-1 to treat air terminal handling cost as non-distance related. He also applied the long-standing methodology of allocating weight related distance and non-distance related costs to the Priority Mail weight cells and zones including a markup and a contingency.[3]

In Docket No. R94-1, the Commission accepted an even incremental rate

---

[3] *In its Docket No. R94-1 Recommended Decision, the Postal Rate Commission* accepted, in principle, the suggestion to separate and recover nondistance-related air transportation costs through the piece charge, but only reflected 50% of the adjustment in the rates recommended in that case. *See* PRC Op., R94-1, at V-37.

differential of $1.00 between the two- to five-pound unzoned Priority Mail rates, based, in part, on witness Haldi's testimony in that case. *See* PRC Op., R94-1, at V-40. In the current case, witness Sharkey does not propose an even incremental rate differential, but rather proposes a 6.7% increase in the two-pound rate, and a 10% increase in the three-, four-, and five-pound rates. Tr. 4/1950.

2. Intervenor proposals

As in prior cases, only two parties, representing a Priority Mail competitor (UPS) and a coalition of photo-developers who make extensive use of Priority Mail (NDMS), *expressed dissatisfaction with elements of the Postal Service's Priority Mail* rate design. Their criticisms are not sufficiently compelling to cause the Commission to depart from Mr. Sharkey's recommendations.

a. Witness Haldi's proposed increase in the breakpoint between Priority and First-Class Mail should be rejected.

Witness Haldi argues that the $0.57 "gap" – which he defined as the difference between the proposed maximum First Class rate and the minimum Priority Mail rate – is not as small as possible and that "no good reason has been proffered as to why a gap this large should be considered acceptable." Tr. 20/10307. As the record of this case shows, the size of the proposed gap can be supported on several grounds. First, it must be borne in mind that Priority Mail users benefit from service features not available to First-Class Mail users. These benefits include delivery within two days between a greater number of origin and destination post offices (749,886 for Priority Mail, as compared to 155,515 for First Class Mail.) See Tr. 4/1927. They also include a separate sorting and distribution network designed to expedite the

delivery of Priority Mail, as well as delivery confirmation and pickup services available for an additional fee. Tr. 4/1977. The proposed Priority Mail rates are designed to cover the costs of these services using a longstanding rate design methodology, as modified by the Commission in its Opinion in R94-1. See USPS-T33 at 24-26. As Witness Sharkey indicated, the Postal Service's rate design attempts to mitigate the gap by proposing a lower-than-average increase in the two-pound Priority Mail rate in recognition that "two-pound rate mail is most likely to contain monopoly protected letter mail" while still providing an adequate level of cost coverage for all weight and zone classifications of Priority Mail. Tr. 4/1950-51.

In addition, witness Haldi argues "that the current 11-ounce maximum weight for First-Class Mail not be maintained if it results in an artificially low two-pound-and-under Priority Mail rate." Tr. 20/10307. His testimony continues to imply that the current, Commission-approved, Priority Mail rates for zoned parcels over five pounds subsidize lower weight, unzoned Priority Mail rates. Setting aside these bald assertions, there is no evidence in the record that suggests that cross-subsidization exists between the Priority Mail zoned and unzoned rate classifications. The characterization of the two-pound Priority Mail rate as "artificially low" hinges on Dr. Haldi's analysis designed to demonstrate that the Priority Mail rates for zoned parcels over five pounds are too high. As discussed below, his analysis does not present an adequate basis to depart from Mr. Sharkey's proposals.

b. The Commission should again reject Witness Haldi's alternative procedure to project test year after rates volumes and revenues by applying the estimated own-price elasticity to individual rate cells, in favor of the standard

method used by the Postal Service.

In his Priority Mail testimony on behalf of NDMS, witness Haldi again proposes that the Commission abandon the established procedure to distribute to rate cells the forecasted test-year after rates volumes for Priority Mail, in favor of a method that would project test year after rates volumes and revenues by applying the estimated own-price elasticity to individual rate cells. Witness Haldi claims that use of such a method would avoid counter-intuitive and misleading results. According to witness Haldi, the change in Priority Mail volume from 1993 to 1996, when compared with the *changes in rates for each cell, suggests that more realistic volume forecasts would* have been projected had elasticities been applied at the cell level rather than at a more aggregated level. Tr. 20/10310-16.

In advocating application of the own-price elasticity developed by witness Thress for all of Priority Mail to individual rate cells, Dr. Haldi has overlooked the history surrounding this issue. In fact, the Commission has previously considered this suggestion and found it lacking in merit. In the reconsideration stage of Docket No. R94-1, the Commission stated its position on the matter:

> Notwithstanding the technical criticisms raised by Nashua/District Photo, the Commission is confident that its volume estimates for Priority Mail are the most accurate projections that the record of this proceeding can support. While it may be possible, in theory, to derive more accurate estimates of the volume effects of disparate rate increases, the methodologies and data required to produce such estimates are not *available.* * * * * *[I]mplementing such an approach would require a* reliable model of the demand function for each rate cell, or reasonable certainty that a given demand function applies to a specific grouping of cells. To the Commission's knowledge, this requisite knowledge does not exist. * * * * Nothing in the testimony of Postal Service witnesses Tolley and Musgrave would justify such a cell-by-cell

> application of the fitted aggregate demand function. The aggregate functions used by the Commission to estimate the impact of rate changes on volume for the various subclasses are extremely complex and expensive to develop. In developing rates the Commission cannot ignore cost differences and the varying impacts of the factors of the Act due to the absence of separate demand functions for each of the hundreds of discrete cells for which rate changes must be recommended.

PRC Further Op., R94-1, *at* 63.

Nothing has changed in the years following that would dictate a reversal of the Commission's position. As in the past, the extensive and complex demand information contained in the record, while state-of-the-art, is not so finely honed that it would permit the development of demand functions applicable to individual rates cells, nor should it be expected to reach such a level of precision, given the existing complexity of the volumes estimation analysis and the inherent limitations on the ability of the Postal Service and the Commission to formulate perfect forecasts. Thus, the impediment to application of the Haldi approach cited by the Commission in Docket No. R94-1 continues to exist, and witness Haldi has not, and cannot, provide a means to overcome it.

Perhaps more fundamentally, Dr. Haldi has himself demonstrated that the consequences of using what he views as the "suboptimal" standard procedure are, in fact, trivial. His Table 3, appearing at Tr. 20/10319, yields a forecasted volume difference of 0.07 percent, and forecasted revenue, cost, and contribution differences clustered around 0.01 percent. Recall that these differences reflect what Dr. Haldi has termed the "widely varying percentage changes" proposed for Priority Mail in this case, as compared with the across-the-board proposal in Docket No. R94-1. Tr.

20/10311. Dr. Haldi is to be commended for his candor and the thoroughness of his presentation, but his own Table 3 provides compelling evidence that whatever questionable theoretical merit his arguments may have, their practical consequences are immaterial. The computational complexities inherent in his proposal -- which may not appear daunting *post hoc*, when there is only one set of rates for which to forecast volumes, but which would be highly vexing during the iterative process necessary to evaluate and adjust alternative rate proposals -- are not worth the candle. As in Docket No. R94-1, therefore, the Commission should continue using the established approach. A related discussion is presented earlier in this brief in the context of a discussion of OCA witness O'Bannon in Section II regarding volume forecasting.

c. The Commission should again reject witness Haldi's proposal to eliminate the mark-up on the distance-related component of transportation costs.

Witness Haldi also revives his proposal to eliminate the mark-up on the distance related component of transportation costs. Tr. 20/10325-30. To his credit, in this instance he acknowledges that his proposal has been rejected by the Commission in the past. Id. at 10322. His current testimony is insufficient, however, to overcome the Commission's justifiable concerns regarding the merits of the approach.

In Docket No. R94-1, as in Docket No. R90-1, the Commission was concerned about the possible disruption which would accompany such a dramatic change in the way Priority Mail rates have consistently been developed. PRC Op., R94-1, at V-38.

Noting that witness Haldi's proposal would have the effect of reducing Priority Mail rates in distant zones and increasing them for shipments to close-in zones, the Commission was reluctant to change the rate design without a clear estimate of the dislocation in the Priority Mail market to be caused by the change. Because witness Haldi did not provide a rate structure which shows, in isolation, the impact of his proposal on Priority Mail rates for material sent to the close-in zones, the Commission rejected his proposal. Id. at V-39.

Witness Haldi has yet to provide the requisite isolated impact analysis sought by the Commission. He attempts to finesse the problem in this docket by contending that his current testimony "attempts" to cure this defect. According to witness Haldi, "[o]ther than my decision to maintain uniform $1.10 rate increments for unzoned 2- to 5-pound packages, the Postal Service's rates and my rates reflect the contrast the Commission wanted to see." Tr. 20/10324.

Of course, this is nothing other than an admission that he has failed to isolate the impact of not marking up distance related costs. The rates he proposed reflect not only this effect, but also his uniform rate increments. In addition, Dr. Haldi's rates also reflect changes in established volume and revenue projection methods, are accompanied by a rise in the breakpoint between First-Class and Priority Mail, and reflect other judgmental allocations embedded in his rate design. This is hardly the "hold-constant" comparison required by the Commission.[4]

---

[4] It is notable that witness Haldi at no point discusses what the result of such a precise "hold-constant" comparison would be, or whether it would reveal the types of disruption feared by the Commission.

It must also be noted that Dr. Haldi failed to provide the Commission with any guidance on how the distance-related costs of other zoned, heavier-weight classifications, such as Bound Printed Matter or Parcel Post should be handled. This lack of consistent treatment further undermines his proposal. The proposal should again be rejected.

d. Uniform incremental rates are not justified in this case.

Witness Haldi incorporates in his rate design uniform $1.10 increments between the 2- through 5-pound unzoned Priority Mail rates. The Commission, with the support of the Postal Service, on at least one prior occasion expressed approval for uniform increments. The current unzoned rates, which increase at dollar increments through the first five weight levels, reflect this decision.

In the instant proceeding, witness Haldi proposed uniform $1.10 increments between the 2- through 5-pound unzoned Priority Mail rates, suggesting that the Commission's approval for such even increments in R94-1 "apparently has been well received." Tr. 20/10321. In evaluating Dr. Haldi's proposal, it must be noted that while the Commission approved even increments in the prior case, the Commission recognized that an even rate increment "deviates from the Postal Service's distribution of costs by weight increment." In the special circumstances of that case, where an "across the board" approach to pricing had been proposed, and the rates under consideration were set at even dollar levels, the Commission determined that the "benefits of a simple and identifiable relationship between rates" outweighed the importance of the deviation from costs. Docket No. R94-1, PRC Op. at V-40.

In the present case, the Postal Service believes that the balance weighs in favor of a return to rates that more closely reflect underlying cost differences. It is clear that the underlying cost differentials are not uniform, and do not support even incremental rate differentials. Tr. 4/2097. While in the unusual circumstances of Docket No. R94-1, the Commission's even increment design may have had appeal because it resulted in simple, even-dollar unzoned rates, the current NDMS proposal inadequately reflects the available cost data, and does not provide the advantages of even-dollar increments, let alone even-dollar rates.

Furthermore, the only "uneven" rate differential proposed by witness Sharkey is that between the 2- and 3-pound unzoned rates. This variation adds little complexity to a rate schedule which has 390 rate-zone classifications for pieces weighing between 6 and 70 pounds (65 weight classifications times 6 zones). As Witness Sharkey indicated, moreover, the lower-than-average increase in the two-pound Priority Mail rate is also justified in light of importance of this rate, which applies to over eighty percent of projected test year volume and drives the average price increase for Priority Mail. He also set the rate in recognition that "two-pound rate mail is most likely to contain monopoly protected letter mail," while still providing an adequate level of cost coverage for all weight and zone classifications of Priority Mail. Tr. 4/1950-51.

The rate design proposed by witness Haldi would impose a much higher rate increase on the vast majority of Priority Mail users, simply to maintain a non-cost-based ideal of even rate increments. Moreover, it is not clear that Mr. Haldi's true

interest is maintaining even increments, or in raising the two-pound rate. If even increments had been a strong objective, Mr. Haldi could have left the proposed two-pound rate as proposed by Mr. Sharkey, and altered the remaining unzoned rates so that they conformed to his even-increments policy. Instead, he chose to raise the minimum Priority Mail rate, despite the fact this would add substantially to the "gap" problem he also identifies. Not surprisingly, the particular way in which Dr. Haldi chose to deal with rate simplicity is the one which would most favor his clients, who are mailers of higher-weight Priority Mail pieces. The Commission should bear this in mind when evaluating his proposal to further burden the remaining 80 percent of Priority Mail users.

e. UPS witness Luciani's proposed surcharge for Priority Mail parcels should be rejected.

In his testimony in this case, UPS witness Luciani proposes a separate rate treatment for Priority Mail parcels and advocates a ten cent per piece surcharge for these parcels. Tr. 26/14328. The justification for this surcharge is a reference to UPS witness Sellick's analysis of the costs to process Priority Mail parcels as compared to the costs to process Priority Mail flats in the test year. *Id.* at 14329. While Mr. Luciani admits, "[Mr. Sellick's] analysis does not consider the impact of the Priority Mail Processing Center ("PMPC") contract" on the costs to process Priority Mail flats, Mr. Luciani adopts Mr. Sellick's 19.5 cent cost differential to develop his Priority Mail parcel surcharge. Id.

Because this rate design ignores the impact of the PMPC contract on Priority Mail processing costs, it cannot be justified as reflecting the actual costs of

processing Priority Mail parcels following the implementation of the PMPC contract. In the past, the Commission has emphasized that new rate designs should be appropriately cost based. By ignoring the impact of the PMPC contract, Witness Luciani clearly has not based his rate design on the cost patterns underlying the *current method used to process Priority Mail, nor has he indicated how his proposal* would benefit either Priority Mail users or the Postal Service. At best, he offers the arguments that "[u]se of a surcharge would encourage the Postal Service to keep track in the future of the separate costs it incurs for parcels and for flats" and would "mitigate the mystifying crossover problem between Parcel Post rates and Priority Mail rates" Tr. 26/14330. Because Mr. Luciani's Priority Mail parcel surcharge proposal is not appropriately cost based and has not been shown to benefit either Priority Mail users or the Postal Service, the proposal must be rejected.

f. The precipitous Priority Mail rate increase proposed by witness Henderson should be rejected as conceptually unsound and obviously self-serving.

UPS witness Henderson recommends an overall increase in Priority Mail rates *of 32 percent, a staggering increase well beyond that proposed by the Postal Service.* In place of the average rate of $3.78 proposed by witness Sharkey, witness Henderson proposes an average rate of $4.66, almost a dollar more per piece. To understand the potential impact of this proposal, consider that a 32 percent increase to the existing $3.00 two-pound-and-under rate would raise that rate to $3.96, or $4.00 if raised to the next five-cent increment.

Besides this higher average increase in Priority Mail rates, witness Henderson

does not take issue with the remainder of witness Sharkey's recommendations. However, given the sheer magnitude of the overall increase he proposes, one must carefully consider the basis for his general conclusion that Priority Mail rates must increase precipitously. As the analysis elsewhere in this brief demonstrates, the proposed increase to Priority Mail rates (and other increases to Express Mail and Parcel Post) stem directly from his underlying approach to postal costing and pricing, which emphasizes, among other things, the use of incremental costs as the basis for mark-ups in pricing, the continued use of a now-invalidated assumption of 100 percent volume variability of mail processing costs, and other similarly unsound adjustments to the costing and pricing approach advanced by the Postal Service. Not surprisingly, the UPS methodology would tend to significantly increase the cost base for those postal services which directly compete with UPS service offerings. As shown elsewhere, however, the approach suggested by witness Henderson and other UPS witnesses is seriously flawed. It is thus not surprising that his misguided methods produce Priority Mail rates that approach absurdity. Because of its underlying conceptual and practical defects, witness Henderson's suggested Priority Mail rate increase must be rejected in favor of the more reasonable rates proposed by witness Sharkey.

C. The Express Mail Rates Proposed By Witness Sharkey Should Be Recommended As Sound, Fair, Cost-Based And Amply-Supported.

The record of this case establishes that the Postal Service's proposed rates for Express Mail are reasonable and well-founded. The proposed modifications sought

by UPS, however slight, derive from unsound analysis and should be rejected.

1. The Postal Service's proposed Express Mail rates are reasonable and consistent with prior Commission recommendations

The Postal Service's goals for Express Mail in this case are modest, and would preserve the basic, unzoned rate structure established in the most recent omnibus rate proceedings. No classification changes are proposed.[5] As explained by witness Sharkey, the Postal Service proposes moderate rate adjustments designed to meet a reasonable overall cost coverage target of 204 percent established by witness O'Hara. USPS-T-30. The proposed adjustments result in an average increase of 3.65 percent overall.[6] The Post Office to Addressee letter rate, for pieces weighing up to 8 ounces, is proposed to be increased from $10.75 to $11.25, a rise of approximately 5 percent. In designing the proposed rates, witness Sharkey constrained the rate increases for each rate element to be no more than 11 percent, he rounded rates up to the nearest nickel, and he set the rates for Post Office to Addressee service to be at least twice the Priority Mail rates for zone 5. Some rates, such as the two-pound rate, are to receive slight decreases. All of the proposed rate

---

[5] The Postal Service thus proposes to maintain a classification for Same-Day Airport Service, despite the fact that this service is currently suspended for security reasons. The Postal Service desires that this classification will continue in anticipation of a change in circumstances which may permit its resumption at a future date.

[6] It should be noted that a minor typographical error in Mr. Sharkey's Table 4 was detected following the admission into evidence of this witness's testimony. This error was subsequently corrected, clarifying that the Postal Service intends to continue the policy of charging all Express Mail weighing over a half a pound and no more than two pounds the applicable two-pound rate. See Tr. 31/16490.

elements cover implicit calculated costs. USPS-T-33 at 14-16.

2. Although UPS witness Henderson essentially supports Mr. Sharkey's proposed rate increases for Express Mail, his slightly higher average rate increase must be rejected as unsound.

The reasonable and well-supported proposed Express Mail rates put forward by witness Sharkey met with little comment in this case, and with little opposition. The only witness offering any alternative to Mr. Sharkey's proposals, not surprisingly, testified on behalf of the United Parcel Service, competitor to the Postal Service in the next-day delivery market. UPS witness Henderson recommends an overall increase in Express Mail rates of 4 percent, an increase slightly higher than that proposed by the Postal Service.

Other than this higher average increase in Express Mail rates, witness Henderson does not take issue with the remainder of witness Sharkey's recommendations. He does not criticize witness Sharkey's rate design, nor does he propose any classification changes to Express Mail. He does not propose a specific schedule of Express Mail rates. He does not specifically oppose the few rate reductions proposed by Mr. Sharkey.

As is noted elsewhere in this brief, witness Henderson's recommendations of higher Express Mail, Priority Mail and Parcel Post rates stem directly from his underlying approach to postal costing and pricing, which emphasizes, among other things, the use of incremental costs as the basis for mark-ups in pricing, the continued use of a now-invalidated assumption of 100 percent volume variability of mail processing costs, and other similarly unsound adjustments to the costing and

pricing approach advanced by the Postal Service. Not surprisingly, the UPS methodology would tend to significantly increase the cost base for those postal services which directly compete with UPS service offerings. As shown elsewhere, however, the approach suggested by witness Henderson and other UPS witnesses is unsound. Because of its significant underlying defects, witness Henderson's suggested adjustment to the overall Express Mail rate increase proposed by the Postal Service, however minor, must be set aside, and Mr. Sharkey's proposals adopted *in toto*.

D. The Postal Service's Proposed Standard Mail (A) Rates Employ Comprehensive, Sensible, And Improved Approaches To Measuring Cost Differences And Designing Rates, And Should Be Recommended.

1. *An overview of the proposed Standard Mail (A) rate change.*

The proposed average overall rate changes for Standard Mail (A) subclasses are summarized in the Table below.

SUMMARY OF RATE CHANGES FOR STANDARD (A) SUBCLASSES (STEP 5 FOR NONPROFIT SUBCLASSES)	
Regular	4.1%
ECR	3.2%
Nonprofit	15.1%
NECR	-4.8%

USPS-T-36 at 2.

Although the rate changes on a subclass basis are modest,[1] the rate design for Standard (A) is sensitive to the effect on individual rate categories occasioned by the adoption of new costing methodologies, as well as to the collection and use of new cost information on shape, dropshipment, and weight. The rate design proposed by witness Moeller accounts for updated cost information while emphasizing and adopting measures to promote rate stability and mitigate the level of increase on individual categories.

[1] The rate change for Nonprofit is significantly higher than its commercial counterpart due to increases in its reported costs and the implications of the RFRA. *See* USPS-T-36 at 33-34.

2. Witness Moeller's rate design fairly balances multiple, sometimes competing, considerations.

The major considerations employed in the design of Standard Mail (A) rates in this case were many, and their interrelationships complex, as explained by witness Moeller. Witness Moeller's reasonable and balanced development of Standard Mail (A) rates achieves multiple, basic objectives.

The first is that the rate design preserves recently adopted incentives for worksharing while accounting for changes in cost data. Introduction of improved costing methodologies in this docket have led to changes in cost differentials; consequently, the rate design remains sensitive to, and attempts to limit, rate swings for individual categories.

Second, the rate design remains sensitive to the need to moderate the impact of price changes of individual categories, so that no single rate category receives a disproportionately high rate increase. Tr. 6/2786; USPS-T-36 at 17. Witness Moeller explains that the rate design adopts a guideline to limit the rate change in any particular commercial Standard (A) category to 10 percent, thereby mitigating the impact of the rate change on mailers. Tr. 6/2786; Tr. 6/2842.

Third, the rate design facilitates the evolution of the Postal Service's letter automation program. To achieve this purpose, the shape passthrough in the ECR and NECR Basic tier is minimized, thereby resulting in incentives for nonbarcoded letter mail to migrate to Regular or Nonprofit Automation 5-Digit. USPS-T-36 at 28; Tr. 6/2814.

Fourth, the rate design balances the Commission's desire to recognize the effect of shape on cost while maintaining simplicity of the rate structure. Towards this end, the Postal Service proposes a surcharge on residual shaped pieces within the nonletter categories of Regular and Nonprofit Presort and ECR and NECR. These pieces, defined as pieces that do meet the dimensional criteria of a letter or flat, or are prepared according to preparation standards for parcels, have been shown to have demonstrably higher cost characteristics than other nonletters. The proposed surcharge recognizes the cost differences of these residual pieces, while avoiding the introduction of undue complexity in the rate structure. Tr. 6/2741.

Fifth, the Postal Service's proposed Standard Mail (A) rates more directly account for the effect of weight on costs through conservative reductions in all but the Nonprofit subclass pound rates. The current ECR pound rate, which causes the rate for pound rated saturation pieces to increase in direct proportion with weight, produces unreasonable results. Both quantitative and qualitative evidence in this docket provides firm support for the proposed reductions. USPS-T-36 at 15-16, 24-27.

Finally, witness Moeller's rate design preserves the Commission's rate design formula to set the basic rate elements. USPS-T-36 at 8-9. In this case, however, in order to incorporate more directly the compelling new evidence favoring a reasonable reduction in the pound rate, witness Moeller uses the Commission's formula to solve for the piece rate for pound rated pieces, rather than solve for the pound rate algebraically. USPS-T-36 at 15-16, 24-27.

3. The Postal Service's letter and non-letter presort discounts in the Regular and Nonprofit subclasses fairly balance the considerations of recognizing the value of worksharing and impact of rate changes on mail.

In this proceeding, presort and automation discounts in the Regular and Nonprofit subclasses serve to recognize cost differentials while minimizing rate swings on mailers.

a. Measurement of the presort- and automation-related cost differences should be adopted by the Commission.

The Postal Service has undertaken to provide the Commission with detailed, up-to-date cost information upon which its discounts are based. The studies and analyses underlying the presort and automation discounts are comprehensive and remain unchallenged on the record.

i Witness Talmo presents the results of two major data collection efforts which are used to better assess the presort-related costs for Standard Mail (A).

Postal Service witness Talmo (USPS-ST-50) supplies two recently conducted mail characteristics studies, which are designated as USPS LR-H-105 and USPS LR-H-195. The studies facilitate more precise and accurate modeling of the presort-related costs of Regular and Nonprofit Standard Mail (A). The studies also provide updated conversion factors and entry profiles which are used in the calculation of destination entry cost avoidances presented by witness Smith (USPS-ST-46). USPS LR-H-105 and USPS LR-H-195, Tables 17 and 18. In addition, the studies enable

the estimation of the letter volume that has the density to migrate from the carrier route basic letter tiers to the Regular and Nonprofit Automation 5-Digit categories. USPS LR-H-105 and USPS LR-H-195, Table 16.

The studies provide a solid foundation for the development of Standard Mail (A) costs through analysis of the most current container and package presort practices. The studies undertake to provide quantitative information on profiles of containers, packages, and other characteristics of Regular and Nonprofit Standard Mail (A) preparation.

Both studies represent major undertakings aimed at obtaining comprehensive mail makeup information in a "post reclass" environment. For each study, transactions were randomly sampled by acceptance personnel at 40 randomly selected post offices. Post offices and transactions were selected according to a stratified random sample covering all eligible transactions. USPS LR-H-105 and USPS LR-H-195, Tables 1 to 4. These studies were carefully designed to provide detailed entry profiles of mail. Not only do the studies provide data by container and presort level, they also distinguish the data by shape, automation compatibility, and machinability. USPS LR-H-105 and LR-H-195, Tables 5 to 15.

The survey protocol randomly selects individual transactions and then completely inventories all containers in the transaction by container type and presort level. This represents an effective method for counting a large number of containers and provides a much greater sample of containers than previous studies. In total, over 700,000 containers were inventoried. This very large number of observations

produces sufficiently low standard errors to ensure reliability in the results. USPS LR-H-105 and LR-H-195, Tables D1 to D11.

The mail characteristics surveys are comprehensive in scope, sound in methodology, and uncontested on the record. The surveys should accordingly be accepted by the Commission.

ii. Witness Daniel has improved the methodology by which presort and automation cost differentials are estimated for letters.

Witness Daniel (USPS-T-29) provides comprehensive and accurate cost estimates for Regular and Nonprofit categories. Witness Daniel's testimony continues the use of detailed mailflow diagrams which formed the basis of the Commission's recommended rates for Standard (A) in Docket Nos. MC95-1 and MC96-2. These mailflow diagrams determine the processing path in the test year through sorting operations of pieces within each rate category. Witness Daniel updates the mailflows with new inputs, including mail characteristics, accept and upgrade rates, and coverage factors to determine the mix of processing steps that an average piece in each rate category receives. With this information, modeled unit costs for each rate category are developed using updated productivities, piggyback factors, wage rates, and premium pay factors.

Witness Daniel's Standard (A) models refine the methodology for determining the CRA adjustment. In particular, witness Daniel's methodology responds to the Commission's concern, expressed in its Opinion in Docket No. MC95-1, that the information available in that docket did not "provide a basis for treating only some of

the listed mail processing activities as causally related to the worksharing required." PRC Op. MC95-1 at ¶ 4281. Witness Daniel explains that, in this docket, the Postal Service has undertaken to disaggregate shape-specific costs taken from the CRA into worksharing- and nonworksharing-related cost pools, thereby enabling cost differentials based on modeled costs to be adjusted only by those that are in fact worksharing related. *See* Exhibit USPS-29A at 2; Exhibit USPS-29B at 2. This represents an improvement to the "nonmodel cost factor" introduced by witnesses Takis, Smith, and Brattli in Docket No. MC95–1, in that it enhances precision in estimating mail processing costs. In its absence, the Commission would be left with the same choice it confronted in Docket No. MC95-1 in reconciling the modeled costs to the CRA. *Cf.* PRC Op. MC95-1 ¶ 4281.

Witness Daniel's cost estimates provide a firm basis for the worksharing discounts proposed by witness Moeller (USPS-T-36). No party in this case has proposed changing the requested presort and automation discounts in Regular and Nonprofit by challenging the presort- and automation-related cost differentials. The Postal Service accordingly urges that witness Daniel's cost estimates and methodology be adopted by the Commission.

iii. Witness Seckar has improved the methodology by which presort and automation differentials are estimated for nonletters.

Witness Seckar presents Standard Mail (A) flats mail processing costs based in large part on the past methodology of witness Brattli. Specifically, CRA subclass

costs are de-averaged through the use of piece-distribution and bundle sorting costs. USPS-T-26 at 10.

Witness Seckar refines past methodologies' treatment of Standard Mail (A) flats costs beyond piece distribution and bundle sorting costs by estimating these other costs through the use of a proportional CRA adjustment factor as well as a fixed add-on component. USPS-T-26 at 23-24. Witness Seckar makes further refinements to past methodologies to account for changes to the flats mail processing environment such that the models accurately reflect the test year. The planned test year calls for the use of FSM-881s, FSM-BCRs, FSM-1000s, and FSM-OCRs to process flats mail. USPS-T-26 at 33.

Witness Seckar makes use of average test year deployment for the FSM-1000 and FSM-OCR. USPS-T-26 at 34. The treatment of the FSM-1000 correctly relies on the FSM-881 downflow densities as suitable proxies because of the similar number of breakouts each machine makes. Witness Seckar has also refined the analyses to incorporate unique FSM-1000 acceptance rates. Because the OCR is to be retrofitted onto all the FSM-881s, Witness Seckar correctly uses the downflow densities for the FSM-881 and FSM-BCR to model machinable and automation mail, respectively. USPS-T-26 at 33.

Witness Seckar makes use of a number of library references to provide the most recent inputs into the cost models. The Standard Mail (A) Regular Rate (LR-H-105) and Nonprofit (LR-H-195) mail characteristics studies provide key inputs in the form of the distribution of Standard Mail (A) non-barcoded flats mail between the

machinable and nonmachinable categories. *See, e.g.*, LR-H-134 at Section 1 page 3, at Section 3-5 page 5; *cf.*, Tr. 4/1877-79. Witness Seckar's reliance upon this input allows for an accurate estimation of nonautomation costs that correctly represents the machinable and nonmachinable mix of nonautomation flats based upon the most recent data the USPS has available.

The respective mail characteristics studies are also used to generate another key input to witness Seckar's analysis, the mail entry compositions. USPS-T-26 at 25-26. The mail characteristics are used in two different ways to develop different sets of mail entry compositions for each Standard Mail (A) subclass of flats mail, the actual mail makeup and the constant mail makeup. The first set examines the actual makeup of all classes of flats mail according to the actual data within the mail characteristics studies and generates costs accordingly. This treatment preserves the uniqueness of the automation and nonautomation mail entry compositions such that all cost differences between automation and nonautomation mail are captured.[2] The second set relies upon a constant mail makeup for the generation of Standard Mail (A) flats costs that examines only the difference the mailer-applied barcode has on mail processing costs. USPS-T-26 at 12-13.

Witness Seckar makes significant refinements to the development of accurate productivity inputs to treat the FSM-881 and FSM-BCR operations as separate. Specifically, he uses FY93 MODS data to reflect accurately the FSM-881 keying

---

[2] These cost differences include those that result from different worksharing activities, different eligibility requirements, and different density makeups. USPS-T-26 at 13.

environment, and the application of an adjustment ratio to these productivities to reflect a pure scanning environment for the FSM-BCR. USPS-T-26 at 30.[3] Witness Seckar continues to treat FSM processing of automation and machinable flats mail processed manually through the incoming secondary distribution operation at plants with FSMs as it was in Docket No. MC96-2, USPS-T-4. USPS-T-26-27. This treatment relies on separate productivities for manual distribution to FSM and non-FSM zones. Non-FSM zones, or synonymously -- nonautomation zones, are defined as 5-digit zones with fewer than ten delivery routes or zones at non-FSM facilities. Tr. 4/1883-84 (response to TW/USPS-T26-4(c)). Use of these separate productivities correctly represents the distribution effort based on the number of breakouts in each zone and therefore accurately portrays the different levels of manual sortation that exist for machinable and automation mail.

b. The proposed passthroughs for the Regular and Nonprofit presort and automation discounts recognize the calculated cost savings while tempering the rate increases for individual rate categories.

Witness Moeller's rate design maintains appropriate incentives for generating low cost mailstreams. Changes in the costing methodology introduced in this docket have affected existing cost differentials. USPS-T-36 at 16-17. Consequently, in order to promote rate stability and minimize the effect of increases on mailers, witness Moeller proposes presort and automation passthroughs that are designed to

[3] The ratio is developed from witness Pham's study of FSMs, USPS-T-2, Docket No. MC91-1. USPS-T-26 at 30.

maintain the discounts between 80 to 90 percent of their existing value. USPS-T-36 at 17-18. The rates proposed by the Postal Service in this docket accordingly preserve the incentives and avoid disruptions in established price signals which have formed the basis for mailers' investment in worksharing planning, infrastructure, and equipment to provide low cost mail to the Postal Service. Tr. 7/3146. Nevertheless, the rate design acknowledges and accounts for the cost differences resulting from the new costing methodologies, and prudently adjusts worksharing discounts in the direction suggested by the studies.

The presort passthroughs witness Moeller proposes are derived by use of the "presort tree" proposed by witness Mitchell and adopted by the Commission in Docket Nos. R90-1 and MC95-1. Docket No. MC95-1 ¶ 5640; Docket No. R90-1, USPS-T-20 at 109-09; USPS-T-36 at 16; Tr. 6/2782. The presort tree applies passthrough percentages for each letter presort level and for each letter-nonletter differential. Using the presort tree, the shape differential at each presort tier, along with the letter presort passthroughs, determine the nonletter presort passthroughs. For the Regular subclass, witness Moeller proposes presort passthroughs of 167 percent for letters and 78.3 percent for nonletters. USPS-T-36 at 48. These proposed presort passthroughs are reasonably designed to maintain the discounts at approximately 80 percent of their existing value. USPS-T-36 at 17-18. For Nonprofit, witness Moeller proposes presort passthroughs of 90 percent and 66 percent for letters and nonletters, respectively. USPS-T-36 at 35, 49. The Nonprofit presort passthroughs,

which closely approximate those recommended in Docket No. MC96-2, serve to "temper[] the increase on any one category." USPS-T-36 at 35.

Witness Moeller's automation passthroughs promote stability and maintain appropriate rate relationships. For Regular, the automation passthroughs range between 100 percent and 135 percent. USPS-T-36 at 18-19, 48. For Nonprofit, the automation passthroughs range from 90 percent to 160 percent. USPS-T-36 at 35-36, 49. These proposed passthroughs serve the dual purpose of mitigating the rate changes on individual categories and preserving a measure of rate stability.

No participant has challenged the presort and automation passthroughs in Regular and Nonprofit. The Postal Service accordingly urges the Commission to follow the guidelines witness Moeller incorporates into his rate design, and recommend the proposed discounts proposed by the Postal Service.

4. The Postal Service's letter and non-letter density and automation discounts in the ECR and NECR subclasses fairly balance the considerations of degree of mailer preparation, rate incentives, simplicity, and impact of rate changes on mailers.

The proposed rates for ECR and NECR clearly have been carefully designed to promote multiple, sometimes competing, objectives. The preeminent concern embodied in witness Moeller's rate design for ECR is rate stability for individual categories. In recognition of lower volume variable costs for NECR, however, most rates in this subclass are proposed to *decrease*. USPS-T-36 at 29.

a. Measurement of the presort- and automation-related cost differences should be adopted by the Commission.

i. Witness Daniel's development of automation cost differentials in ECR and NECR is comprehensive and accurate.

Witness Daniel follows the Commission's methodology adopted in Docket No. MC95-1 and MC96-2 to determine the unit mail processing costs for ECR and NECR Automation letters. Witness Daniel begins by modeling the cost to sequence the subset of Automation carrier route letters that are processed at sites equipped with CSBCSs. USPS-T-29 at Appendix I, pp. 9-10. To calculate the additional unit mail processing costs, witness Daniel uses updated coverage factors, productivities, piggyback factors, wage rates, and premium pay factors. Witness Daniel then adds this additional cost to the average Basic ECR letter unit cost to determine the total unit mail processing cost for Automation carrier route. Exhibit USPS-29C at 2, 4. No party in this case has proposed changing the proposed automation discount ECR and NECR. The Postal Service accordingly urges that witness Daniel's cost estimate and methodology for Automation carrier route be adopted.

ii. Witnesses McGrane and Daniel present a more advanced and comprehensive measure of ECR and NECR mail processing cost differentials.

A significant advancement in the analysis of carrier route mail processing costs is also presented in witnesses McGrane's and Daniel's testimony. Previously, the mail processing cost differential between the ECR and NECR presort tiers was assumed to be zero. *See, e.g.,* Docket No. MC95-1, USPS-T-36 at 29. A new

analysis of IOCS tallies performed by witness McGrane, however, shows that ECR categories exhibit different mail processing cost characteristics. Exhibit USPS-44A. Witness McGrane's analysis separates carrier route mail processing costs into four components for each carrier route subclass: Basic carrier route ("non walk-sequenced endorsed") and combined High Density and Saturation ("walk-sequenced endorsed") for letters and nonletters. Exhibit USPS-44A. Witness Daniel then undertakes to normalize witness McGrane's findings to account for the dropshipment profile of walk-sequenced endorsed categories. Exhibit USPS-29D.

The results confirm that the mail processing costs of denser carrier route mail are lower than those for the Basic tier. Exhibit USPS-29D. These differences in mail processing costs, along with differences in delivery costs, properly form the basis for witness Moeller's rate design for carrier route categories. Witness Crowder affirms that this approach "represents an improvement in both tracing costs to underlying mail characteristics and ratemaking efficiency." Tr. 34/18332. The use of this new analysis in the rate design serves the Commission's interest in better aligning rates with costs. The proposed discounts, along with the underlying methodology, accordingly warrant adoption by the Commission.

b. Witness Moeller's proposed basic tier shape passthrough serves important operational objectives.

In this proceeding, witness Moeller follows the Commission's Docket No. MC95-1 recommended classification structure for the ECR subclass by preserving letter categories in ECR. USPS-T-36 at 27. For the high density and saturation tiers,

witness Moeller proposes sharp increases in the shape differential between letters and nonletters to better reflect the measured cost differences. Tr. 6/2782. In particular, witness Moeller proposes to increase the high-density shape differential by 100 percent, from 0.5 cent to 1.0 cent, and the saturation shape differential by 75 percent, from 0.4 cent to 0.7 cent.

For the basic density tier, however, witness Moeller offers a compelling justification for minimization of the shape differential. Continuation of a letter-nonletter differential would stymie efforts to sequence more letter mail on automation. By minimizing the differential, the ECR basic letter rate is proposed to be 0.4 cent higher than the Automation 5-Digit letter rate. This rate relationship facilitates the migration of letters with the density for ECR basic to the Automation 5-Digit category in Regular. Tr. 6/2814. The proposed rate design is reasonable, and serves to balance "the Commission's concern for recognition of cost differences while giving special consideration to the Postal Service's concern regarding its letter automation program." USPS-T-36 at 27-28.[4] Changes in mail processing have tipped the scales in this consideration and make it more compelling that the proposed rate relationship be established. Tr. 6/2872-73. No participant has challenged the shape passthrough in the ECR and NECR tiers, and the record offers ample justification for the proposed rate design.

---

[4] Witness Moeller further explains that the proposal to set the shape passthrough at zero is superior to the alternative of eliminating the basic letter category altogether, since "distinctive preparation requirements by shape" would continue to apply to basic category letter-size pieces. Tr. 6/2796.

c. The proposed passthroughs for the ECR and NECR density and automation discounts recognize the calculated cost savings while remaining sensitive to the rate increases for individual rate categories and relevant rate relationships.

Witness Moeller's rate design for the carrier route subclasses employs the presort tree to determine the appropriate passthroughs. As in case of the Regular subclass presort tree, in the carrier route tree, selection of the density passthrough and density tier-specific shape differentials generate the nonletter density passthroughs for the high-density and saturation tiers.

Witness Moeller offers numerous, compelling justifications in favor of the proposed carrier route rate design. For ECR letters, witness Moeller proposes passthroughs of 95 percent and 100 percent for the high-density and saturation tiers, respectively. USPS-T-36 at 29, 48. For nonletters, however, by operation of the presort tree, the proposed passthroughs are substantially lower: 40 percent for the high-density tier and 72 percent for the saturation tier. USPS-T-36 at 29, 48. Witness Moeller explains that the relatively low passthroughs for nonletters are reasonable, since passing through more of the cost savings would cause the nonletter basic rate category increase to rise even more significantly. USPS-T-36 at 29.

For NECR letters, witness Moeller proposes passthroughs of 95 percent and 100 percent for the high-density and saturation tiers, respectively. As in the case of the corresponding commercial subclass, the presort tree generates substantially lower nonletter passthroughs: 41.6 percent for high-density, and 76.9 percent between

high-density and saturation. USPS-T-36 at 49. Witness Moeller explains that the proposed NECR passthroughs are reasonably designed to facilitate the appropriate rate relationship between the Basic tier and Nonprofit 5-Digit automation. USPS-T-36 at 40-41.

For ECR and NECR automation basic, witness Moeller proposes passthroughs of 110 percent and 120 percent, respectively. USPS-T-36 at 28, 49. Witness Moeller explains that the 110 percent passthrough for the ECR automation rate category mitigates the increase for that category, which is proposed to receive an above-average increase of 7.5 percent. USPS-T-36 at 28. The 120 percent passthrough for NECR automation basic serves to mitigate the increase on that category, which, incidentally, is the only category to receive an increase within NECR. USPS-T-36 at 41, 49. In addition, witness Moeller justifies the passthrough on the grounds that it maintains the appropriate relationship with Nonprofit 5-Digit Automation. USPS-T-36 at 41 n.54. Specifically, he explains that the automation basic NECR rate should be lower than Nonprofit 5-Digit rate, *id*; otherwise, there would be no rate incentive to use Automation ECR Basic in lieu of Automation 5-Digit.

The record provides ample support for the proposed carrier route rate design. The Commission should accordingly recommend the Postal Service's proposal.

d. NAA witness Donlan presents no justifiable reason for the Commission to reject the Postal Service's carrier route density discounts.

NAA witness Donlan challenges the Postal Service's density discounts for ECR categories. His three criticisms of the Postal Service's approach are short on substance and lack evidentiary support. First, he claims that the approach used by the Postal Service to calculate mail processing cost savings among ECR density tiers "is not representative of current operating conditions" by not accounting for changes in the unit mail processing cost differential for nonletters occasioned by the implementation of classification reform. Tr. 27/14677-78. Second, he criticizes the absence of confidence intervals for the mail processing cost estimates. Third, he claims that the Postal Service's discounts are exaggerated because they fail to account for savings in delivery for ECR Basic letters processed in the DPS mailstream. Witness Donlan's recommendations suffer from internal inconsistencies and would result in rate anomalies.

i. Witness Donlan's conclusion that classification reform resulted in a narrowing of the mail processing cost differentials lacks evidentiary support.

Witness Donlan's criticism that classification reform had the effect of narrowing the nonletter mail processing cost differential suffers from multiple infirmities. Witness Donlan objects to use of the BY costs based upon the fact that the ECR mail processing unit cost differential between non walk-sequenced and walk-sequenced endorsed nonletters narrowed after classification reform was introduced in the 11th AP of FY 96. Tr. 27/14678. Witness Donlan's conclusion is based on the unproven assumption that classification reform should have served to narrow the nonletter

carrier route differential. Indeed, witness Donlan expresses contradictory beliefs in this regard. In his direct testimony, witness Donlan concludes that "available data indicates that reclassification has affected ECR mail processing costs." Tr. 27/14677. His responses to interrogatories, however, reveal far more equivocation on this point. In response to USPS/NAA-T2-1(c)(iv), he states that the change in the pre- and post-reclassification nonletter mail processing cost differentials "*suggest[]* that reclassification *may have* affected mail processing costs." Tr. 27/14686 (emphasis supplied). Furthermore, in his response to USPS/NAA-T2-2, witness Donlan is unable to offer an explanation for the narrowing of the differential: "I did not attempt *to explain the causes of the unit cost differences reported in Table 5 of my* testimony." Tr. 27/14688. Witness Donlan simply cannot establish a nexus between classification reform and a narrowing of the mail processing cost differential for nonletter carrier route categories. In the absence of proof of such a nexus, witness Donlan's testimony amounts to little more than idle speculation.

Indeed, there is no reason why classification reform should have narrowed the *mail processing* cost differential for ECR nonletters. Witness Donlan's suggestion that classification reform "may have affected" the ECR nonletter mail processing cost differential is in direct conflict with witness McGrane's testimony. Witness McGrane explains that the major changes for ECR implemented in connection with classification reform include a change in endorsements, traying requirements for letters, *optional pallet makeup at 250 pounds, and line of travel sequencing for Basic* carrier route mail. Tr. 15/7667. None of these changes should have affected the

mail processing cost differential for carrier route nonletters. *See* Tr. 15/7771. The only significant change that was specific to the Basic ECR category was line of travel sequencing. Yet witness McGrane confirms that line of travel sequencing is unrelated to unit ECR mail processing cost differentials for nonletters:

> whether the basic mail is presented in line of travel or not really shouldn't have much of an impact on mail processing cost, which was the basis for my study.

Tr. 15/7761. Witness Donlan concedes, moreover, that he has no explanation as to how classification reform could have affected the mail processing cost differential. Tr. 15/14686.

In addition, witness Donlan's criticism that classification reform is responsible for a narrowing of the nonletter mail processing cost differential is based upon a relatively unreliable comparison of pre- and post-reclassification costs in the BY. *See* Tr. 34/18345. Classification reform was implemented on July 1, 1996, 70 days before the termination of the base year used in witness McGrane's ECR cost analysis. Tr. 27/14686; Exhibit USPS-44A. As such, witness Donlan's criticism is founded upon a comparison of mail processing costs from the last 70 days of the BY with mail processing costs from the remainder of the BY. Tr. 27/14686; 34/18333. Witness McGrane affirms that this sort of comparison is contrary to accepted practice:

> generally, for mail processing costs, we rely on an entire base year for developing costs and that looking at a 2 1/2 AP period is not standard practice for the cost systems.

Tr. 15/7763. Witness Crowder echoes this criticism. She affirms that "the partial-year data are clearly less reliable than the base-year data developed by witnesses

McGrane and Daniel." Tr. 34/18345. Witness Crowder agrees that "a full year of data . . . is substantially more reliable . . . ." Tr. 34/18340. One could easily conceive of a variety of explanations as to why the cost differential for the 70 day period falling at the end of the BY differs from the cost differential computed for the remainder of the BY, such as seasonality effects or differences in dropshipment behavior. Tr. 34/18344. Yet for witness Donlan to suggest that classification reform is responsible for this phenomenon is no more believable than blaming the rooster for sunrise in the morning.

Even if witness Donlan's testimony is to be given any credence, his criticism is, as a practical matter, negated by witness Moeller's modest nonletter passthroughs for density. Witness Moeller's density passthroughs for nonletters are both well below 100 percent: 40 percent between Basic and High Density and 72 percent between High-Density and Saturation. USPS-T-36 at 29, 49; Tr. 34/18338. Because the density passthroughs are so low, witness Crowder affirms that the delivery cost differential of 2.353 cents *alone* is sufficient to maintain the Saturation discount of 2.3 cents. Tr. 34/18337-38. The implication of this is, of course, that one could completely ignore the mail processing cost differential for ECR demonstrated in witness McGrane's testimony, and maintain the same discount for saturation proposed by the Postal Service based on the delivery cost differential alone. Thus, as a practical matter, even if witness Donlan's criticisms were to be believed, they are inconsequential.

ii. *Mail processing cost estimates are not unreliable.*

Witness Donlan's criticism that the Postal Service has not provided "standard errors" for the "unit cost estimates," Tr. 27/14691, deserves no weight. His criticism is based upon the assumption that the Postal Service had the choice of providing "supporting evidence that *the cost estimates* produced [by the Postal Service] are reliable." Tr. 27/14676 (emphasis supplied). In fact, standard errors *cannot* be calculated for the unit cost estimates, since they are calculated using a combination of sampling and non-sampling data systems. Tr. 15/7697, 15/7710. It must be emphasized, moreover, that while witness Donlan is prepared to attack the Postal Service's mail processing cost differentials for ECR on the basis of the absence of a statistical measure of uncertainty, witness Donlan draws sweeping conclusions on the basis of 70 days' worth of "post reclassification" data in the BY, for which he provides no statistical measure of reliability. Tr. 27/14678; Tr. 34/18344-45.

iii. Delivery costs account for DPS savings.

Witness Donlan's criticisms regarding the measurement of DPS savings for ECR letters is based on the erroneous and unquantified assumptions. The essence of witness Donlan's criticism is that the Postal Service has ignored any "offsetting delivery cost savings for DPS" for ECR Basic tier letters. Tr. 27/14679-80. This, he reasons, results in total cost differentials that "overstate the actual cost difference between basic and high-density/saturation letter mail." Tr. 27/14680. These criticisms deserve no weight.

First, it is important to point out that the Postal Service's delivery costs account for savings in delivery accruing as a result of automated delivery point sequence sortation, to the extent that there are any. Tr. 34/18342-43 & n.2. Witness Hume's delivery costs implicitly include any savings in delivery resulting from automated delivery point sequence sortation for *all* nonautomation category ECR letters, whether walk-sequenced or non walk-sequenced. Tr. 34/18341-42; Tr. 34/18403. Any such savings would be reflected in lower delivery costs reported by IOCS data. Tr. 34/18341-42; Tr. 34/18401. Witness Crowder explains, "to the extent there are DPS savings for [nonautomation] ECR letters, [witness Hume] has included them in the base and test year unit delivery costs for each non-automation-rate ECR letter category." Tr. 34/18342. Thus, it is wrong to suggest that the Postal Service has not accounted for any offsetting savings in delivery for DPS for nonautomation ECR letters.

Assuming that witness Donlan's criticism is intended to convey that the Postal Service has not accounted for offsetting DPS savings separately by density tier, his criticism is based upon two assumptions that are unsupported on this record. The first is the absence of evidence proving the existence of DPS savings for nonautomation Basic letters. As witness Crowder observes, the Postal Service may be processing nonautomation ECR letters for the benefit of other letters in the system, "rather than to increase cost savings" for nonautomation ECR letters. Tr. 34/18343 n.2. The second assumption is that nonautomation basic letters and high density/saturation letters exhibit different DPS delivery cost savings characteristics.

Witness Donlan must be assuming that basic tier letters are processed on automation to delivery sequence in greater proportion than high density/saturation. Otherwise, there would be no reason to calculate explicit delivery savings for the Basic tier. The record offers absolutely no quantitative support for this implicit assumption, since there is no estimate of the proportion of nonautomation ECR letters processed to delivery sequence on automation *for each density tier.* Tr. 34/18404. Instead, witness Crowder observes that her review of the record shows that "it appears that basic-rate and walk-sequenced ECR letters were . . . automated in the base year." Tr. 34/18340.

iv. *Witness Donlan's recommendations result in* arbitrary and unreasonable outcomes.

In lieu of using the Postal Service's cost differentials for ECR discount categories, witness Donlan advocates that the "Commission maintain the current discounts for these categories of mail." Tr. 27/14669; Tr. 27/14693-94. The practical effect of witness Donlan's recommended discount proposal results is an anomalous rate structure, as shown in Attachment 1 to USPS/NAA-T2-5, Tr. 27/14695. For instance, if the Docket No. MC95-1 discounts are used in lieu of those proposed by the Postal Service, the saturation letter rate would exceed the rate for saturation nonletters. Tr. 27/14696. This outcome apparently led witness Donlan to retreat in written cross-examination from his recommendation that the old discounts be maintained:

> I do not recommended [sic] a particular rate structure for Standard A ECR mail in my testimony. The ECR rate structure is likely to be affected by many other issues outside the scope of my testimony.

Tr. 27/14694. This statement, of course, contradicts his testimony, where he advocates maintenance of the existing discounts. Based upon these conflicting statements, it is impossible to discern what precisely he recommends the Commission do. In any event, even if witness Donlan's recommendations were taken seriously, witness Crowder convincingly demonstrates that witness Donlan's approach is far more inferior than simply adopting the Postal Service's methodology:

> Given that there are clear density-related mail handling differences, as even witness Donlan's own results show, it is wrong to ignore them and pretend that all ECR letters and non-letter incur the same unit mail processing cost, regardless of density. Costs based on such a false assumption are obviously less reliable than 1996 costs.

Tr. 34/18345. Indeed, nowhere in his testimony does witness Donlan claim that the approach of including mail processing costs in the discounts would not serve to enhance precision in cost attribution. Simply put, disaggregation of the mail processing costs is far superior to the *status quo*.

e. Witness Haldi's "bottom up" approach to the ECR rate design should not be adopted.

Val-Pak Direct Marketing Systems, Val-Pak Dealers' Association, and Carol Wright Promotions, Inc. witness Haldi urges that the Commission adopt a novel "bottom-up" costing approach for establishing rates for individual rate categories in the Standard (A) ECR subclass. VP/CW-T-1, Tr. 27/15038 *et seq*; Tr. 27/15199. In theory, witness Haldi's "bottom up" rate design determines the rate for each individual

rate cell by applying a target markup to the average volume variable cost for each individual rate cell. Further adjustments to the initial target rates are then made "through a conscious balancing" of the rate criteria of 39 U.S.C. § 3622(b). Tr. 27/15078.

While the theoretical construct of witness Haldi's proposed rate design may have some logical appeal, adoption of his proposed methodology is not possible at this time. In short, the record does not provide a sufficient basis for the determination of the total volume variable costs for individual rate cells. The record does not provide a firm basis upon which volume variable costs can be computed for individual rate categories from the ground up. As a consequence, this requires the adoption of numerous assumptions, as described by MOAA witness Prescott. *See* MOAA-RT-1, Tr. 36/19505 *et seq.*

Although the Postal Service has chosen not to raise theoretical objections to witness Haldi's bottom up methodology, its position in this proceeding is not intended to be a manifestation or indication of approval of the "bottom up" rate design for the ECR subclass. The Postal Service submits, moreover, that evaluation of the reasonableness and fairness of witness Haldi's rate design can best be evaluated if and when the Postal Service chooses to recognize factors other than mail processing and delivery in determining worksharing discounts for ECR. Until then, the Postal Service urges the Commission to continue to use the rate design methodology employed since Docket No. R90-1, with the improvements proposed by witness Moeller in this docket.

5. The proposed pound rates better recognize the cost effect of weight and the proposed residual shape surcharge, and witness Moeller's use of the PRC-Recommended rate design formula is appropriate.

   a. The proposed modifications to the rate design formula are necessary to incorporate the residual shape surcharge and to allow for a more direct establishment of the pound rate.

For each of the four bulk subclasses in Standard Mail (A), witness Moeller adopts the rate design formula employed by the Commission in Docket No. MC95-1. USPS-T-36 at 8, 23, 33, 39. Witness Moeller proposes two reasonable modifications to the formula, one of which is necessary to recognize the revenue to be derived from the proposed Residual Shape Surcharge. USPS-T-36 at 8, 9-12. Without such modification, the revenue to be derived from surcharge would not be offset by a reduction in the revenue from non-surcharged pieces. No party in this docket has challenged the method by which witness Moeller has proposed to account for the surcharge revenue in the rate design, and the Postal Service urges that this change be adopted.

The second modification is simply a change in the variable for which the formula solves. USPS-T-36 at 8, 13-15. It allows for a more direct consideration of a major rate element, the pound rate, rather than having it determined by the selection of a less-significant rate element, the piece-rate for pound-rated nonletters. USPS-T-36, 11-13.[5] Witness Moeller's proposed use of the rate design formula and the

---

[5] *This is not to suggest that the per-piece rate for pound-rated nonletters is not an* (continued...)

resulting proposed pound rates represent a modest evolution in the rate design for Standard (A) Mail and should be recommended. In lieu of selecting the piece rate for pound rated pieces in the formula, witness Moeller simply proposes to consider relevant information and input the pound rate in the formula to solve for the piece rate for pound rated pieces. For the ECR subclass, the proposed pound rate is 53 cents. Even Dr. John Haldi, who objected to the magnitude of the proposed pound rate reduction in Docket No. MC95-1, deemed the proposed reduction in this docket as "conservative." Tr. 27/15162; Tr. 27/15171-72.

The proposed pound rate for the Regular subclasses reflects a more modest reduction than that proposed for ECR. This modest reduction reflects the diminished, but continuing, role of the pound rate as a proxy for shape change. USPS-T-36 at 15.[6] Also, a larger reduction in the pound rate would increase the piece rates beyond the 10 percent maximum increase guideline followed by witness Moeller. USPS-T-36 at 16.

The proposed pound rate for the Nonprofit subclass is driven primarily by the desire to temper the increases for individual categories. Witness Moeller proposes an increase in the pound rate which is similar to the overall increase for the subclass, 15.1 percent. USPS-T-36 at 2. By increasing the pound rate by a similar amount,

---

[5](...continued)
important rate determinant. It does appear, however, to garner much less attention and controversy than the pound rate.

[6] Indeed, a number parties object to the proposed residual shape surcharge on the grounds that the pound rate serves as a means of obtaining additional revenue from parcels. *See, e.g.,* Tr. 24/12967.

the increase for the piece rates remains nearer the overall increase. USPS-T-36 at 34. Since the overall change in rates for Nonprofit ECR is negative, there is not as great of concern regarding the push-up on the piece rates to fund a reduction in the pound rate. Therefore, a reduction similar in magnitude to the reduction for commercial ECR is proposed.

Multiple factors support witness Moeller's thoughtful and considered evaluation of the appropriate pound rate, or at least the direction and magnitude in which the pound rate should be adjusted. First, the proposed introduction of the residual shape surcharge diminishes the need for the Regular subclass pound rate to act as a proxy for changing shape mix with weight. Regular subclass parcels are generally heavier than flats; consequently, the pound rate has been viewed as a mechanism for obtaining more revenue from parcel-shaped pieces. USPS-T-36 at 15. Witness Moeller's proposed reduction in the pound rate in the Regular subclass is based in part on the concomitant introduction of a residual shape surcharge. USPS-T-36 at 15. In ECR, however, the weight for parcels and flats is about the same, so introduction of a residual shape surcharge is not a basis for the proposed reduction in the pound rate in ECR. USPS-T-36 at 25 & n.37. Thus, to the extent that the existing ECR pound rate is currently justified on the grounds that it is serves as a device for extracting greater revenue per piece from costlier shapes, the pound rate should be reduced even absent a residual shape surcharge, since the ECR pound rate does not act as a proxy to collect revenue from costlier shapes. Tr. 6/2780.

Second, witness Moeller persuasively demonstrates that the current use of the formula results in rates which double with weight for the most finely prepared mail in the subclass. USPS-T-36 at 24-25. This outcome results when the per-piece rate of zero is derived in the formula for that particular pound-rated mail. Although this use of the formula creates the impression that there is no subjectivity in determining the pound rate, it nonetheless implicitly selects a pound rate which results in some nonletters having their rate based solely on weight, with no per-piece component. Nothing on this record compels the conclusion implied by the current formula that costs for saturation nonletters weighing more than the breakpoint do not bear piece-related costs. In fact, the record shows that various components of saturation delivery and mail processing costs can be considered piece-related. *See* Tr. 34/18330. Moreover, the outcome of the formula, as it is currently used, implies the unrealistic proposition that cost varies directly with weight, that is, that the costs of the most finely presorted pound-rated mail are purely weight related. By way of example, this implies that the Postal Service is indifferent, in terms of cost, between delivering one 8-ounce saturation piece, and two 4-ounce saturation pieces. USPS-T-36 at 24. It makes little sense to perpetuate this outcome. USPS-T-36 at 24. It is far more sensible for these pound-rated pieces to bear some per-piece component. Witness Moeller's selection of a pound rate that results in a positive per-piece rate for saturation nonletters achieves that rate design objective.[7]

---

[7] Adaptation of the formula is not absolutely necessary for that objective to be met. The per-piece rate for basic pound rated nonletters could be selected so that the (continued...)

Third, a new cost study, presented by witness McGrane (USPS-ST-44), provides compelling support for the proposition that costs do not increase with weight as dramatically as implied by the current pound rates. Exhibit USPS-44B. The study documents unit volume variable costs for Standard Mail (A) by weight increment using FY 1996 data. While earlier studies of this type have been criticized for not including all cost segments, this new study distributes costs from all segments to weight increment. Exhibit USPS-44B Table 3. Analysis of costs shows that weight and cost do not vary directly; indeed, witness Moeller observes that the study shows that weight plays a "very small role" in ECR costs. USPS-T-36 at 25. In Regular, the weight study suggests that weight is not as significant a cost driver as the pound rate would imply, USPS-T-36 at 16; however, since the pound rate continues to act as a proxy for shape in the Regular subclass, and a further decrease in the Regular pound rate would require a greater corresponding increase in the piece rates to fund a reduction, witness Moeller proposes a small decrease in the Regular pound rate. USPS-T-36 at 15-16.

The results of the weight study are consistent with the weight study presented in Docket No. MC95-1, designated as USPS-LR-MCR-12.[8] The Docket No. MC95-1

---

[7](...continued)
resulting per-piece rate for saturation pieces is not zero. In fact, the Postal Service and the Commission on several occasions departed from the theoretical determination of the per-piece rate in order to avoid a large increase in the pound rate. *See, e.g.,* PRC Op. MC95-1 ¶ 5643; Docket No. MC96-2, USPS-T-9 at 6.

[8] In Docket No. MC95-1, the Commission's Opinion noted that the weight study provided in that proceeding, USPS-LR-MCR-12, was cited by proponents as evidence (continued...)

study also showed a relatively flat cost curve as weight increases. The same result holds true in Exhibit USPS-44B, especially for ECR. Exhibit USPS-44B, Chart 1. Further confirmation of the study's conclusions is provided by ADVO witness Crowder. She shows that per-pound costs are only a fraction of the proposed ECR pound rates. Tr. 34/18317.

Fourth, the pound rate reduction, particularly in ECR, recognizes that rates should be considered in light of the availability of alternative media. USPS-T-36 at 26; Tr. 6/2791; Tr. 23/12091.

b. Mailers support the ECR pound rate proposal.

Mailers have offered substantial support for the pound rate proposal. Saturation Mail Coalition (SMC) witness Buckel provides industry analysis regarding the pound rate and the need for it to be lower. Tr. 23/12091-2. In particular, witness Buckel explains that rates for pound rated pieces are not competitive. Tr. 23/12091. He further explains that a reduction in the pound rate does not spell doom for

---

[8](...continued)
that a lower pound rate was appropriate. The Commission, however, stated that retention of the Docket No. R90-1 methodology resulted in little latitude in the pound rate. PRC Op., MC95-1, para. 5649. Yet the Commission did not feel restricted in Docket No. R90-1, when it chose a per-piece rate for pound rated mail that resulted in a per-piece rate of 0.3 cent for saturation. Although the Docket No. R90-1 methodology is relatively cost-based, as discussed in more detail below, it would be more cost-based if it were to result in a pound rate for saturation nonletters that did not imply that costs are driven exclusively by the weight of the mailpiece. Witness Moeller's adaptation of the rate design formula in this proceeding provides the latitude to consider the analyses of witnesses McGrane and Crowder that show that the proposed pound rate for ECR is appropriate.

publications currently carried via alternative delivery. In particular, he testifies that reasonable reductions in the pound rate will encourage circulars and community newspapers, and even newspaper total market coverage programs to "consider returning to the mail." Tr. 23/12092.

AISOP witness Otuteye's testimony demonstrates the importance of reasonable ECR rates to small businesses. Tr. 27/14494 *et seq.* Advertising mail serves as a means of stimulating and promoting small business through "cost effective ways to do mass media advertising to geographic zones . . . ." Tr. 27/14504. Witness Otuteye favors a reduction in the pound rate so that businesses like his can expand their market coverage and provide "larger and more varied ads" for business advertisers. Tr. 27/14508.

c. Intervenor criticisms of the proposed pound rates should be rejected.

i. AAPS misunderstands the basis for the proposed ECR pound rate.

AAPS witness Bradstreet misunderstands the basis for the proposed ECR pound rate. He apparently believes there is a significant linkage between the proposed residual shape surcharge and the proposed reduction in the ECR pound rate. He states that, "the appeal [of the residual shape surcharge] is lost if the surcharge is used to reduce an inadequate and anticompetitive pound rate." Tr. 23/12022. When asked if it was his understanding that the residual shape surcharge is being used to reduce the pound rate, he replied that "it is used as a justification". Tr. 23/12041. To the contrary, witness Moeller observes that since the weight of flats

and parcels in ECR is similar, the pound rate should be reduced *even in absence* of the residual shape surcharge. Tr. 6/2780.

Witness Bradstreet also criticizes the weight study presented by witness McGrane. He says that the analysts working on the study deliberately rigged the results, and defined his use of "rigged" as "to manipulate or control, usually by deceptive or dishonest means." Tr. 23/12065-66. He also concludes that the weight study should be disregarded since it "inappropriately includes only in-office cost segments." Tr. 23/12017. In fact, the study includes all cost segments. Exhibit USPS-44B, Table 3.

ii. NAA's criticisms mischaracterize record evidence and defy common-sense.

In lieu of submitting any record evidence challenging witness McGrane's weight study designated Exhibit USPS-44B or witness Moeller's proposed ECR pound rate, NAA instead filed a Memorandum of Law on the Pound Rate for Standard (A) Enhanced Carrier Route Mail less than one week prior to the due date for initial briefs. NAA's criticisms of the cost study presented in USPS-ST-44 center around three major areas: the nature of the data used, data thinness, and assumptions regarding delivery costs. Apart from the fact that NAA has conveniently avoided potential evidentiary challenges to its position, NAA's criticisms of the weight study do not withstand scrutiny and must be rejected. In addition, NAA's criticisms of the rate design are completely unavailing.

(a) NAA's weight study criticisms lack merit.

First, NAA's challenge to the study's character, NAA Memorandum of Law at 12, completely ignores the nature of the data underlying the results. NAA's criticism essentially repeats criticism of the study, first raised by Dr. Haldi in Docket No. MC95-1, that the study lacks a theoretical basis for measuring the cost weight relationship, and that other types of studies, such as simulation studies and regression analysis, should have been undertaken. This argument disregards the fact that one of the principle sources of data for the study is the IOCS. The fundamental purpose of the IOCS is to measure the time required to handle mail. Tr. 15/7724. If heavier mail indeed costs more to handle than lighter mail of the same subclass, this relationship would manifest itself in IOCS costs. Thus, the IOCS serves as a reasonable tool for performing an analysis of the effect of weight on cost.

NAA's insistence that a "better study" is needed before any modification is made to the current pound rate serves as nothing more than an unnecessary delay tactic. NAA Memorandum of Law at 12. Given NAA's position in its Memorandum regarding the use of the formula and the mechanistic determination of the pound rate, why NAA even insists upon a "better study" is completely puzzling. One may reasonably question what use NAA would suggest be made for such a study, since NAA contends that the Commission should continue to use the formula in a manner that would result in a zero piece rate for pound-rated saturation mail. If the formula's use dictates the pound rate, then any "better study" would be absolutely useless. In

any event, NAA ignores the fact that the Postal Service did investigate alternative means of studying the weight-cost relationship.[9]

NAA's second criticism that the data in the weight study are too thin, NAA Memorandum of Law at 12-17, misinterprets the Postal Service's use of, and its conclusions drawn from, the study. Most of these arguments are leveled against the mail processing costs of ECR mail, and focus on comparing the unit costs between adjacent weight increments. *See generally* NAA Memorandum at 12-17.[10] This focus is misplaced, because the Postal Service has not represented that the study is intended to serve as means of estimating the unit costs for any particular weight increment. Tr. 6/2996; 15/7657. Witness McGrane clearly explained that "the study . . . *was not intended to measure specific cost relationships between individual weight* cells, but rather to provide the overall relationship between weight and cost for Standard Mail (A)." Tr. 15/7657. Specific costs for each weight increment would have no practical value, since the pound rate is set at single value for pound rated mail, which implies the pattern of costs across all weight increments is more relevant than estimated costs reported for any given individual weight increment. Tr. 15/7714;

---

[9] These efforts did not bear fruit, however, due to the large number of assumptions necessary to study this relationship. Tr. 15/7775-76. Witness McGrane volunteered, however, that the preliminary results showed less of a relationship with weight than that IOCS based study. Tr. 15/7826.

[10] NAA's focus on the variations misses the point. Witness McGrane explains that the fluctuations upon which NAA directs its attention "are relatively small given the magnitude of the pound rate." Tr. 15-7791.

Tr. 15/7749. Furthermore, witness Crowder has shown that this pattern has remained stable for many years. Tr. 34/18314-15.

NAA's third criticism relates to the reasonableness of the study's assumption that delivery costs are related to pieces, as opposed to weight. This criticism overlooks the fact that rural carrier costs, which constitute 41 percent of ECR delivery costs, Tr. 34/18330, are directly related to pieces. NAA also alludes to the possibility that elemental load costs are weight-, as opposed to piece-related, as the study assumes. NAA Memorandum at 18. NAA jumps to the conclusion that since the effect of weight on elemental load has not been studied, it must be related directly with weight. The record in this docket offers no evidentiary support for this proposition. This conclusion is also contrary to common sense. As witness McGrane states, "elemental load consists of the carrier reaching into the satchel and fingering the mail that he needs to deliver to that particular receptacle, lifting it out and placing it in the receptacle." Tr. 15/7780 It is obviously a piece related cost.

NAA also places undue reliance upon witnesses Bradstreet's and Nelson's testimonies. Although NAA is correct that witness Nelson's states that route driving time costs are related to weight because additional stops are required for heavier mail, USPS-T-19 at 6, such costs constitute a tiny percentage of the commercial ECR city carrier street time costs. Exhibit USPS-5A at 29. Thus, the fact that driving time costs are weight related does not undermine the assumption used in the weight study. NAA's reliance upon witness Bradstreet's argument adds little more to the equation. Witness Bradstreet argues that, as weight increases, more time is required

to return to a vehicle and load mail into a satchel. Tr. 23/12011-15. Witness Crowder thoroughly and convincingly rebuts witness Bradstreet's claims on this point. Tr. 34/18325-30. Even accepting witness Bradstreet's argument at face value, much of the costs he identifies are already covered by the driving time costs described by witness Nelson, which, as stated above, constitute a tiny fraction of total ECR city carrier street time costs. Exhibit USPS-5A at 29. The remainder is covered by the street support component, which is a small percentage of city carrier street time costs. Exhibit USPS-5A at 29. In addition, both witness Nelson's and Bradstreet's analyses are confined to foot routes, which account for 75 percent of volumes delivered by city carriers. Tr. 34/18331. In sum, NAA misplaces reliance upon witnesses Nelson's and Bradstreet's testimonies in challenging the study's use of piece volumes as a distribution key for city carrier street time costs.

(b) NAA's rate design criticisms lack merit.

NAA's contention that there is "no doubt" that the Postal Service seeks through the proposed reduction deliberately to encourage the shift of advertising dollars away from newspapers and into direct mail is extreme hyperbole. NAA Memorandum of Law at 2. Contrary to NAA's implication that the pound rate is proposed to be reduced solely for competitive reasons, the Postal Service provides several reasons for the proposed pound rates for Standard Mail (A). Only one of those reasons concerns alternative media, and it merely states that the rate structure should consider prices of alternatives. USPS-T-36 at 24-26.

NAA's contention that the Postal Service has arbitrarily chosen the pound rate and the per piece rate for saturation mail displays a gross misunderstanding of how the rate design formula works. NAA Memorandum of Law at 3-4. NAA overdramatizes the modification that witness Moeller makes to the Commission-accepted rate design formula and implies that Moeller's usage of the formula is less cost-based than the Commission's usage. The proposed usage of the formula is arguably more cost-based since analysis and judgment are used is determining the pound rate rather than relying on an algebraic solution. USPS-T-36 at 24-26. There is nothing more inherently cost based about the Commission's usage of the formula as opposed to Moeller's usage. The only difference, other than the pound rate calculation, was that the Commission used as a starting point a zero per-piece rate for pound rated saturation mail. The cost basis for this starting point is presumably that there are no piece-related costs for pound-rated saturation mail, a notion which seems implausible, and, in fact, is contradicted on the record. Tr. 34/18330-31. Alternatively, witness Moeller's usage results in a positive per-piece rate for saturation pieces which would appear to be more realistic since it recognizes that indeed there are piece-related costs for this mail.

NAA lists several intervenor witnesses who addressed the pound rate in direct or rebuttal testimony, NAA Memorandum of Law at 6, but curiously fails to list Val-Pak witness Haldi[11] who, independent of the weight study presented by witness

[11] Witness Haldi is, curiously enough, listed in a paragraph of witnesses "critical of the proposed ECR reduction and its rationale" despite his declaration that the pound rate reduction is conservative.

McGrane, declares the proposed pound rate to be "conservative." Tr. 27/15162; Tr. 27/15171-2. Witness Haldi's conclusion is particularly illuminating in that he expressed opposition to the magnitude of the pound rate reduction in Docket No. MC95-1 (VP-T-1), and, to the extent that Val-Pak mails piece-rated pieces, might stand to gain from a higher proposed pound rate. NAA also relegates the analysis of ADVO witness Crowder which supports and strengthens witness McGrane's study to a mere footnote. NAA Memorandum of Law at 6.

NAA's lengthy discussions regarding the First-Class additional ounce rate and its relationship to the ECR pound rate are primarily an attempt to rekindle the old First-Class versus third-class battle. NAA states that "the Postal Service's targeting of a unjustified rate reduction for selected ECR mailers, while continuing to burden First Class mail, is a clear example of a federal agency that has lost sight of its purpose," NAA Memorandum of Law at 21, implying that, somehow, the "burden" on First Class would be lower if the pound rate was not proposed to decrease. The determination of the pound rate in ECR has no effect on the rates for First-Class Mail. A higher proposed pound rate in ECR would not, given witness O'Hara's target cost coverages, result in lower First-Class Mail rates. There is simply no linkage, a fact of which NAA is apparently ignorant.

6. The proposed residual shape surcharge addresses concerns expressed by the Commission and is the latest step in the march toward more cost-based rates.

In this proceeding, the Postal Service has provided a wealth of information to respond to the Commission's concerns raised in Docket No. MC95–1 that the Postal

Service expeditiously propose a "comprehensive parcels proposal with supporting information." PRC Op., MC95–1 ¶ 5569. In Docket No. MC95-1, the Commission identified a "serious equity problem" based upon its review of information showing that average revenue for Standard Mail (A) parcel-sized pieces was less than the average cost for those pieces. PRC Op., MC95-1 ¶ 5559. The Commission concluded that flats and parcels within Standard Mail (A) "do not form a homogeneous grouping of mail" in view of disparities in the cost for these shapes. PRC Op., MC95-1 ¶ 5560. The Commission determined, however, not to recommend classification and rate changes due to the absence of information on the revenue and volume effects, and the "substantial uncertainty" regarding "how to define new parcel rate categories and on how to set the rates." PRC Op., MC95-1 ¶ 5562-63. The Commission accordingly determined to defer the matter for a reasonable limited time in order to give the Postal Service the opportunity to complete its analyses of parcel costs and market characteristics. PRC Op., MC95-1 ¶ 5565. The Postal Service has responded to these requests in this proceeding through its proposal for a residual shape surcharge.

The Postal Service proposes a 10-cent surcharge for all Standard (A) pieces that are not letter or flat shaped, or are prepared as parcels. Tr. 6/2819. This surcharge recognizes new cost data confirming that these pieces exhibit substantially higher costs than flat-size pieces. *See* Testimony of witness Crum, USPS-T-28. The 10-cent surcharge represents an implicit passthrough of 28.6 percent, the second

lowest passthrough in the Standard Mail (A) rate design. Tr. 6/2818.[12] This measure promotes fairness and equity by lessening the rate averaging that occurs between these shapes and flat- and letter-size advertising pieces. Tr. 6/2740. The proposal is, moreover, consistent with the Commission's recognition that shape differentials "promote more cost based rates . . . ." PRC Op., MC95-1 at ¶ 5592. By setting a low passthrough for the surcharge, witness Moeller properly balances the need to recognize costs in rates, while remaining sensitive to the impact of the effective rate change on mailers. In addition, the low passthrough is sensitive to the concern that different types of nonflat shapes within the nonletters categories exhibit different cost characteristics. Tr. 6/2740.

a. The proposed residual shape surcharge satisfies the classification criteria of the Act.

The record conclusively demonstrates that the proposal complies with and furthers the classification criteria of the Postal Reorganization Act. Witness Moeller explains that the proposal promotes fairness and equity (criteria 1 and 5) through de-averaging. De-averaging, witness Moeller concludes, is beneficial to the "great majority of Standard Mail (A) users in that they will bear less of the additional costs associated with residual shape pieces." USPS-T-36 at 14-15. In this regard, the

[12] Describing or assigning a passthrough to cost differences between shapes is not without precedent. In fact, the letter/nonletter differential is a prime example of the recognition of shape in the rate design for third-class/Standard A. There, too, the pieces in each shape grouping are not necessarily of the same weight, since letters can weigh up to 3.3 ounces, yet nonletters can weigh up to 16 ounces. In fact, in Docket No. MC95-1, the Postal Service and ADVO witness Crowder criticized Val-Pak witness Haldi for passing through 100 percent of the cost differential between the shapes. *See* Docket No. MC95-1, USPS Brief at 260.

proposal also serves to further the Commission's interest in better aligning rates with costs (criterion 1). *See* PRC Op., MC95-1 at ¶¶ 5559, 5592.

The record also demonstrates the proposal's desirability from both the Postal Service's and customers' perspectives (criterion 5). Specifically, this proposal is advantageous for both Standard Mail (A) mailers and the Postal Service, because it serves to reduce the burden borne by advertising letter- and flat-sized advertising mail of the "additional costs of the residual, predominantly non-advertising pieces." USPS-T-36 at 15. Finally, the proposal serves both the Postal Service's and its customers' common interest in simplicity in the classification schedule. The proposal introduces a "reasonable measure" of deaveraging to the Standard (A) classifications "without adding significant complexity . . . ." USPS-T-36 at 15; Tr. 6/2891.

The fact that certain subsets of residual shapes will exhibit cost characteristics below the measured cost difference of residual shapes does not serve as a basis for rejection or further amendment of the proposed rate design. Witness Moeller explains that this outcome is a natural consequence of disaggregation of the type proposed here: "[a]ny line that is drawn to distinguish between two rate categories may well result in subsets of pieces falling on either side of the line that are very similar in cost." Tr. 6/2741. Furthermore, recognition of the average costs of residual shapes through establishment of the surcharge is superior to the *status quo*:

> [t]he proposed surcharge . . . is more compatible with fairness and equity than is the alternative, which is the absence of any surcharge whatsoever and the continuation of a situation where the typical Standard Mail (A) letter or flat is burdened with the higher costs of the residual shape pieces.

Tr. 6/2740-41.

b. Witness Crum provides a conservative estimate of the additional costs due to shape within the non-letter category.

Witness Crum calculated the cost differences within Standard Mail (A) nonletters between parcels and flats, using information from the Permit/Bravis system, RPW, IOCS, and the CRA, in additional to special studies supplying additional data as necessary. Witness Crum estimated a test year cost difference between parcels and flats of 42.4 cents per piece. Because flats are more finely presorted and more deeply dropshipped than parcels, witness Crum adjusted the cost difference to 35.1 cents as his estimate of the test year shape-related volume variable cost difference between Standard Mail (A) flats and parcels. USPS-T-28, at 11-12.

In addition to generally conservative approach witness Crum chose, as described above, many of the specific details of witness Crum's analysis were very conservative, *i.e.*, tending toward understating, rather than overstating, the cost difference between flats and parcels. *Id; see also* Tr. 5/2200, 2267-68 (use of data from the rural and city carrier cost systems resulted in a shift of costs away from parcels to letters and flats, leading to an understatement of the cost difference); Tr. 19E/9850 (use of a simplifying formula to approximate cubic volume for a portion of parcels studied resulted in a smaller cost difference between flats and parcels). Thus, the cost study presented by witness Crum comfortably supports the modest 10-cent surcharge proposed by witness Moeller.

c. The various criticisms of the proposal are without merit.

A number of intervenor witnesses criticized witness Crum's study and witness Moeller's proposed surcharge. As will be shown, these criticisms are without merit. Witness Crum's analysis is reasonable, conservative, and appropriate for the proposed surcharge. The surcharge proposed is eminently reasonable in light of the cost analysis.

i. RIAA *et al.* witness Andrew's criticisms of witness Crum's cost analysis are without merit.

(a) Witness Andrew's comparison of the revenue and cost differences between flats and parcels was not properly conducted.

Witness Andrew attempts to examine the revenue difference between parcels and flats and contends that, to the extent parcels contribute additional revenue, the difference should be offset against the surcharge. Tr. 22/11652. Witness Andrew finds a revenue difference of 24.6 cents per piece and compares that to witness Crum's adjusted cost difference of 33.4 cents per piece, yielding a difference of 8.8 cents, to conclude that the 10-cent surcharge is not justified. Tr. 22/11654, 11657.

On cross-examination, it was demonstrated that witness Andrew had compared costs adjusted to *exclude* the effects of differing levels of presortation and dropshipment with revenues that were similarly unadjusted and therefore *included* those effects. He conceded that a better comparison would be to compare adjusted costs with adjusted revenues, but that he did not have the data to make an adjustment to revenues similar to the adjustment to costs that witness Crum had made and which witness Andrew adopted for his comparison. Tr. 22/11716-23.

As shown by Postal Service witness McGrane on rebuttal, one must compare apples to apples, whether unadjusted costs to unadjusted revenues or adjusted costs to adjusted revenues. Both of these comparisons yield a difference between revenues and costs of almost 16 cents, which comfortably exceeds the proposed surcharge. Tr. 35/18957-61. Thus, if one wishes to make a comparison between costs and revenues as a means of evaluating the appropriateness of the surcharge, a properly performed comparison supports the proposed surcharge.[13]

(b) Witness Andrew is not correct that the cost distribution within the non-MODS pool is flawed, leading to incorrect cost estimates.

Witness Andrew believes that, since variabilities were not estimated for individual operation groups within the non-MODS pool, the cost distribution within this pool is "flawed." He states, "the implicit and unsupported assumption that is made in the use of the MODS system average variability in all non-MODS cost pools is that the mix of costs in the non-MODS offices and the variabilities of these costs must remain the same and the relative magnitudes of the cost pools are equal." Tr. 22/11661. Witness Degen demonstrates that if operation-based pools are defined within the non-MODS offices as recommended by witness Andrew, neither the overall variability estimated for non-MODS offices, nor the distribution of costs to subclass, change to any great degree. Tr. 36/19360-62.

[13] Interestingly, using witness Andrew's definition of a "justifiable surcharge," witness Jellison's cost comparison also supports the proposed surcharge. Tr. 35/18976.

Furthermore, if the remedy proposed by witness Andrew is examined in detail, it is obvious that his attempt to redistribute costs ignores reality and is not credible. In USPS-ST-45 (LR-H-106), the non-MODS costs for Standard (A) flats are $306,279,000 and for parcels are $38,624,000. Witness Andrew's non-MODS costs for Standard (A) flats are $222,604,000 and for parcels are $12,820,000. Since his argument for this redistribution is that the non-MODS variability of 79 percent is not applicable to every individual operation within non-MODS offices, the variabilities that he implies should be examined. Tr. 22/11662. He implies a variability for flats of 57 percent (79% * 222,604 / 306,279) and a variability for parcels of 26 percent (79% * 12,820 / 38,624). These variabilities are simply too low to be believed.

What witness Andrew has ignored is the operational reality behind the relative costs for letters, flats, and parcels in non-MODS offices. Since witness Andrew distributes non-MODS cost in proportion to piece volume, he is assuming that each shape has the same unit cost within non-MODS offices. But letters are almost exclusively sorted to carrier route outside of non-MODS offices, so mail processing within non-MODS offices for letters consists of moving trays of mail from the dock to individual carrier's cases. Only a portion of flat mail is sorted to carrier routes before reaching a non-MODS offices, so some piece sortation of flats to carrier routes occurs within non-MODS offices. Almost no parcel mail is sorted to carrier route before reaching a non-MODS office, so most of this mail will receive a piece distribution before reaching the carrier case. To expect that all three of these shapes would have the same unit cost in non-MODS offices is clearly wrong.

(c) Witness Andrew's criticisms of the parcel density used and his proposal for the use of substitute data are unfounded.

Witness Andrew claims that the Standard (A) parcel density used by witness Crum is overstated. Tr. 22/11665-75. Witness Andrew's contention that 3.3 cents of the cost difference calculated between Standard Mail (A) parcels and flats should be removed because of inaccurate density data should be rejected for several reasons.

(i) Witness Crum uses the most reliable data available.

In USPS-T28, Exhibit K, Table 3, witness Crum uses the data from a density study presented in Docket No. MC95-1 to estimate the average cubic volume for Standard (A) flats. LR-MCR-13. These were the only data witness Crum had available for flats and the study was particularly undertaken with the intention of getting density data for Standard (A) letters and flats. The survey had a reasonable sample of 462 flat containers. *Id.*

Witness Crum uses data from a parcel density study presented in Docket No. MC97-2 (LR-PCR-38) to estimate the average cubic volume of Standard (A) parcels. This study is the best information available on parcel densities. It was specifically stratified to get a representative sample of Standard (A) parcels. Detailed characteristic information was collected on 15,859 parcels from 4,624 mailings during 1996. *See* response of witness Crum to AMMA/USPS-T28-11. The results appeared generally reasonable and consistent and were close to the long calculated density of 7.0 pounds per cubic foot of parcel post. LR-H-2, 1996 Cost and Revenue Analysis Report at 20.

(ii) Use of the Docket No. MC95-1 data, as suggested by witness Andrew, is not appropriate.

Witness Andrew suggests using data from the Docket No. MC95-1 survey for parcel density. That survey was not conducted with the specific purpose of getting parcel data, a very small sample of only 42 parcel containers was taken, the results were provided only in response to an interrogatory, and the data did not appear to be logical given the intuitive mix and known density of pieces in the Standard Mail (A) parcel mailstream. Docket No. MC95-1, Tr. 7/2338; LR-MCR-13, Supp. 1. Witness Andrew's suggestion should therefore be rejected.

(iii) Is there a physicist in the house?

Witness Andrew relies on research on the physics of granular materials to argue that the sampling scheme used in LR-PCR-38 for density estimates would be biased towards less dense pieces, and hence should not be relied upon. He imagines convection currents, with small parcels flowing downward along the outside walls, and large parcels flowing upward in a middle vertical column becoming trapped at the top of BMCs and OTRs. All this continuous movement of mail within containers is purported to be caused by the vibration as containers are rolled around facilities and as they are being transported between facilities.

There is no reason to believe that the density estimates in LR-PCR-38 are biased due to the physics of granular materials. It is preposterous to believe that the normal vibration induced by transporting and processing mail is sufficient to cause convection currents and trapping of large pieces at the top of containers. Witness

Andrew confirms that the research which he cites actually was conducted on disks, beads, poppy seeds, brass spheres, sandpiles, cereal grains, and other small, smooth, semi-round particles. Tr. 22/11684-85. Furthermore, witness Andrew, who *is not a physicist, and has not authored or coauthored any scientific journal articles* on granular physics, Tr. 22/11686, fails to provide any evidence that the theory of granular physics would apply to faceted objects of a size and shape similar to those found in the mailstream when subjected to vibrations normally encountered while transporting and handling mail containers. Tr. 22/11686-87. For these reasons, his arguments concerning granular physics should be completely disregarded.

(iv) No reliance can be placed on RIAA's informal survey.

Similarly, witness Andrew's contention that his informal survey data indicate bias in the Postal Service's methodology to estimate densities of Standard (A) mail is unsupported and wrong. Witness Andrew draws conclusions from "an informal *survey conducted of members of the associations sponsoring Dr. Andrew's* testimony." RIAA *et al.* Trial Brief at 3. Witness Andrew does not attest to the data's accuracy and reliability. Indeed, the survey is not statistically reliable, and witness Andrew's testimony regarding the survey has critical shortcomings.

The informal survey data summarized in witness Andrew's Exhibit 1F lack a minimal acceptable survey design. "The data were provided to [witness Andrew] by counsel for RIAA, *et al.* [Witness Andrew] was not provided the detail of what was asked of each mailer, including the number of mailers asked." Tr. 22/11695. This

informal survey design introduces uncorrected-for sampling and non-sampling bias into the data. This unquantified bias severely degrades witness Andrew's analyses and inferences by increasing variability and uncertainty.

The informal survey data are not statistically sound. The data do not represent the Standard (A) parcel population or all Standard (A) mailers. In fact, no one has provided any analyses that demonstrate that the profile of the "sampled" pieces even remotely depicts the profile of the non-sampled patterns of mailers, products, piece weights, piece dimensions, number of pieces per mailing, total weight per mailing, total pieces per mailing, densities, and total cube. Witness Andrew himself states, "I am unable to form an opinion regarding whether pieces not in the RIAA data *may/ may not* have a significantly different profile." Tr. 22/11695 (emphasis added). Witness Andrew is therefore unable to form an opinion on the 67 percent of the number of parcel pieces and the 55 percent of the parcel weight handled by the Postal Service that are not in the RIAA data. *Id.* One cannot, therefore, form any legitimate opinion on the parcel population based on his sampled data.

Even if the informal survey data had merit, witness Andrew's reliance on it suffers from critical shortcomings. The informal survey included data from 1996 and 1997. *Id.* Combining data from several years is not incorrect, but witness Andrew erred when he compared the data to data that spanned only one year. Witness Andrew should have compared the informal survey's data from 1996 and 1997 to aggregate data from 1996 and 1997 or compared on a 1996 to 1996 basis. Witness Andrew did not correct for this incongruity. As such, his comparison is not reliable.

Witness Andrew shows that the informal survey's average weight per piece is 136 percent of the official USPS parcel average weight. *Id.* He then adjusts the informal survey's average density for this weight differential. This is evidently to take into account the fact that the informal survey's parcels were found to be heavier than the average parcel as reported by the Postal Service. Witness Andrew does not evince a similar concern as to whether the informal survey's parcels were also different in cube than the average parcel in the Postal Service? Because density is a function of both weight and cubic feet, witness Andrew's analysis is lacking in that it does not consider adjusting the informal survey's average density for any cubic differential.

ii. NDMS Witness Haldi's doomsday scenario of "mischief" of repackaging is unlikely.

NDMS witness Haldi predictions of dire consequences due to "massive repackaging of mailpieces now classified as parcels" if a Standard A surcharge is implemented will not materialize. Tr. 23/12145. On the surface, such repackaging would appear to be a favorable outcome since flats are less costly to handle than parcels, but witness Haldi contends that these repackaged pieces would be more costly as flats due to the characteristics of the pieces. Tr. 23/12146. Even if one accepts witness Haldi's contention that these pieces will cost more configured as flats than if they were configured as parcels, there are a number of factors that work to diminish the likelihood of reconfiguration as a means to avoid the 10-cent surcharge.

First, there is some retooling cost associated with repackaging, and it is possible that the alternative packaging itself would be more expensive than the

existing packaging, which witness Haldi acknowledges. Tr. 23/12190. He acknowledges that he has no measure of the costs of retooling and repackaging, Tr. 23/12215, but it is clear that these costs would offset some of the 10 cents the mailer would avoid with repackaging.

Second, mailers who repackage would face higher mail preparation costs. As noted by witness Moeller when citing a DMA report regarding the surcharge, the machinable parcel preparation requirements are much easier than the preparation requirements for flats. Tr. 7/3162. The flat preparation rules require many more separations which translates into higher costs, which in turn will eat into the 10 cents avoided by repackaging as flats.

Third, not only are the preparation costs higher for flats, but preparing pieces according to the requirements for flats leads to increased rates if the mailing is not of significant density to qualify for the 3/5-digit presort discount. As machinable parcels, pieces need only meet the minimum quantity or weight for a BMC service area to qualify for the 3/5-digit discount. Tr. 7/3162. Witness Haldi acknowledges that this could further offset some of the savings from avoiding the surcharge. Tr. 23/12182. The per-piece loss in presort discount would be 6 cents under the proposed rates.

Fourth, mailers may hesitate to reconfigure if their customers prefer to receive parcel-shaped pieces. Under cross-examination, witness Haldi acknowledged that customers may prefer to receive the products they order in boxes rather than some sort of reconfigured flat package. He discussed a scenario where the customer might currently use the packaging as a storage container rather than discarding it, and the

repackaging effort diminishes the ability to use the packaging for storage. Tr. 23/12253. This potential loss of customer satisfaction could also offset some of the monetary gain of avoiding the 10-cent surcharge.

Fifth, customers might also object to the new containerization if it results in unsuccessful delivery of the piece. Witness Haldi raises the point that reconfigured packages might not fit in the mailbox of the mailers' customers. Tr. 23/12148. He also acknowledges that it would be less convenient for the recipient if the piece could not be delivered via the mailbox. Tr. 23/12194. He also acknowledged that one of the benefits of photofinishing services, for example, through the mail is that the recipient need not take the film in to a store, nor retrieve the finished photos. Tr. 23/12261. If the repackaging results in pieces which do not fit in mailboxes, and therefore the photos must be retrieved at the post office, then one of the advantages of photofinishing through the mail is diminished. Mailers might be taking the risk of losing business through repackaging if the resulting packaging causes inconvenience for their customers. This risk would at least partly offset the gain achieved through avoiding the surcharge.

Sixth, witness Haldi acknowledges that one of the possible reactions of the Postal Service to "perversely created cumbersome flats" might be to change the definition of a flat. Tr. 23/12193. In that instance, the investment horizon of the retooling cost would be shortened. One would think that the prospect of a possible change in the definition of a flat such that the reconfigured piece would not avoid the surcharge might dampen the eagerness to repackage, although witness Haldi

believes the mailers would not weigh the possibility of a change in the definition very heavily. Tr. 23/12266.

In sum, there are a number of factors which appear to diminish the gain mailers would achieve through repackaging. If indeed mailers created such "mischief," using witness Haldi's term, Tr. 23/12150, and the pieces were very high cost compared to typical flats, then it would behoove the Postal Service to change the definition in order to protect other mailers of flats which are of average cost. In other words, the mischief might be short-lived.

iii. Despite the intervenors' concern that the increase will result in substantial price increases for certain Standard (A) pieces, the resulting rates are still a bargain in comparison to alternatives.

The intervenors note that the proposed surcharge will cause a significant percentage increase for certain pieces. *See, e.g.,* Tr. 24/12964. These criticisms overlook the fact that the proposed surcharge results in rates which are still favorable when compared to private parcel services, despite the large percentage increase implied. Although PSA witness Jellison was unable to provide the rate paid to UPS for pieces under one pound, he acknowledged that such pieces would be subject to a $1 surcharge if they were delivered to a residence. Tr. 23/13039-40. That surcharge alone is significantly higher than the maximum rate a shipper would pay for a Standard (A) parcel, 84.3 cents. Tr. 23/13039-40. When UPS's surcharge is added to the base rate it charges, the resulting price will greatly exceed the Postal Service's price, even with the residual shape surcharge. Perhaps this rate disparity accounts

for the fact that the Postal Service carries 97.6 percent of these pieces under one pound. Tr. 24/12988.

Not only are Standard (A) rates significantly below private parcel services' rates, they are also significantly different from the Postal Service rates for parcels over one pound. Witness Haldi confirms that, even with the surcharge, the rate for a 15.9 ounce Standard (A) DSCF piece would experience a greater than 100 percent increase if it became a 16.1 ounce Parcel Post DSCF piece and the rates proposed in this docket were applied. Tr. 23/12216-7.

Simply put, the Postal Service's proposed Standard (A) rates, even with the surcharge, are a relative bargain.

iv. Even the information presented in PSA witness Jellison's testimony implicitly supports the propriety of the surcharge.

Witness Jellison provides a Table in his direct testimony purporting to present the Postal Service's figures regarding revenues and costs for Standard Mail (A) by shape. Tr. 24/12971. Yet even the figures presented in his testimony point to the conclusion that Standard (A) parcels fail to cover their costs, thereby warranting a surcharge. Witness Jellison's Exhibit A depicts implicit coverages for groupings of mail by shape. In the absence of a 10-cent surcharge, such pieces would have implicit coverages below 100 percent.[14] By adding 10 cents to the revenue per piece of parcels as reported in witness Jellison's testimony, the implicit cost coverage

[14] *See* Tr. 24/12971 (showing implicit coverages for Regular, ECR, Nonprofit, and Nonprofit ECR at 91 percent, 35 percent, 40.2 percent, and 9.2 percent for NECR).

would become 110 percent for Regular parcels, 17 percent for NECR, 55 percent for Nonprofit, and 57 percent for ECR. Tr. 24/12971.[15] The coverage for Regular parcels would still be well below that of Regular flats (133 percent), and well below the cost coverage of the subclass (152 percent). *Id.* Simply put, it is not unfair to ask parcels to make some contribution to institutional costs, as even witness Andrew confirmed.[16]

7. The proposed destination entry discounts continue to recognize the cost savings due to dropship, while limiting the increase in the basic rates.

   a. Witness Smith's development of destination entry cost differences are comprehensive and unchallenged on this record.

---

[15] The calculation is as follows:

CALCULATION OF IMPLICIT COVERAGES FOR STANDARD (A) PARCELS WITH 10-CENT SURCHARGE USING WITNESS JELLISON'S REVENUE PER PIECE ESTIMATES			
Subclass	Witness Jellison's Revenue per piece + 10 cents	Cost Per Piece	Implicit Coverage
Regular	46.45 + 10 = 56.45	51.3	110%
ECR	15.80 + 10 = 16.80	45.5	57%
Nonprofit	26.50 + 10 = 36.50	138.2	55%
NECR	16.80 + 10 = 26.80	65.9	17%

Tr. 24/12971.

[16] When asked if parcels, as a group, should make no contribution, he said "no." Tr. 22/11701.

Postal Service witness Smith (USPS-ST-46) presents updated cost avoidances for Periodicals and Standard Mail (A) dropshipping in a study designated as USPS LR-H-111. This study supports witness Moeller's, Kaneer's, and Taufique's proposed destination entry discounts Periodicals and Standard Mail (A) subclasses. For Periodicals, the study updates the non-transportation cost avoidance for both commercial and nonprofit, which were most recently presented in Docket No. MC95-1 by witness Byrne (USPS-T-11), and by witness Seckar (USPS-T-2) in Docket No. MC96-2, and adopted by the Commission in those proceedings. For Standard Mail (A), the study updates the transportation and non-transportation cost avoidances for both commercial and nonprofit, which were last presented in Docket No. MC95-1 by witness Acheson (USPS-T-9) and Docket No. MC96-2 in USPS LR-PRR-7, and adopted by the Commission in those proceedings. Witness Smith's study employs the same approach as witnesses Acheson and Bryne in Docket No. MC95-1, and witness Seckar in Docket No. MC96-2, with the exception of changes resulting as a consequence of the development of volume variable mail processing costs presented by witnesses Degen, USPS-T-12, and Bradley, USPS-T-14. The study is sound and uncontested, and should be accepted by the Commission.

b. Witness Moeller proposes passthroughs for destination entry discounts that maintain incentives for dropshipment while limiting the increase in the basic rates.

Witness Moeller proposes reasonable passthroughs for destination entry. Witness Smith's analysis of destination entry costs (USPS-ST-46) shows that destination entry cost savings have increased. USPS LR-H-111; USPS-ST-46.

Witness Moeller accordingly proposes a passthrough of 80 percent to maintain consistency in the discounts. USPS-T-36 at 20. This passthrough still results in increases in half of the destination entry discounts, as shown in the table below.

COMPARISON OF CURRENT AND PROPOSED DISCOUNTS			
CATEGORY	**CURRENT DISCOUNT (cents)**	**PROPOSED DISCOUNT (cents)**	**PERCENT INCREASE IN SAVINGS**
Per Piece			
BMC	1.3	1.5	+15%
SCF	1.8	1.8	0%
DDU	2.3	2.3	0%
Per Pound			
BMC	6.4	7.2	+12.5%
SCF	8.5	8.8	+3.4%
DDU	11.1	11.0	-1%

USPS Request at Attachment B at 15.

Adoption of a higher destination entry passthrough would result in larger increases in for nondestination entry, and would conflict with the rate design's goal of limiting rate increases to 10 percent. USPS-T-36 at 20; Tr. 6/2913. Furthermore, the 80 percent passthrough assuages concern that the per-piece destination entry discounts are inflated by virtue of the fact that they are determined by using the breakpoint weight. Tr. 6/2897. The Commission should follow witness Moeller's rate design, which balances the importance of worksharing with the need to avoid significant rate increases for dropshipped mail.

c. AMMA witness Andrew's proposed entry discounts would result in a substantial rate increase for nondestination entry mail and offer little or no relief to piece-rated dropshipped mail.

AMMA witness Andrew criticizes the proposed dropship discounts because "under Witness Moeller's proposal, mail that is dropshipped will have a greater contribution to institutional costs than mail that is not dropshipped." Tr. 20/10135. This contention, however, contradicts VP-CW Witness Haldi who shows a decreasing contribution per piece for ECR pieces with increasing levels of dropship under the proposed rates. Tr. 27/15066, 15069-70. Witness Andrew also contends that anything less than 100 percent passthrough "is a failure to meet the objective of "maximiz[ing] productive efficiency." Tr. 20/10136. Yet he acknowledges that if the cost avoided by the Postal Service in certain instances is less than the discount claimed, then maximum productive efficiency is not met in those instances. Tr. 20/10155-56.

Witness Andrew's proposed solution to the alleged problem is to pass through 100 percent of the calculated cost savings. Tr. 20/10131. He acknowledges, however, that his proposal would increase the piece-rated ECR non-dropshipped piece rates by one-half cent beyond the increase proposed by the Postal Service. Tr. 20/10152. He further acknowledges that his proposal would result in no change from the Postal Service's proposed rates for piece-rated DSCF and DDU ECR pieces, and an **increase** in the DBMC ECR piece rates over and above the Postal Service's proposed rates. *Id.*

d. The record contains alternative passthroughs that would address intervenor concerns regarding the reduction in the DBMC/DSCF differential.

AMMA Witness Schick explains the importance of the differential between the DBMC and DSCF discount and suggests that the proposed reduction in the differential might have significant consequences for mailers and their dropship decisions. Tr. 27/15236. Notwithstanding, he endorses AMMA witness Andrew's proposal which *also* reduces the DBMC-DSCF differential. Tr. 27/15340. In response to an interrogatory, witness Moeller provided alternative passthrough options that would maintain the differential at the current level, while having little or no effect on the other proposed rates. Tr. 6/2760-61. When witness Schick was questioned about these alternatives upon oral cross-examination, he expressed a preference for maintenance of the existing DBMC-DSCF discount differential at current levels without concomitant rate increases, indicating that would be "optimum". Tr. 27/15249-50. The Commission should consider the expressed importance of the DBMC-DSCF differential when recommending the passthroughs.

8. The Postal Service's proposed Nonprofit and Nonprofit ECR rates comply with the Revenue Forgone Reform Act.

a. Witness Moeller's proposed nonprofit rates adhere to the requirements of the Revenue Forgone Reform Act.

Witness Moeller's rate design conforms to the unique statutory scheme for preferred rate mail set forth in the Revenue Forgone Reform Act (RFRA). Briefly, RFRA establishes a six year phasing schedule beginning in 1994 and ending at the end of test year. Over the course of the six year period, the markup for nonprofit

increases by 1/12 the commercial markup. The result for FY 99 and beyond is that the nonprofit markup would be 1/2 the comparable commercial markup. 39 U.S.C. § 3626(a)(3)(B). The test year in this docket represents the fifth step, with the markup representing 5/12 the corresponding commercial subclasses. *Id.* The Commission, *however, recommends "full" or step 6 rates, while the Postal Service establishes* rates at each step by operation of the temporary authority for reduced rates granted to it under 39 U.S.C. § 3642.

Pricing for the nonprofit categories in this case consisted of conducting rate design exercises that would generate the target cost coverages mandated by section 3626 of the Act. As with the commercial Standard (A) subclasses, witness Moeller uses the modified rate design formula as a basis for the proposed Nonprofit and Nonprofit ECR rates. USPS-T-36 at 33 and 39. In projecting those rates, he takes the floor provision of the RFRA into account, which causes some rates for FY98 to be "full" rather than Step 5 rates. USPS-T-36 at 43. For the Nonprofit and NECR subclasses, witness Moeller's rate design is intended to generate rates that have a markup of 5/12ths of the corresponding TY commercial markup as proposed by witness O'Hara. USPS-T-36 at 43-45.[17]

Although witness Moeller attempts to mitigate the increases for individual rate cells, the overall rate change for each of the nonprofit subclasses is a function of the reported volume variable costs and the RFRA-prescribed markups. In the Nonprofit

[17] The markup for Nonprofit is tied to Regular, and the markup for NECR is tied to ECR.

subclass, the costs and markup result in a significant increase overall for the subclass. USPS-T-36 at 33-34. The Commission is urged to recommend witness Moeller's proposed rates and the guidelines adopted to temper the increase for individual rate categories.

b. NFN witness Emigh expresses frustration with the proposed Nonprofit rates, but provides no other alternative to the Postal Service's proposal which complies with the RFRA.

NFN witness Emigh's frustration with the rates which result from the application of the provisions of the RFRA leads to a misrepresentation of the actual impact on the rates. She provides a tables denoting "asymmetrical" changes in the rates that presumably is intended to show the adverse effects of the proposal on nonprofit mail. Tr. 28/15978-9. The tables are misleading due to several factors. First, witness Emigh admits that the percentage differences are not volume-weighted. Tr. 28/16060. Second, witness Emigh acknowledges that most of the asymmetric changes are in the favor of nonprofits, which obviously favors nonprofit mailers. Tr. 28/16054. Third, witness Emigh acknowledges that not all of the rate categories are included, and that she ignored those categories for which the percentage change was nearly equal for commercial and nonprofit. Tr. 28/16062. Despite the misleading and incomplete nature of these tables, the Postal Service does not contest witness Emigh's contention that Nonprofit rates are increasing by a relatively high amount. Witness Moeller notes that the overall increase is 15.1 percent on the second page of his testimony, and later notes that the increase is due to cost increases and the

RFRA-prescribed cost coverage. USPS-T-36 at 2 and 33-34. Witness Moeller emphasizes, however, that rate design decisions were made to mitigate the increases for individual categories within Nonprofit. USPS-T-36 at 34-36. In any event, witness Emigh does not offer any solution compatible with RFRA for ameliorating what she views as an unwarranted rate increase.

c. Witness Emigh seems to misunderstand the implication of RFRA by suggesting that increases in nonprofit rates are being used to fund a "rollback" of commercial rates.

Witness Emigh's contention that somehow increases in nonprofit rates are being used to fund decreases in commercial rates (Tr. 28/15992) is unfounded and incongruent with the rate development procedure outlined by the RFRA. This is obviously impossible since if an individual commercial rate is "rolled back" (in isolation of other changes in the subclass) that would lead to lower revenue, contribution, and coverage, all else equal. A lower coverage for the commercial subclass would translate to a lower coverage for the nonprofit subclass by virtue of the RFRA. Any effort to suppress commercial rates would have a beneficial effect on nonprofit rates. When asked what the consequence would be on a given nonprofit subclass if the cost coverage for its commercial counterpart were reduced, witness Emigh responded, "I don't know. It would be up to the Commission to determine where to make up the revenue." Tr. 28/16048. Although witness Emigh correctly concludes that the Commission would have to make up the revenue, the Commission clearly could not fund the reduction in the commercial subclass revenue by raising

nonprofit rates. The coverage for nonprofit would have to decrease by virtue of the RFRA.

d. Despite NFN's unhappiness with the increase in nonprofit rates, the Commission has little choice but to follow the RFRA as the Postal Service has in formulating its rate proposal and just as it did in Dockets No. MC95-1 and R94-1.

The implication of the RFRA is that the rates for nonprofit are tied to nonprofit costs, and to the cost coverage for corresponding commercial Standard Mail (A) subclasses. In Docket No. R94-1, this led to significantly lower increases for nonprofit mailers as opposed to commercial mailers, 10.2 percent versus 1.6 percent. PRC Op. Docket No. R94-1 at iii. In Classification Reform, commercial mail rates were calculated on a contribution neutral basis, but nonprofit rates were designed to generate a lower contribution. Tr. 28/15988-9.

E. The Postal Service's Proposed Rates for Standard Mail (B) Should Be Recommended By the Commission as Proposed

In this case, the Postal Service has proposed that the benefits of classification reform and worksharing be extended to those subclasses which had formed the class formerly known as Fourth. Many of these proposals had been made in the parcel classification reform case, Docket No. MC97-2, which was withdrawn by the Postal Service in anticipation of the filing of this case. As in the first classification reform case, Docket No. MC95-1, the rates proposed here are intended "to align the rates more closely with the degree of preparation of mail for entry into the mailstream and the cost-causing characteristics of mail overall," and "provide strong incentives to drive costs out of the system by linking postage rates more closely with cost characteristics."[1]

Extensive new studies of the processing and transportation of Parcel Post provide the most complete picture to date of the costs associated with handling parcels, and permit a rate design which more fully reflects these costs. In summary, the Postal Service's Parcel Post proposal provides customers a broad array of worksharing opportunities. Witness Mayes proposes the following worksharing discounts: OBMC entry, BMC presort, DSCF dropship, DDU dropship, and prebarcoding. These new worksharing opportunities will enable customers to choose those alternatives which best meet their particular needs. Moreover, these options,

[1] Docket No. MC95–1, Request of the United States Postal Service For Recommended Decision on the Classification Reform of First-, Second- and Third-Class Mail at 12.

along with costing refinements and the reinstatement of the "balloon" rate, allow for a more cost-based Parcel Post rate design. While these approaches may appear novel to Parcel Post, they are not new in the formulation of rates and classifications by the Postal Service or the Postal Rate Commission. For instance, SCF and DDU dropshipping incentives are available in Periodicals and Standard A. Barcoding discounts are available for letter- and flat-shaped items already. Even the balloon surcharge exists already in Priority Mail. As such, these proposals are based upon building blocks that have already been applied and found fundamentally sound.

Similarly, the rates proposed for Bound Printed Matter, Special Standard, and Library mail are cost-based. Witness Adra recalculates the rate element for the first pound in Library Mail, which has not been compensatory since 1987, to ensure that it reflects costs.

In addition, new service enhancements such as delivery confirmation and barcode discounts are proposed to make Standard (B) parcel products more convenient and useful for customers. The specific proposals made in this case are described in more detail below.

1. Parcel Post

    a. Witness Mayes's proposed rates for Parcel Post should be recommended by the Commission.

The Postal Service has proposed that the basic structure of Parcel Post established in Docket No. R90-1 remain essentially unchanged, with additional discounts taken from the three main rate schedules, Inter-BMC, Intra-BMC and Destination BMC (DBMC). Unlike in the past, however, the three rate schedules are

based on the transportation costs derived independently in the analysis performed by witness Hatfield (USPS-T-16).

i. The testimony of witness Hatfield represents a significant improvement over the previous methodology for assigning Parcel Post transportation costs to rate category and zone.

The direct testimony of witness Philip A. Hatfield (USPS-T-16) estimates the transportation costs for each rate category of Parcel Post. He presents a new methodology for assigning Parcel Post transportation costs to rate category and zone, which improves the existing method by correcting the current allocation to zone of transportation costs associated with intermediate transportation (between SCFs and BMCs) on the basis of long-haul transportation distances (between BMCs). Mr. Hatfield additionally calculated the transportation costs associated with two new categories of Parcel Post being proposed in this docket, DSCF and DDU dropship.

ii. Using this information, the Parcel Post rate design is largely traditional.

As explained by witness Mayes:

> The rate development process in this docket followed, in large part, the methodologies used by the Commission and previous Postal Service witnesses. The transportation costs as identified by Postal Service witness Hatfield (USPS-T-16), which are incurred primarily on the basis of cube and distance, were distributed to weight and zone separately for intra-BMC, inter-BMC and DBMC, utilizing three independent cube/weight relationships. The rate for each piece includes the two-cent per-pound weight-related nontransportation handling cost applied on the basis of postage pounds to each cell, in keeping with Commission practice. The costs thus allocated through the two-cent per-pound charge were subtracted from the non-transportation costs, and the remaining costs were recovered through the per-piece elements of the rates.
>
> At the conclusion of the rate development process, largely as a result of incorporating the updated transportation cost analysis, the rate changes

> implied for some weight and zone combinations would have been excessive. As both the Postal Service and the Commission have done in the past, the proposed rate design incorporates constraints that mitigate the impact of the rate changes. In keeping with Commission precedent, any revenue loss or gain as a result of instituting the constraints was incorporated into the next iteration of the rate design, thus keeping as close as practicable to the desired revenue and cost coverage.

USPS-T-37, at 4-5.

Similarly, in recognition of the likelihood that some mailers may already be preparing their Parcel Post in such a way that would qualify them for worksharing discounts, witness Mayes incorporated into her rate development the associated cost savings and revenue reductions based on the results of a survey of large mailers, who are the likely users of the discounts. The rates therefore reflect the revenue, cost, and volume adjustments associated with these changes. *Id.* at 5-6. PSA witness Jellison criticized the survey results and offered his own survey of PSA members. Tr. 24/12952-53. Although the PSA survey results were supportive of the concept of introducing the discounts, Tr. 24/12949-50, they were not adequate for use in calculating revenue, volume, and cost adjustments.

Witness Mayes also incorporated the effects of other changes: a shift to Priority Mail of some Parcel Post based on the introduction of packaging service, as described in the testimony of witness Plunkett (USPS-T-3) in Docket No. MC97-5; a loss of Parcel Post volume due to the introduction of the Other Mailable Hazardous Materials Surcharge described by witness Currie in this docket (USPS-T-42); an increase in volume due to the introduction of Delivery Confirmation Service and the expansion of the maximum combined length and girth limitation for Parcel Post, both

proposed in this case; and a change in revenue associated with the proposed change in the pickup fee. USPS-T-37, at 6-7, 22-23.

iii. The Postal Service's treatment of intra-BMC intermediate transportation costs is correct.

Mr. Hatfield proposes significant changes to the traditional treatment of intermediate transportation costs for both inter-BMC and intra-BMC Parcel Post. Witness Luciani takes issue with this proposal as it regards the costs for intra-BMC Parcel Post. Mr. Hatfield recommends that intra-BMC intermediate transportation costs be treated as non-distance related because there is no causal relationship between the actual distance traveled by intra-BMC parcels and GCD, the distance used to calculate zone. USPS-T-16 at 10-11. This proposal is based on the fact that intra-BMC parcels tend to travel from origin SCF to BMC to destination SCF, whereas the GCD measurement is made based on the distance directly between SCFs. *Id.* In this situation, the zone of the parcel is determined by the geographical location of Postal Service processing facilities and not the actual distance traveled by the parcel. *Id.*

Mr. Luciani points out (correctly) that this new treatment of intra-BMC intermediate transportation costs creates a question in intra-BMC and DBMC rate design. Because the destination BMC and the destination SCF of a DBMC parcel define both its transportation path and its GCD measurement, there is a direct causal relationship between transportation cost and zone. USPS-T-16 at 11. For this reason, intermediate transportation costs for DBMC Parcel Post are treated as distance related. The dilemma is that non-distance related intra-BMC transportation

costs, coupled with distance related DBMC transportation costs, result in zone 4 and 5 DBMC Parcel Post receiving more transportation cost per unit than intra-BMC. Tr. 26/14321.

Mr. Luciani's solution to resolving this rate anomaly takes the inappropriate step of doctoring cost data simply to achieve a rate result. In fact, he states: "I recommend for rate design purposes that the transportation costs by zone for intra-BMC Parcel Post be set to be an equal amount (in dollars per cubic foot) below the corresponding total of inter-BMC transportation costs by zone." Tr. 26/14402. He Using this logic, Mr. Luciani could have proposed his desired rates without regard to any cost data put forth by Mr. Hatfield.

Mr. Luciani has argued that witness Hatfield has not "fully justified his position that no intra-BMC intermediate transportation cost should be treated as distance related." Tr. 26/14321. Using a hypothetical example, Mr. Luciani attempts to show that there can be situations where the actual distance traveled by an intra-BMC parcel is correlated to the GCD. Mr. Hatfield acknowledges this point. USPS-T-16 at 10. The reality is that there are no data to indicate the degree of correlation. Mr. Hatfield defended his position that, despite a possible correlation in the data, the fact that there is no causal relationship between intra-BMC actual distance traveled and GCD, dictates that the costs should be treated as non-distance related. Tr. 8/3991-95.

Clearly, it is not appropriate to manufacture cost data to support a desired rate outcome. This is the only argument that witness Luciani has put forward to support

his modification to Mr. Hatfield's transportation cost analysis for the treatment of Intra-BMC intermediate transportation costs. The Postal Service acknowledges that Mr. Hatfield's results do raise an issue with respect to a crossover in intra-BMC and DBMC rates. However, this issue is properly handled in rate design, not by manipulating cost data.

b. The various Parcel Post discounts, surcharges, and enhancements proposed are well supported and should be recommended by the Commission

i. Destination Bulk Mail Center (DBMC) Discount

As discussed by witness Mayes, the only step that the Postal Service and the Commission have taken heretofore to encourage worksharing by Parcel Post mailers has been the DBMC discount, established in Docket No. R90-1. This discount has, by all measures, been a tremendous success. *See* USPS-T-37, at 2-3; Testimony of John L. Clark on behalf of CTC Distribution Services, Tr. 20/10170-72. Parcel Post volume has increased considerably from its low point in 1989 and 45 percent of all Parcel Post in 1996 was entered at DBMC rates. USPS-T-37, at 3.

In this docket, Witness Crum has refined and updated the cost study on which the first DBMC discount was based in Docket No. R90-1. It should be remembered that no update of this study was done in the subsequent general rate case, Docket No. R94-1, due to the exceptional nature of the rate design undertaken in that case. Therefore, by the time witness Crum undertook his study, DBMC had been a functioning rate category for over six years. Much more was known about DBMC than at the time it was established in Docket No. R90-1.

(a) UPS witness Luciani's criticisms regarding mail preparation and platform acceptance costs do not support changes in the cost savings estimate.

Nevertheless, witness Luciani criticizes witness Crum for a revision he made to refine the cost study underlying the DBMC discount. Witness Crum included mail preparation and platform acceptance costs in the pool of costs which DBMC parcels avoid. Witness Luciani challenges this as a departure from precedent, but provides little other illumination to support his criticism. What he does offer does not stand scrutiny.

It is accurate that witness Acheson in Docket No. R90-1 did not include these costs in his cost avoidance calculation. At that time, DBMC was proposed as a new category, and witness Acheson took an extremely conservative approach, identifying only certain of the costs expected to be avoided by DBMC parcels. Witness Crum, by contrast, had the benefit of over six years of actual DBMC operations on which to model his study. He included platform acceptance and mail preparation costs in his pool of avoided costs because these costs are indeed generally avoided by DBMC parcels. *See* Rebuttal Testimony of Witness McGrane, Tr. 35/18950.

Regarding platform acceptance costs, witness Luciani claims that their inclusion in the pool of avoided costs results in a "clear" double count of these costs within window and acceptance costs. Tr. 26/14293. When asked to quantify the amount of the double counting, however, he was unable to do so. Tr. 26/14369. Thus, even if there had been double-counting, the record provides no "clear" dollar figure to be used in making an such an adjustment.

Regarding mail preparation costs, witness Luciani's approach is based only on a combination of precedent and speculation. Tr. 26/14292, 14268. Although, as noted above, witness Acheson did not include these costs in his cost avoidance calculation in Docket No. R90-1, DBMC parcels clearly avoid these costs. Tr. 35/18950-51. If the Commission is to recommend DBMC rates which accurately reflect the costs avoided by such mail, mail preparation costs should clearly be included in the calculation of costs avoided. Witness Luciani speculates that "...it is likely that outgoing mail preparation costs at non-BMCs are associated with local intra-BMC parcel that do not travel to the BMC." Tr. 26/14368. Witness McGrane, whose knowledge of mail processing operations is vastly superior to witness Luciani's cursory knowledge based on a few facility visits,[2] provides facts which contradict this assertion: "To the contrary, any Parcel Post mail that is entered at AOs and SCFs, local or not, will incur outgoing mail preparation, since much of the costs for Parcel Post in these facilities falls under the description of mail preparation." Tr. 35/18951. Moreover, witness McGrane explains that "regardless of whether or not outgoing mail preparation costs at AOs and SCFs are for local parcels, DBMC parcels will not incur these costs." *Id.* Costs not incurred by DBMC parcels should not be excluded from the calculation of costs avoided by DBMC mail.

Witness Luciani attempts to correct for the errors he perceives by breaking out mail preparation and platform acceptance costs using UPS witness Sellick's data. Tr. 26/14293-94. There is a serious logical flaw in his analysis, however. Witness

---

[2] *Compare* Tr. 26/14288, lines 10-13 *with* Tr. 35/18949, lines 8-15.

Luciani claims later in his testimony that ASF costs should be not included in the pool of avoided costs and makes an adjustment to remove all ASF costs. (This adjustment will be discussed specifically below.) Witness Luciani, however, fails to account for the fact that witness Sellick's mail preparation and platform acceptance costs *include* ASF costs. Tr. 26/14234. He therefore subtracts ASF costs twice, putting aside for now the other problems (discussed below) associated with witness Luciani's ASF analysis. This double-counting error alone makes witness Luciani's removal of $4,250,000 from the pool of avoided costs, Tr. 26/14294, not reliable.

(b) Outgoing ASF costs should remain in the pool of costs avoided.

Witness Luciani argues that $3.3 million of outgoing mail processing costs at ASF facilities are incorrectly included as costs avoided by DBMC Parcel Post. Even if one were to accept his premise, which the Postal Service disputes, as explained below, witness Luciani's estimate of outgoing ASF costs is too high, because he uses a method inconsistent with the way the Postal Service estimates outgoing SCF costs. Witness McGrane shows that the actual amount of outgoing ASF costs included in witness Crum's avoided costs is $1,981,000. Tr. 35/18952-53. Moreover, witness McGrane then demonstrates that because ASFs function both as BMCs and SCFs, only part of the amount he calculates for outgoing ASF costs should arguably be excluded from the avoided cost pool, if one were to accept witness Luciani's criticism. Tr. 35/18953.

The Postal Service believes that, having considered both witness Luciani's criticism on this matter and witness McGrane's corrections, the better approach is to

use witness Crum's original calculation. The total arguable effect of these corrections is under 2 cents per piece. Witness Luciani himself has shown that DBMC saves almost 8 cents per piece at BMCs, Tr. 26/14415, yet the Postal Service has assumed these savings to be zero, Tr. 35/18954, more than offsetting the less than 2 cents. Given the complicated nature of the issue of ASF costs, and witness Crum's extremely conservative assumption regarding avoided costs at BMCs, his original approach is the most reliable on the record.

ii. Origin Bulk Mail Center (OBMC) Discount

Witness Mayes proposes a discount of 57 cents per piece from the applicable inter-BMC rates for properly prepared inter-BMC mailings of 50 or more pieces entered at a BMC which is not the destination BMC, but which is presorted by BMCs. As such, the discount provides a worksharing alternative that involves substantial dropshipping. The proposed discount is based on cost savings developed by witness Crum of 57.6 cents per piece. The cost savings reflect the costs avoided because the parcels are sorted to BMC (10.7 cents) and because they bypass upstream facilities (46.9 cents), saving the equivalent of the upstream costs avoided by DBMC Parcel Post. No party opposed the establishment of this discount, or the concept that it should be calculated by adding BMC presort savings and DBMC upstream savings. UPS witness Luciani criticized only the calculation of the particular amount of DBMC cost savings due to bypassing upstream facilities. As shown in the section above on DBMC savings, UPS's criticisms of the DBMC calculation are

without merit and should be disregarded. Accordingly, the OBMC discount should be recommended by the Commission as proposed by the Postal Service.

iii. BMC Presort Discount

Witness Mayes proposes a discount of 12 cents off inter-BMC rates for properly prepared mailings of at least 50 pieces, separated into machinable and nonmachinable pieces, that are presorted by destination BMCs or secondary sort operations. USPS-T-37, at 8-9. This discount will be especially useful for mailers who have sufficient volume to prepare their mail sorted to the destination BMCs, but do not have the volume or inclination to purchase transportation to a BMC, either the destination or the origin BMC. The discount is based on mail processing cost savings estimated by witness Crum at 13.9 cents per piece for machinable and 12.5 cents per piece for nonmachinable parcels. USPS-T-28, at 8-9. No party challenged this discount or the cost savings on which it was based.

iv. Destination Sectional Center Facility (SCF) and Destination Delivery Unit (DDU)

The Postal Service proposes discounts that recognize the willingness of Parcel Post mailers to engage in the kind of dropshipment engaged in by mailers of other classes of mail (many of whom are the same mailers). Parcel Post entered at the destination sectional center facility (SCF) serving the recipient of the parcel would receive a discount based on the parcel's bypassing all facilities upstream of the destination BMC and all BMC processing activities, in addition to the transportation associated with the trips to the origin BMC, from the origin BMC to the destination BMC, and from the destination BMC to the destination SCF. USPS-T-37, at 9. Mail

entered at DDUs bypasses virtually all transportation and most mail processing operations and associated costs. *Id.* at 10. Extending the dropship discounts available to other classes of mail, the Postal Service proposes to offer Parcel Post mailers discounts for entry at such facilities of properly prepared Parcel Post mail in mailings of at least 50 pieces. In the case of DSCF, the mail must be sorted to the five-digit level, so that the SCF receives the parcels at least as finely sorted as are parcels received from the destination BMC.

The proposed discounts calculated by witness Mayes are based on the non-transportation cost savings described in the testimony of witness Crum (USPS-T-28), and the transportation cost savings calculated in the testimony of witness Hatfield (USPS-T-16) and in witness Mayes's workpapers.

(a) Witness Luciani's criticisms are based only on speculation and are minor compared to the extremely conservative approach taken by witness Crum

Witness Luciani criticizes witness Crum's calculation of cost savings for DSCF and DDU entry discounts, based on speculation and a series of inferences and assumed similarities to the current practices for unrelated mail classes. Witness Luciani argues that current statistics regarding Parcel Post as a whole, for such matters as the number of pieces per container, and current policies applicable to other classes of mail should be applied to lower the cost avoidance calculations. Tr. 26/14298-301. Witness Crum's approach in this regard is superior. To the extent witness Crum had to make assumptions, as does any analyst conducting a cost study, he made them based on expectations concerning the manner in which the

discounts for which he calculated cost savings would be administered. The Postal Service, moreover, in implementing these discounts, is mindful of the assumptions witness Crum made and will translate those into practical reality as closely as possible. While all the details remain to be worked out, witness Luciani assumes that in every case, the result will be to lower the cost savings estimated. It is unrealistic to assume that all uncertainties will be resolved in that direction. Regardless, given the number of extremely conservative choices witness Crum made in his analysis, his estimates of cost savings remain reliable and reasonable.

One of these choices was not to apply a CRA adjustment factor (non-modeled cost factor). Like witness Daniel (USPS-T-29), witness Crum used modeled costs to estimate savings. Witness Daniel used a CRA adjustment factor to expand the modeled costs up to CRA costs for the discounts and surcharges described in her testimony. Because DSCF and DDU are new worksharing discounts, witness Crum purposely chose to not apply a CRA adjustment factor to his results. This was an extremely conservative choice.

UPS witness Luciani agrees that "the use of a non-modeled cost factor may arguably be appropriate when determining a cost differential across a broad range of numerous processing activities (such as that between inter-BMC and intra-BMC Parcel Post)." Tr. 26/14306-07. DSCF and DDU savings very clearly involve numerous processing activities. Had witness Crum applied the factor used by witness Daniel, his estimated savings would have risen by a factor of 1.621. *See, e.g.,* USPS-29E, at 6. In these circumstances, issues of the kind raised by witness

Luciani regarding DSCF and DDU, and based only on speculation and unfounded assumptions, can safely be ignored without any fear of an overstatement of cost savings.

(b) Witness Luciani's criticisms based on the difference between DBMC parcels and other Parcel Post demonstrate the conservative nature of witness Crum's estimates.

Witness Luciani correctly notes that DBMC parcels are slightly larger on average than non-DBMC parcels. Tr. 26/14313. Although he uses this fact to create the impression that witness Crum's cost savings are overstated, he completely ignores the other side of the story. DBMC mail processing cost savings are based on costs avoided by DBMC parcels at outgoing mail processing facilities. Because DBMC parcels are larger than non-DBMC parcels, if there were no rate incentive and these parcels fell back to being entered at origin facilities rather than the destination BMC, Postal Service per-piece costs would rise more than witness Crum's estimated cost savings would estimate. A balanced assessment therefore shows that witness Crum's estimates are quite reasonable. While there may be offsetting factors from the BMC onward, witness Crum's calculation of DBMC cost savings is clearly understated as a result of any size differences related to DBMC parcel post. With respect to DSCF and DDU, if one assumes that DSCF and DDU parcels will be more like DBMC parcels in terms of average size (as witness Luciani has done), witness Crum's savings are, again, understated, because the savings are based on the smaller (actually in this case, average size) pieces which cost slightly less to process.

(c) Witness Luciani's criticism of the DSCF local transportation costs is based upon a misunderstanding of them.

Witness Luciani contends that Mr. Hatfield's treatment of DSCF local transportation costs is incorrect, arguing that DSCF Parcel Post will incur 12.3 percent more local transportation than DBMC Parcel Post, instead of receiving the same amount of local transportation. Tr. 26/14302.

Because 12.3 percent of DBMC Parcel Post avoids a leg of local transportation, USPS-T-28 at 5, Mr. Hatfield develops an average unit cost of local transportation for all DBMC Parcel Post which reflects that only 87.7 percent of DBMC Parcel Post actually receives a leg of local transportation. Tr. 8/3956-57. Mr. Hatfield's estimate of the unit cost for local transportation associated with DSCF Parcel Post is exactly the same as his unit cost estimate of local transportation associated with DBMC Parcel Post. USPS-T-16, Appendix III, at 4.

UPS witness Luciani assumes that 100 percent of DSCF mail will receive a leg of local transportation. Tr. 26/14302. Therefore, he argues that the average unit cost for local transportation of DSCF Parcel Post should be 12.3 percent higher than the estimate for DBMC Parcel Post and that Mr. Hatfield is incorrect to use the same cost estimate for both DBMC and DSCF local transportation costs.

Witness Luciani's assumption that 100 percent of DSCF Parcel Post receives a leg of local transportation is incorrect, and contradicts information provided by the Postal Service in response to a discovery request, UPS/USPS-T16-42 (redirected to the Postal Service for response). This interrogatory asks the Postal Service to "Confirm that 100 percent of Parcel Post mail that receives the DSCF Parcel Post

discount (and not the DDU Parcel Post discount) will incur a transportation leg from the DSCF to the destination AO." The Postal Service response states, "Yes, provided the mail in question is not entered at the co-located DDU." Tr. 19D/9555.

Any DSCF pieces bound for delivery from a delivery unit that is co-located with the DSCF will not receive the local leg. These delivery units are located at the same site as the SCF. If mail bound for the co-located unit is entered at the DSCF, it will not incur any transportation costs between the DSCF and the co-located delivery unit. Tr. 8/3957.

Witness Luciani argues that no pieces receiving the DSCF rate will ever be bound for delivery from a co-located delivery unit. Tr. 26/14303, footnote 21. Clearly, the Postal Service's response specifies that only DSCF mail that is *not* entered at a co-located delivery unit would always receive a local leg of transportation. In addition, by clarifying that the DSCF mail in question is not entered at a co-located delivery unit, the Postal Service response indicates that a certain portion of DSCF mail can be entered at the co-located delivery unit.

While witness Luciani appears to have misunderstood the Postal Service's response, it is still true that the proportion of DSCF mail that will avoid a local leg of transportation is unknown. If one were to use DBMC as a proxy, the percentage that avoids a local transportation leg is 12.3 percent. However, for DBMC Parcel Post this 12.3 percent figure reflects two different scenarios by which parcels can avoid local transportation: (1) where the BMC has a direct transportation link with the delivery unit or (2) where the parcel is bound for delivery from a unit that is co-located with

the DSCF. Because DSCF mail bypasses the DBMC, the first scenario does not apply here. Therefore, the correct proxy would be the proportion of DBMC that is bound for delivery from a unit that is co-located with the DSCF. Unfortunately, the 12.3 percent figure for DBMC cannot be separated between the two different scenarios. Therefore, it is reasonable to predict that the amount of DSCF mail that is bound for delivery from a co-located unit is greater than 0 percent and less than 12.3 percent. The result is that the true local transportation cost of DSCF Parcel Post will be between Mr. Hatfield's estimate of $0.3337 per cubic foot and Mr. Luciani's estimate of $0.3805 per cubic foot.

v. Balloon Rate

Witness Mayes proposes the reinstitution of a surcharge for bulky, lightweight parcels. Specifically, parcels weighing less than 15 pounds but having a combined length and girth exceeding 84 inches would pay the rate applicable for a 15 pound parcel. Witness Mayes supports this proposal in great detail in her testimony at pages 11-18. No party has challenged this proposal and it should be recommended as proposed.

vi. Increase in Maximum Combined Length and Girth

In response to customer requests, the Postal Service is proposing that the maximum combined length and girth for Parcel Post be increased from the current 108 inches to 130 inches. No more than 10 percent of the pieces in a mailing could exceed 108 inches, due to the increased costs of these parcels, as explained by

witness Mayes at pages 18-20. No party has challenged this change and it should be recommended by the Commission.

vii. Witness Daniel's testimony provides detailed, comprehensive, and accurate cost support for the nonmachinable surcharge, intra-BMC cost avoidance, and customer barcoding discounts.

Witness Daniel's testimony updates the Parcel Post mailflow models presented in prior dockets to estimate the mail processing cost difference between inter-BMC machinable and nonmachinable outside (NMO) parcels, which serves as the basis for the inter-BMC nonmachinable surcharge, as well as the costs avoided in mail processing by intra-BMC parcels and the additional mail processing costs of handling oversized parcels. USPS-T-29, at 14-19. Witness Daniel also estimates the cost savings associated with customer barcoded Standard (B) parcels, thereby establishing a sound basis for the new prebarcoding discount proposed by witnesses Mayes and Adra for Standard (B) subclasses. USPS-T-29, at 19-20. The mailflow models incorporate recent operational improvements, including the package barcoding system, the Postal Pak network, and direct-to-secondary induction capability. USPS-T-29, at 14-20. New inputs enabled witness Daniel to present up-to-date information about the paths parcels take through the postal system and the attendant costs of mail processing operations.

Witness Daniel also adopts two recently conducted Bulk Mail Center (BMC) studies designed to better assess productivities of operations in BMCs, profiles of containers leaving the BMCs, and the subclass-specific arrival containerization and barcode profiles of Standard B parcels. Tr. 5/2410; USPS-LR-H-131; USPS-LR-H-

132. The studies provide a solid foundation for the development of costs supporting the intra-BMC parcel post discount, the inter-BMC NMO surcharge, and the barcode discount for Standard B parcels through analysis of the most current BMC productivities and containerization and barcoding profiles of Standard B parcels. Activity at eight BMCs was measured in the first study (USPS LR-H-131). This study refines, expands and updates a similar study conducted in 1983 to analyze flow densities, containerization profiles and productivities at BMCs. BMCs in this study were asked to complete to provide containerization profile estimates for arriving and dispatched machinable and nonmachinable parcels. BMC volume and workhours data generated by the Productivity Information Reporting System (PIRS) were also used in calculating average productivities. These productivities were converted to marginal productivities using Dr. Bradley's variability estimates. The volume and workhours data received from each of the BMCs were weighted appropriately to annualize the raw data to a FY 1995 full-year level. Outlier analysis was conducted to identify and remove observations from input data that represented impossible or highly unlikely productivities.

For the second study (USPS LR-H-132), nine BMCs were chosen to be representative of various characteristics of all BMCs. Each of the BMCS selected for the study differs in physical structure, mail profile, processing operations and geographic location. Data collection was performed at the inbound docks over a three-day period at each sample site as incoming truck was unloaded. From each sampled truck, two of each container type were sampled randomly. Pieces from each

sampled container were sampled based on a fixed skip interval (every 10th piece). A total of 8,170 pieces were sampled from 748 containers from 299 trucks over a three-week period. Separate arrival and barcoding profiles were developed for each subclass in question (Parcel Post, DBMC, and Special Standard); arrival profiles for machinable and non-machinable pieces were developed for each subclass. The data were inflated to obtain national estimates. Standard sampling procedures were followed throughout the process. As such, a general level of confidence can be attached to the results of this survey. These studies of Bulk Mail Center operations serve as rich sources for productivity and arrival and dispatch mail profiles. Witness Daniel's Standard (B) cost analysis and underlying BMC studies are comprehensive in scope, sound in methodology, and generally uncontested on the record. The Postal Service accordingly urges that the results be used by the Commission.

Based on witness Daniel's studies, the Postal Service has proposed a discount of 4 cents per piece for all prebarcoded Standard (B) parcels routinely processed individually on BMC parcel sorters equipped with barcode readers. Thus, the discount is not proposed to be available for DSCF and DDU Parcel Post, for Carrier-Route Bound Printed Matter, or for 5-digit Special Standard mailings.

UPS Witness Luciani criticizes witness Daniel for using a non-modeled cost factor in her calculation of barcode savings. According to Witness Luciani, Witness Daniel accounted for every single element of cost in her calculation of barcode cost savings and she has shown no evidence otherwise. Tr. 26/14307. Although witness Daniel does not include the additional cost of handling miskeyed pieces, USPS-T-29,

at 20, she has described the additional steps incurred when a parcel is miskeyed. Tr. 5/2528. Witness Luciani confirms, and witness Daniel agrees, that mailer applied barcodes may be more reliable, but quantitative measurement of keying error is not available. Tr. 26/14419; 5/2529. It does not make sense to ignore the existence of a cost driver simply because it is not completely quantified. In addition, even though Witness Luciani testified that there would be no cost difference associated with a mailer-applied barcode versus a Postal Service-applied barcode, he confirms the fact that there are several instances in which a mailer applied barcode cannot fall off, e.g., barcodes directly printed onto a parcel and showing through a window. Tr. 26/14307, 14419.

Witness Daniel's use of a non-modeled cost factor is justified because it accounts for costs that her model does not directly measure such as the additional costs associated with Postal Service-applied barcodes discussed above. Witness Luciani is wrong to maintain that there are no non-modeled costs to justify the use of a non-modeled cost factor. The Commission should therefore recommend the proposed 4-cent discount.

c. Witness Mayes's proposed passthroughs are appropriate.

The discounts proposed by witness Mayes pass through as close to 100 percent of the estimated cost savings as practicable. USPS-T-37, at 6. There is significant testimony on the record from potential users of these discounts supporting the proposition that the maximum passthrough is necessary in order to make it

economical for mailers to engage in the required worksharing, particularly given the start-up costs involved. *See* Tr. 20/10175-76, 24/12953-54, 25/13447-48.

i. Witness Luciani's criticisms regarding full passthrough of the discounts are unfounded as a matter of rate design.

Witness Luciani recommends passthroughs of 77 percent, based on his interpretation of the Commission's passthrough of DBMC non-transportation savings in prior cases. Tr. 26/14309. His argues that when the DBMC, DSCF and DDU entry discounts for what was then third-class mail were introduced in Docket No. R90-1, the Postal Service proposed 70 percent passthroughs of the estimated savings for these new discounts. The Commission, according to witness Luciani, then adjusted the avoided cost estimates and recommended discounts with effective passthroughs ranging from 76 to 80 percent. *Id.* His most important reason for reducing the passthroughs is "simply uncertainty about the amount of the costs involved." *Id.* at 14311.

Witness Luciani's opinion ignores several facts: that the Postal Service and the Commission now have considerable experience in estimating cost savings; that many mailers now have considerable experience in using worksharing discounts similar to those proposed for Parcel Post in this case; and that the Postal Service has considerable experience in administering such discounts. Since the dropship discounts were introduced in Docket No. R90-1, the Postal Service and its customers have thus had more than six years of experience with such discounts. The concept of a dropship discount is not new, either to the Postal Service or to its customers. As a general matter, moreover, witness Luciani's opinions, at least on such qualitative

issues, should be given little weight by the Commission. One must seriously question Mr. Luciani's general knowledge of the parcel delivery business. During oral cross-examination, Mr. Luciani stated that he did not know whether UPS offered individually negotiated volume discounts to its customers. Tr. 26/14449-50. That UPS does so is common knowledge to anyone the least bit familiar with the package delivery industry. Every businessperson in every strip shopping center in America knows this. Yet Mr. Luciani states that he does not know this. Lacking such basic knowledge regarding the package shipping industry, Mr. Luciani's level of expertise and opinions relating to the choices, activities, and operations of package shippers as they affect postal operations are suspect.

Moreover, witness Luciani's discussion of the passthroughs applied to the then-new dropship discounts for third-class mail fails to acknowledge that there may have been other reasons for using passthroughs of less than 100 percent when introducing — and indeed, continuing — the dropship opportunities in the rate design for third-class mail. That is, the development of rate design for any particular subclass or rate category of mail tends to be unique, encompassing and accommodating a wide range of issues and influences, only some of which may overlap with the rate design concerns of other subclasses or rate categories. For instance, in Docket No. R90-1, the dropship discounts were implemented at the same time as the shaped based pricing differentials and saturation discounts. The compounded impact of these changes on the rates that customers paid needed to be addressed in that circumstance. Furthermore, other factors influence rate design concerns, such as

maintaining logical rate relationships within each subclass or rate category. The Commission should not be bound by mechanistic approaches to rate design such as automatically applying the same passthroughs to comparable worksharing programs across every subclass or rate category of mail. Such a mechanistic approach denies the unique rate design concerns, including underlying costs, rate development histories, and customer needs, which are associated with different subclasses and rate categories of mail.

It should also be noted that, consistent with the efforts classification reform, it is appropriate to pass through more of the estimated savings than was the case in the pre-classification reform environment of Docket No. R90-1. The Parcel Post rate design approach was developed initially as part of classification reform, and continues in that intention to reflect, as fully as practicable, the savings associated with worksharing programs.

ii. Witness Luciani's criticisms are countered by the conservative nature of witness Crum's cost estimates.

Witness Luciani's recommendation regarding reduced passthroughs is inconsistent with the extremely conservative approach taken by witness Crum in estimating the cost savings underlying witness Mayes's proposed discounts. Contrary to witness Luciani's opinion, there is no significant uncertainty in witness Crum's estimates, which are discussed in more detail below.

iii. Several of witness Luciani's arguments for lower worksharing passthroughs ignore witness Hatfield's testimony.

Witness Luciani offers, as additional rationale for limiting the passthroughs associated with Parcel Post worksharing, a table comparing Parcel Post cost avoidance estimates from Docket No. MC97-2 and the current docket. Tr. 26/14313. This table is included in a section of his testimony entitled "Inexplicable Changes from Prior Cases." Were Mr. Luciani to review the work of Mr. Hatfield, USPS-T-16, however, he would find that the differences in the transportation cost estimates between Docket No. MC97-2 and the current docket are fully explicable. Mr. Hatfield's testimony includes a number of sections that were not included in his Docket No. MC97-2 testimony, which clarify the differences between the two analyses. Specifically, Mr. Hatfield made two significant changes to his Docket No. MC97-2 testimony: he included postal owned vehicle costs, and divided commercial air transportation costs into those that are distance related and those that are non-distance related. USPS-T-16 at 14-16. To characterize these differences as "inexplicable" is, in itself, inexplicable.

Another argument that UPS witness Luciani puts forward to reduce worksharing discounts is that Mr. Hatfield "did not take into account eight of the 13 flowpaths in the postal transportation system that were used by Mr. Acheson in his Docket No. R90-1 study of avoided transportation costs for Third Class mail. Tr. 26/14316. Mr. Luciani argues that if Mr. Hatfield were to develop a flowpath model similar to witness Acheson's Docket No. R90-1 study, the results would show that Mr.

Hatfield has underestimated the costs associated with DBMC and overestimated the costs associated with non-DBMC. Tr. 26/14316.

This argument is based a number of incorrect assumptions and is not supported by any quantitative evidence. First, Mr. Luciani directly, and inappropriately, compares the methodologies used in Mr. Hatfield's testimony and in witness Acheson's Docket R90-1 testimony. Mr. Acheson's testimony developed the transportation costs avoided by third-class mail. Mr. Hatfield's testimony separates total Parcel Post purchased transportation costs into rate categories and zones. Tr. 8/3916-18. Because of its different purpose, Mr. Hatfield's analysis does not contain and was not designed to contain a flowpath model that accounts for all connections in the postal transportation network. Tr. 8/3916.

Witness Luciani also fails to consider the impact that accounting for specific flowpaths would have on the allocation of inter-SCF transportation costs to the rate categories of Parcel Post. In Mr. Hatfield's testimony, inter-SCF transportation costs are treated as intermediate, and therefore, are assigned to all rate categories of Parcel Post. Tr. 8/3913. Mr. Luciani's proposal for developing a Parcel Post flowpath model similar to witness Acheson's would show that DBMC mail avoids all inter-SCF transportation costs.[3] Therefore, while Mr. Hatfield's analysis assigns a certain proportion of inter-SCF costs to DBMC, Mr. Luciani's would assign none. The impact

[3] Mr. Acheson's flowpath model shows that only two paths incur inter-SCF transportation. These paths (nos. 6 and 7) both originate at the origin SCF. Therefore, none of the paths originating at the DBMC (nos. 11 and 12) incur any inter-SCF transportation cost. Docket No. R90-1, USPS-T-12, at 8-9.

would be to lower DBMC costs under the Luciani proposal and raise the amount of costs avoided by DBMC.

Mr. Luciani speculates that the impact of re-assigning inter-SCF costs would be outweighed by other considerations. Tr. 26/14399-400. However, when asked to provide quantitative evidence he responded, "The quantitative evidence is based on the probability of there being a skip around the simplified transportation path model of Mr. Hatfield." Tr. 26/14399. Mr. Luciani never quantifies this probability or provides any other figures to support his speculation.

2. *Bound Printed Matter*

Witness Adra proposed an increase in existing rates for Bound Printed Matter of an average of 5 percent based on the same rate design methodology that has been used in the past. Based on witness Crum's updated cost study, the current 6.3 cents for the carrier route presort discount is proposed to be increased to 6.7 cents. These proposals have not been challenged by any party and should be recommended by the Commission as proposed. The barcode discount described above will be available to Single-Piece and Basic Bulk Bound Printer Matter.

3. Special Standard

Witness Adra proposes that Special Standard rates remain unchanged at $1.24 for the first pound, increased to 51 cents from the current rate of 50 cents for each additional pound through the seventh pound, and decreased to 21 cents from the current rate of 31 cents for each additional pound in excess of seven pounds. Witness Adra recalculated the underlying rate elements of the existing per-piece and

per-pound rate structure based on test year data to ensure that the rates elements comport well with cost causation.

Based witness Daniel's updated cost studies, witness Adra proposed decreases in the 5-digit presort discount to 34 cents from the current 54 cents, and in the Bulk Mailing Center (BMC) presort discount to 12 cents from the current 20 cents.

The barcode discount described above will also be available to Single-Piece and BMC Presort Standard Special mailings.

These proposals have not been challenged by any party. They should be recommended by the Commission as proposed.

4. Library Mail

Witness Adra proposes that library rates (*i.e.*, full rates for step 6) be increased to $1.44 from the current rate of $1.12 for the first pound, to 52 cents from the current rate of 42 cents for each additional pound through the seventh pound, and to 25 cents from the current rate of 22 cents for each additional pound in excess of seven pounds. These increases would be phased in over the remainder of the statutory 6-step phasing period. He has adopted the per-piece and per-pound rate construction of the existing rate structure, but he recalculated the underlying rate elements based on test year cost data to ensure that rate elements comport well with cost causation. Had he not done the recalculations, the rate element of the first pound would not have been compensatory, as he shows it has not been since 1987. The barcode discount described above will also be available for Library rate mailings.

Given that the proposed Library rates are generally higher than those proposed for Special Standard, witness Adra's financial analysis assumed that Library mailings eligible to migrate to Special Standard would do so and pay the corresponding Special Standard rates. He assumed that 5 percent of current Library mailings would continue to use Library rates.

a. OCA's Treatment of Library Rate Mail

i. Witness Collins's proxy recommendation for Library rate costs.

Arguing that Postal Service witness Adra's rate design is a "de facto merger of two subclasses, Library and Special Rate," Tr. 24/13090, OCA witness Collins proposes using Special Standard costs as a proxy for Library rate costs. Tr. 24/13093. In doing so, she argues that the two subclasses have a number of similarities between them, including their rate structure, Tr. 24/13093, the composition of each subclass, *id.*, the processing operations applicable to each subclass, *id.*, and the size of each subclass's sample. Tr. 24/13094. Her testimony infers precedent for this treatment in the Postal Service's MC96-2 proposal to combine Classroom and Nonprofit mail rates and costs, Tr. 24/13090, and seeks support from the response of Postal Service witness Degen in his response to POIR No. 2, Item 1, where he noted the volatility in the estimates of Classroom and Library Rate. Tr. 24/13089.

Witness Collins proposes an extreme treatment of the Postal Service's mail processing cost estimates for Library Rate. Complaining that "the small number of IOCS tallies related to Library Rate and from which the Library Rate costs are derived represents an extremely thin sample," Tr. 24/13086, she recommends their wholesale

rejection in favor of a proxy. Although the Postal Service is quite sympathetic with the motivation underlying the proposal, it is an inappropriate course of action.

ii. Library rate is a small subclass with large coefficients of variation.

The relatively small volume of mail in the Library Rate subclass has led to relatively high coefficients of variation (c.v.'s) surrounding the estimates of the IOCS-reported mail processing costs for that subclass. This circumstance, and the increased unit costs reported for Library Rate mail, has been the subject of several Presiding Officer's Information Request (POIR) items. In response to POIR No. 2, Item 1, Postal Service witness Degen, USPS-T-12, noted that, because Library rate only reports 80.4 tallies per dollar of unit cost, they "suffer from some instability due to the small volume and the nature of the IOCS sampling procedure." Tr. 12/6585. Indeed, witness Degen's testimony reports that the c.v.'s relative to Library rate mail are nine percent, which is higher than the c.v.'s reported for several other subclasses' estimates. USPS-T-12 at 13.

In setting the rates for Library Rate mail, Postal Service witness Adra, USPS-T-38, recognized the significance of the cost increase, and did all that is technically and legally feasible to mitigate the impact. He proposed a rate for the first pound of $1.44, which is only one cent above those costs. USPS-T-38 at 21. He also took into account the fact that the Postal Service's proposed rates for Library rate mail are generally higher than those proposed for Special Rate Standard (B), and made the reasonable assumption that 95 percent of Library Rate mail would migrate to Special

Rate. *Id.* at 22. He saw this shift as a means of partially ameliorating the impact of the higher rates for Library rate mail.

In another item within POIR No. 1,[4] the Presiding Officer recalled the Postal Service's treatment in Docket No. MC96-2 of Classroom mail, another small volume subclass, whose costs the Postal Service proposed to merge with those reported for the Nonprofit subclass of Periodicals. *See* PRC Further Op., Docket No. MC96-2, at 18. Witness Adra indicated, in response, that he had considered "a Classroom-type" remedy for Library rate mail in setting his rates, but explained his specific reasons for not adopting it:

> First, the markup for Library is required to be half of the markup for Special Standard. This is in contrast to the situation in Classroom where I understand that one preferred rate schedule could be adopted for both Classroom and Non-profit. Second Classroom mailers were faced with much larger rate increases than most Library mail customers would be, since they will be able to use the Special Standard rates and thereby mitigate the effective increase from current Library rates.

Tr. 8/4300. As such, the circumstances underlying Library and Classroom are different, and should be treated accordingly.

iii. The c.v.'s for Library rate and Classroom are not comparable.

Simply put, the problem with witness Collins's proposal is that she goes too far. In her testimony, she identifies the issue of small sample size in the Library rate subclass, and she compares it to a similar issue concerning Classroom publications. She gleans parallels between Classroom and Library rate mail, although the Classroom issue concerned a much greater volatility in the reported estimates than

[4] Presiding Officer's Information Request No. 1, Item 4.

that established for library rate, PRC Further Op., Docket No. MC96-2, at 11, not to mention the additional finding of the Commission in that Docket that Classroom Mail had not been covering its costs. *Id.* at 8.

The record is clear that witness Collins's comparison of the "volatility" of costs of Classroom publications and Library rate mail is inapt. First, she did not look into each subclass's c.v.'s, even when presented with the page citation to the testimony of Postal Service witness Degen, USPS-T-12, who presented that information in the Postal Service's direct case. Tr. 24/13124. Instead, she relied solely upon the response of witness Degen to Presiding Officer's Information Request No. 2, item 1, where he considered the number of tallies reported for Library rate mail and the number reported for Classroom publications, and stated that they both "suffer from some instability." Tr. 24/13129; 12/6585. Because of witness Collins's exclusive reliance on the POIR response, she was unable to comment during oral cross-examination on the difference between the c.v.'s for the cost estimates for Library rate,[5] versus those for Classroom publications.[6] Tr. 24/13124. A comparison of these two coefficients of variation reveals that the c.v.'s for Classroom are more than 3.5 times those for Library rate.[7]

---

[5] Witness Degen's testimony reports that this figure is 9.00 percent. USPS-T-12 at 13.

[6] Witness Degen's testimony reports this figure as 32.61 percent. USPS-T-12 at 13.

[7] Witness Collins's evasion of the Postal Service's reported c.v.'s is made more curious by her reliance, in her testimony, upon the discussion between counsel for the OCA and Postal Service witness Nieto (USPS-T-2, testifying on the Postal Service's Transportation Cost System) regarding the appropriateness of comparing c.v.'s in order to assess degrees of variance. Tr. 24/13094.

Moreover, witness Collins can cite no evidence that the IOCS tallies of Library rate mail were in error, Tr. 24/13125, and admits that she had not personally examined the tallies. Tr. 24/13129. Despite this, and despite the fact that the c.v.'s for Library Rate are significantly less than those reported for Classroom, witness Collins proposes a solution that is considerably farther-reaching than the merger of Classroom with Nonprofit publications proposed by the Postal Service in MC96-2.

iv. Witness Collins's tally substitution is inappropriate.

Claiming that witness Adra's treatment of Library Rate mail constitutes a de facto merger of Library Rate and Special Rate, Tr. 24/13090, witness Collins proposes a "merger" of her own, claiming as precedent the treatment of Classroom costs in MC96-2. Tr. 24/13088. However, the major difference between the MC96-2 treatment of Classroom and the OCA's proposed disposition of Library rate costs is that witness Collins does not propose a *merger* of costs, as was done in the MC96-2 proceeding; she advocates the wholesale jettisoning of Library rate costs in favor of her proxy.

Ms. Collins acknowledges that the Postal Service proposed in MC96-2 that Classroom costs be merged with the costs for Nonprofit periodicals to find a proxy. This was "based on a finding of commonalties between the two subclasses. These include the same operational network, the same rate structure, the same RFRA-specified cost coverage, and the same advertising pound rates (also specified by RFRA)." Tr. 24/13090 (citations and footnote omitted). She agrees that the two subclasses' costs were merged, and that Nonprofit costs were not merely substituted

for Classroom publications' costs. Tr. 24/13125. Despite her understanding of these differences, she stubbornly maintains that the Classroom treatment serves as the precedent for her proposed cost substitution. As explained, however, the two situations are not directly parallel, and the approach to Classroom cannot serve as precedent for witness Collins's proposed treatment of library rate.

v. The proposed proxy is problematic.

The Postal Service understands the intuitive appeal of the approach advocated by the OCA. It simply makes sense that a book mailed at the preferred library rate would pay less than a book mailed at the so-called book rate, or Special Standard (B). The problem is that it is not an "apples" to "apples" comparison.

Even if the c.v.'s surrounding the estimates for Library rate mail were so egregious as to warrant their wholesale substitution, the proxy suggested by witness Collins, Special Rate Standard (B), is problematic, and may not be an appropriate substitute. Witness Collins argues that "the composition of both subclasses is very similar." Tr. 24/13093. However, as witness Degen provided in response to POIR No. 2, Item 2, it is likely that Special Standard mail would tend to exhibit lower unit costs than Library rate mail:

> to the extent that Special is bulk-entered and containerized by presort level, we would expect Special rate mail to exhibit lower unit costs. Special rate mail may also enjoy higher productivities in sortation operations because the identical or very similar pieces allow keyers to more easily orient the pieces to read the address or barcode. No studies have been undertaken to quantify the expected difference in unit costs, but the average observed difference is not unreasonable.

Tr. 12/6588. Witness Collins acknowledges that some differences in processing exist; for instance, the bulk entry of Special Standard, compared to the fact that library rate is entered as single piece. Tr. 24/13129. She has not in her testimony, and in fact cannot, say that the two subclasses exhibit the same cost-causing characteristics.

vi. Replacement gives rise to regrettable rate results.

Finally, adoption of witness Collins's proposal could have seriously detrimental rate results for the Library rate subclass. The cost proxy and the rates that witness Collins advocates are based on her assumption that the Postal Service's reported costs are incorrect. By adopting them, the Postal Rate Commission would be recommending rates that would not be likely to be compensatory, if witness Collins's assumption proves to be incorrect. Tr. 24/13130-31 (witness Collins agrees that the Commission must accept her costs in order to accept the rates that she proposes).

Witness Collins expresses concern that the Postal Service is "complacent" about the cost consequences of the migration of Library rate pieces to Special Standard. Tr. 24/13092. She estimates that, "if the attributable costs for Library Rate are truly reasonable and accurate enough to be used for ratemaking," the Postal Service will lose 19 cents for each first pound of Library rate that migrates. *Id.* However, under the same assumption, i.e., that "the attributable costs for Library Rate are truly reasonable and accurate enough to be used for ratemaking," the adoption of her proposed rates, Tr. 24/13097, would result in a loss to the Postal Service of 30 cents for each first pound of Library rate mail. Compare *id.* (OCA's proposed rate of

$1.13) to USPS-T-38 at 20 (witness Adra's estimate of the first pound cost of Library rate mail, $1.43). If witness Collins is concerned about "complacency" on the part of the Postal Service, it is odd that she advocates the implementation of rates that would fail so miserably to cover costs, under the same assumptions she uses to measure the Postal Service's rates.

b. The Postal Service's proposed Library rates should be recommended.

In summary, the Postal Service recognizes that the proposed cost-based rates for Library Mail result in an above-average rate increase. However, the Postal Service did all that is technically and legally feasible to mitigate the impact of such an increase. There was little flexibility beyond what was already done in witness Adra's proposal to alter these results, given the legal constraints imposed on this subclass. Moreover, the Postal service recognizes that most users of Library mail opt to use Special Standard if they deem it more cost-effective. Therefore, the proposed rates should be recommended by the Commission as proposed.

F. The Postal Service's Proposed Periodicals Rates Adopt Sensible And Improved Approaches To Measuring Cost Differences And Designing Rates, And Should Be Recommended.

1. Witness Talmo's mail characteristics survey is the most comprehensive survey to date on the characteristics of Periodicals mail.

Witness Talmo (USPS-ST-50) presents the results of a major Periodicals data collection effort, which is designated as USPS LR-H-190. The study facilitates more precise and accurate modeling of the presort-related costs of Periodicals. This mail characteristics survey produces estimates of mail volume, packages, and containers by package and container presort levels and container type, for barcoded and nonbarcoded flat-shaped Periodicals Mail. The survey samples second-class regular rate transactions at the Business Mail Entry Units (BMEUs) of 45 randomly selected post offices. In addition, Centralized Postage Payment (CPP) transactions are included through a direct survey of these large Periodicals customers.

The survey protocol randomly selects individual periodicals transactions and then completely inventories all containers in the transaction. This is a very effective method for counting a large number of containers and provides a much greater sample of containers than previous surveys. In addition, the non-CPP portion of the survey produced nearly 50 percent more observations than in the survey design.

The survey improves upon the sampling protocols of previous Periodicals mail characteristics surveys. When previous surveys could not keep up to a fixed sampling proportion, the inflation and control processes could result in irregularities in the computation of the estimates. In the survey presented in this docket, well defined

strata with individual revenue control estimates provides improved accuracy in the weighting of the many sample observations.

The separation of CPP customers' transactions from other customers' transactions, and the stratification of transactions into groups with similar billing characteristics also improves the efficiency of the survey. Together with the large number of observations collected, the standard errors of the estimates demonstrate that the results are reliable for use in the cost models.

The mail characteristics survey is comprehensive in scope, sound in methodology, and uncontested on the record. The Postal Service accordingly urges that the results be accepted by the Commission.

2. Witness Seckar has developed costs for Periodicals flats using improved methodologies.

Postal Service witness Seckar (USPS-T-26) presents Periodicals flats mail processing costs based in large part on the past methodology of witness Byrne. Specifically, Periodicals mail processing costs are derived predominantly from piece-distribution and bundle sorting costs. USPS-T-26 at 10.

Witness Seckar refines past methodologies for treatment of Periodicals costs beyond piece distribution and bundle sorting costs in two ways. First, recent Periodicals mail processing cost methodologies were inconsistent with the methodology for the remainder of flats in that they did not examine these other costs at all, whereas Witness Seckar includes them in his Periodicals mail processing cost estimates. Second, Witness Seckar estimates these other costs through the use of a proportional CRA adjustment factor as well as a fixed add-on component. USPS-T-26

at 23-24. Witness Seckar makes further refinements to past methodologies to account for changes to the flats mail processing environment such that the models accurately reflect the test year. The planned test year calls for the use of FSM-881s, FSM-BCRs, FSM-1000s, and FSM-OCRs to process flats mail. USPS-T-26 at 33.

Witness Seckar assumes average test year deployment for the FSM-1000 and FSM-OCR. USPS-T-26 at 34. The treatment of the FSM-1000 correctly relies on the FSM-881 downflow densities as suitable proxies because of the similar number of breakouts each machine makes. Witness Seckar has also refined the Periodicals analyses to incorporate unique FSM-1000 acceptance rates. Because the OCR is to be retrofitted onto all the FSM-881s, Witness Seckar correctly uses the downflow densities for the FSM-881 and FSM-BCR to model machinable and automation mail, respectively. USPS-T-26 at 33.

Witness Seckar makes use of a number of library references to provide the most recent inputs into the cost models. The Periodicals Regular Rate (LR-H-190) and Nonprofit (Docket No. MC96-2, LR-PRR-2) mail characteristics studies provide key inputs in the form of the distribution of Periodicals non-barcoded mail between the machinable and nonmachinable categories. Tr. 4/1877-79; LR-H-134 at Section 1 page 3, at Section 3-5 page 5. Witness Seckar's reliance upon this input allows for an accurate estimation of nonautomation costs that correctly represents the machinable and nonmachinable mix of nonautomation flats based upon the most recent data the USPS has available.

The respective mail characteristics studies are also used to generate another key input to witness Seckar's analysis, the mail entry compositions. USPS-T-26 at 25-26. The mail characteristics are used in two different ways to develop different sets of mail entry compositions for each Periodicals subclass of flats mail, the actual mail makeup and the constant mail makeup. The first set examines the actual makeup of all classes of flats mail according to the actual data within the mail characteristics studies and generates costs accordingly. This treatment preserves the uniqueness of the automation and nonautomation mail entry compositions such that all cost differences between automation and nonautomation mail are captured.[1/] The second set relies upon a constant mail makeup for the generation of Periodicals flats costs that examines only the difference the mailer-applied barcode has on mail processing costs. USPS-T-26 at 12-13.

Witness Seckar makes significant refinements to the development of accurate productivity inputs to treat the FSM-881 and FSM-BCR operations as separate. Specifically, he uses FY93 MODS data to reflect accurately the FSM-881 keying environment, and the application of an adjustment ratio to these productivities to reflect a pure scanning environment for the FSM-BCR.[2/] USPS-T-26 at 30. Witness Seckar continues to treat FSM processing of automation and machinable flats mail processed manually through the incoming secondary distribution operation at plants

---

[1/] These cost differences include those that result from different worksharing activities, different eligibility requirements, and different density makeups. USPS-T-26 at 13.

[2/] The ratio is developed from witness Pham's study of FSMs, USPS-T-2, Docket No. MC91-1. USPS-T-26 at 30.

with FSMs as it was in Docket No. MC96-2, USPS-T-4. USPS-T-26-27. This treatment relies on separate productivities for manual distribution to FSM and non-FSM zones. Non-FSM zones, or synonymously -- nonautomation zones, are defined as 5-digit zones with fewer than ten delivery routes or zones at non-FSM facilities. Tr. 4/1883-84 (*response to* TW/USPS-T26-4(c)). *Use of these separate productivities* correctly represents the distribution effort based on the number of breakouts in each zone and therefore accurately portrays the different levels of manual sortation that exist for machinable and automation mail.

3. Witness Taufique's rate design for the Regular and Within County subclasses fairly balances multiple rate and classification considerations.

Witness Taufique (USPS-T-34) presents the Postal Service's rate and classification proposals for the Regular Rate and Within County Periodicals subclasses. The proposed rate increases average 3.5 percent for Regular Rate , and 2.2 percent for Within County. Direct Testimony of Altaf Taufique on Behalf of United States Postal Service, USPS-T-34 at 1. These moderate increases reflect the cost coverages provided by *witness O'Hara, as discussed in section IV above.*

The Postal Service is also proposing a classification change that would split the existing 3/5-digit ZIP Code category into 3-digit ZIP Code and 5-digit ZIP Code categories and redefine the Basic category. The Basic category would no longer include pieces sorted to non-unique 3-digit ZIP Codes. Pieces sorted to non-unique 3-digit ZIP Codes would be included in the newly created 3-digit rate category. USPS-T-34 at 6. This change will not affect the reliability of cost estimates in the Basic

category, and will be consistent with operational practices that treat non-unique and unique 3-digit mail the same. USPS-T-34 at 9.

This de-averaging of rates into 3-digit and 5-digit classifications and inclusion of non-unique 3-digit pieces in the newly created 3-digit category would better reflect costs in the piece rate design, would better reflect mailer worksharing efforts, and would cut costs by providing an increased incentive for mailers to presort their mail more finely. USPS-T-34 at 6. These changes have not been opposed by any participant, and the Postal Service urges the Commission to recommend the requested changes in DMCS §§ 421.3 and 423.7.

Cost avoidance estimates for mail processing are based on witness Seckar's (USPS-T-26) Periodicals flats models using constant mail entry profile. The mail delivery cost avoidance estimates are based on costing models developed by witness Daniel (USPS-T-29).

The desire to avoid rate shock is a major concern in the Periodicals rate design. USPS-T-34 at 7. Witness Taufique defines rate shock for Periodicals, in this proceeding, to be increases greater than 10 percent in any rate cell. Tr. 10/4849, 4862. To avoid rate shock, the proposed rates would recover 41 percent of total revenue from pound rates, rather than the current 40 percent. USPS-T-34 at 13, Tr. 10/4928. Also, passthroughs for worksharing discounts are held low in certain instances.[3/]

[3/] USPS-T-34 at 7, 15. These passthroughs would be somewhat higher using the revised cost data filed by witnesses Daniel and Seckar on October 1, 1997. USPS-T-34 at 21-22, as revised October 10, 1997.

Witness Taufique proposes to calculate the editorial pound rate independently of any of the zoned rates (for advertising pounds). USPS-T-34 at 13. The proposed method provides a straightforward way to assure 100 percent cost coverage for editorial matter in future proceedings. *Id.* at 14. The Commission has expressed concern in Docket Nos. R87-1 and R94-1 that the implicit cost coverage on editorial matter should not be below 100 percent, and asked the Postal Service and the parties to examine this issue in future proceedings. USPS-T-34 at 14. Given the overall cost change, the goal of 100 percent implicit cost coverage for editorial matter was not practical in this proceeding. Nevertheless, the Postal Service's proposed methodology takes into account the Commission directive, and if implemented, will allow the long-term attainment of this goal.

Presiding Officer's Information Request No. 6 inquired about the justification for adjusting only the editorial pound rate in order to increase the implicit cost coverage for editorial matter, rather than both the pound rate and the piece rate discount on editorial matter. In response, witness Taufique agreed that eventually both of these elements may need to be adjusted to achieve 100 percent implicit cost coverage for editorial matter. In the current proposal, however, the Postal Service proposes a change only in the editorial pound rate methodology, avoiding an adjustment to the editorial piece rate discount in order to mitigate the impact on high editorial content pieces. Tr. 19E/9873-74.

McGraw-Hill witness Hehir (MH-T-1), while not seeking to alter the proposed rates in this case, expresses concerns regarding the new rate design for editorial matter. He states that:

> unique circumstances in this case should not serve as a precedent for the future that would undermine the historical commitment – grounded in the Postal Reorganization Act – to encourage the widespread dissemination of editorial content through the mail.

Tr. 27/14717-14718. The Postal Service in its current proposal has recognized the educational, cultural, scientific and informational (ECSI) value of the editorial content. USPS-T-34 at 19. The proposed unzoned editorial pound rate is lower than all the zoned advertising rates, except the delivery unit dropshipment rate, and editorial content is also provided a piece rate discount. The Postal Service believes that covering the cost for editorial matter is not incompatible with the recognition of ECSI value or widespread dissemination of editorial matter. The Postal Service seeks the Commission's endorsement to move toward the goal that rates for editorial matter cover the costs for editorial matter.

4. Intervenor criticisms of Periodicals service and rate application are being addressed by the Postal Service, and do not require changes to the Postal Service proposal.

Witnesses Crain (ABP-T-1), McGarvy (ABP-T-2), Hehir (MH-T-1), Speights (NNA-T-2) and Heath (NNA-T-1) have criticized the Postal Service on the issue of service for periodicals. Their criticism, however, is based on anecdotal information, except for witness McGarvy's reliance on a delivery monitoring system operated by the Red Tag News Publications Association. The Red Tag survey uses 104,671,

95,691, and 87,416 Monitor Reports for the years 1995, 1996, and 1997, respectively. Tr. 28/15306-15315. This sample, however, was not randomly chosen to represent all Periodicals mail. In response to a Postal Service interrogatory, witness McGarvy states "[i]t is the publisher who decides which publication to monitor." Tr. 28/15321. The survey provides information about certain mailings for 65 publications with a total circulation of 355 million. Tr. 28/15323-15324. While the Postal Service has no reason to challenge these results as reflecting the actual delivery time for the monitored pieces, drawing inferences about the entire Periodicals Regular Rate subclass is a huge leap of faith. There is no evidence that these results represent the delivery performance for the Periodicals subclass. Other participants relate their personal experiences, which do not provide a substantial basis for ratemaking. Witness Heath has stated that the Postal Service does not maintain ongoing delivery measurements of Periodicals mail, as it does for First-Class mail. Tr. 27/14748. Thus, the Postal Service is not able to verify the claims made by parties in this proceeding. Nevertheless, as Postal Service witness Degen explains, the Postal Service is taking these claims seriously and has initiatives underway that will improve service, control costs, and work with mailers for further improvements. Tr. 36/19355-59.

Witnesses Heath (NNA-T-1) has raised two additional issues. He has requested the Commission to extend Delivery Unit entry rates for mail that uses exceptional dispatch, for both Within County and Regular Rate Periodicals, Tr.

27/14757-14759, and he has challenged the threshold of 125 pieces required to receive the high density walk sequencing rate. Tr. 27 14761-14765.

The Postal Service explained why the delivery unit rate is not applicable to exceptional dispatch entry in witness Taufique's response to interrogatory NNA/USPS-T34-2. Tr. 10/4903-4905. As described in DMM §§ D210.3.1 and D210.3.2, exceptional dispatch authorization allows a publisher, for service reasons, to deliver copies of a time-sensitive Periodicals publication, at the publisher's own expense and risk from the post office of original or additional entry to other post offices. It is intended for use with short-haul local distributions. An exceptional dispatch may be authorized for various types of postal facilities and is not limited to destination delivery units. Postage for exceptional dispatch mail is calculated from and paid at the original or additional entry office from which the exceptional dispatch was authorized. Exceptional dispatch mail is considered to be entered at the original or additional entry office from which the exceptional dispatch was authorized. Exceptional dispatch may not be used for publications authorized to be mailed under the Centralized Postal Payment (CPP) System or under the PVDS postage payment system. For all these reasons, Business Mail Acceptance has determined that matter deposited at a destination delivery unit under exceptional dispatch is not eligible for the destination entry rates.

Exceptional dispatch mailings require only a basic presort, whereas mail qualifying for delivery unit rates must be sorted to a carrier route package that is placed in a carrier-route or 5-digit carrier-routes sack or tray, under DMM § M200, or

palletized, under DMM § M045. Such carrier route pieces must be entered at the facility where the carrier cases mail for the carrier route serving the delivery address on the mailpiece.

Plant-verified drop shipment (PVDS) mailings must be verified at an original or additional entry office for subsequent mailer entry at one or more destination delivery units. Non-PVDS mail must be entered at a DDU at which the publisher has been authorized original or additional entry. Exceptional dispatch mail does not qualify under either of these standards.

Mailings deposited under exceptional dispatch are not eligible for the DDU discount. However, mailers who are using exceptional dispatch could change their operations to receive DDU rates by establishing additional entry at the destination office, or by using PVDS, and meeting the other requirements.

The eligibility of Periodicals mailings deposited under exceptional dispatch for delivery unit discounts was discussed by the Commission in Docket No. MC95-1. PRC Op., MC95-1, at V-131-138. The Commission rejected a similar NNA proposal to make exceptional dispatch mail eligible for the delivery discount, concluding that:

> [i]t seems clear that deposits made under exceptional dispatch, within the framework of the Service's administration of second-class mail, are not on the same footing as those made at offices of original or additional entry. The regulations on point specifically note that exceptional dispatch is intended for use in situations involving short haul distributions. They also indicate that requests for exceptional dispatch should be approved if the arrangement improves service, and does not add to Postal Service costs. In addition, the regulations explicitly note that exceptional dispatch arrangements are not to be used to circumvent the requirements related to requests for

> additional entry. Additional entry requirements entail a much more detailed application, and payment of a one-time fee, which is currently $85.00. The regulations also note that the rate paid is to be "incidental" to the arrangement, rather than the reason for its existence. *See generally* DMM D210.3.1-3.7 and DMM R200.6.0.

Id. at V-136-37.

On the issue of ease of establishing additional entry point, the Commission in Docket No. MC95-1 directed the Postal Service to provide administrative relief to mailers:

> . . . the Commission not only urges the Service to review practices in the field, but to determine if it can provide administrative relief for these publishers, or otherwise assist them in determining whether a transition to the use of offices of additional entry is a feasible alternative.

Id. at V-137-38. The Postal Service has responded to this directive, as NNA witness Heath admits:

> NNA notes that the Mailers Companion of June 1997, pp. 20-22, explains a new "dynamic entry" practice to permit flexible entries, without the need for formal additional entry at all deposit offices. This new step seems to indicate that the many bureaucratic steps previously required for additional entry are not essential and that work-sharing with flexible entry for better service is encouraged by USPS.

Tr. 27/14862.

The Commission also dealt with NNA's 125-piece discount proposal in Docket No. MC95-1. In discussing the history of this discount, the Commission stated:

> The origin of 125-piece walk-sequence discount lies in Docket No. R90-1, where the Service's filing included a proposal for a saturation discount for second- and third-class mailers. Saturation coverage was defined in terms of

> 90 percent of residential addresses or 75 percent of the total addresses on a route, whichever is less. Some second-class mailers were concerned that they would not be able to qualify for the proposed discount, since their mailing densities generally fall short of the percentage needed for saturation coverage. Accordingly, they proposed that some form of recognition also be extended to mailers presenting sequenced mailings at a lower level.
>
> *After considering a number of options, the Commission* recommended a two-tier discount. One tier was established at the saturation level, on the terms proposed by the Service. The other was set at a minimum of 125 pieces. This figure was chosen because it corresponded to a level which, like the saturation level, had been tested in the cost study underlying the Service's filing. Other alternatives, including the option of determining eligibility on the basis of 25-percent coverage, were considered, but rejected for lack of firm costing support. *See generally* PRC Op. R90-1, paras 5367-5368.

PRC Op., MC95-1, at V-129.

The NNA proposal in Docket No. MC95-1 proposed an amendment to the Domestic Mail Classification Schedule to make the high density minimum piece requirement be either 125 pieces or 25 percent of the addresses (whichever is fewer). In the current proposal, witness Heath states: "I urge the Commission, *therefore, to adopt the language proposed by NNA in Docket MC95-1.*" Tr. 27/14765. In Docket No. MC95-1, the Commission broadened the Postal Service's discretion to respond to mailer concerns, by renaming the 125-piece discount the "high density" discount. The Commission concluded that this was an area which should be addressed by the Postal Service "to accommodate situations in which an artificial barrier to eligibility for the walk sequence discount has arisen." PRC Op., MC95-1, at V-131. NNA has not provided any new evidence for the Commission to reconsider its

Docket No. MC95-1 decision to provide the Postal Service with discretion to work with its customers on the application of the walk-sequence discount.

One other factor to be noted in this regard is the implementation of automated delivery point sequencing. Once in place, it will mean that "carriers can spend less time in the office and more time delivering mail to an expanded delivery territory. This will reduce the number of routes which otherwise would be necessary to provide service to all delivery point." Docket No. MC95-1, USPS-T-4, Direct Testimony of Jeffery W. Lewis on behalf of the United States Postal Service, at 2-3. The expanded routes due to the implementation of automated delivery point sequencing will make meeting the 125-piece threshold requirement easier.

5. Witness Kaneer's rate design fairly balances cost and simplicity considerations.

The testimony of Kirk Kaneer (USPS-T-35) proposes Nonprofit and Classroom rate design that follows that of Regular Periodicals. The rate design adheres to the requirements of the RFRA and adopts the improved methodology introduced by witness Taufique in this docket for establishing the Nonprofit editorial pound and piece rate discounts, and also extends to Nonprofit and Classroom the proposed Regular Periodicals classification changes, including the division of the 3/5-Digit category into separate presort tiers and the extension of the availability of the 3-Digit rate category to nonunique city destinations. Witness Kaneer acknowledges that continuation of the Nonprofit rate design in Classroom results in a low cost coverage for that subclass, but maintains using the Nonprofit rate schedule is appropriate while uncertainty exists regarding Classroom costs, as he testified in Docket No. MC96-2.

VI. THE FEES AND CLASSIFICATION THE POSTAL SERVICE PROPOSES FOR SPECIAL SERVICES, AND FOR HAZARDOUS MATERIALS, ARE FAIR AND EQUITABLE, COST-BASED, AND CONSISTENT WITH THE STATUTORY RATE AND CLASSIFICATION CRITERIA.

Postal Service witnesses Susan W. Needham and Michael K. Plunkett used sound professional judgment to develop fees and fee designs for the special services.[1/] The Postal Service proposes fees and classifications which reflect costs and the goals of each special service, and are fair to special service users.

The cost coverages which the Postal Service proposes for each of the special services are outlined in the testimonies and workpapers of witnesses Needham (USPS-T-39) and Plunkett (USPS-T-40). Except for return receipt service, the intervenors have not directly challenged these cost coverages. The Postal Service's proposed cost coverages satisfy the criteria of the Act. Consequently, these cost coverages should be accepted and recommended by the Commission.

Witnesses Needham and Plunkett based fees for some of the special services on costs taken directly from the Cost and Revenue Analysis (CRA) roll-forward model.[2/] Witnesses Needham and Plunkett used updated special cost studies to

---

[1/] Direct Testimony of Susan W. Needham on Behalf of United States Postal Service, USPS-T-39; Direct Testimony of Michael K. Plunkett on Behalf of United States Postal Service, USPS-T-40.

[2/] The special services for which data systems costs were used directly include: certified mail, collect-on-delivery, insurance, money orders, registered mail, special handling, and stamped cards.

obtain data for other special services.[3] Witness Needham also relied on a new study of business reply mail costs presented by witness Schenk, USPS-T-27, and witness Lion's development of per box post office box costs from CRA cost information, USPS-T-24.

Intervenors have challenged the Postal Service proposals for the following special services: delivery confirmation, qualified business reply mail (QBRM), post office box service, return receipts, special handling, and stamped cards. The issues for these special services are presented below, along with a brief discussion of three other special services (insurance, registered mail, and stamped envelopes) which, while not challenged, deserve special mention. The Postal Service urges the recommendation of all of its special service proposals, including those that are not addressed below.

A. Using New Cost Study Results, the Postal Service Proposes Cost-Based Business Reply Mail Fees.

The proposed fees for business reply mail (BRM) result in a cost coverage of 114 percent and an overall fee increase of 51 percent.[4] USPS-T-39, WP-17 at 1. The proposals rely upon a new study of the special service costs for business reply

---

[3] The special services for which cost studies were updated include: address change service, caller service, certificates of mailing, correction of mailing lists, insurance, merchandise return, on-site meter setting, Periodicals applications, permit imprints (and other annual permits), restricted delivery, return receipts, stamped envelopes, and ZIP coding of mailing lists. Library Reference H-107.

[4] The large average fee increase reflects the increases for Qualified BRM and the annual accounting fee, but conceals decreases for the "Other" advance deposit and the non-advance-deposit fees.

mail, conducted by witness Schenk.[5] The Postal Service also proposes a classification change to rename the "Pre-barcoded" (BRMAS) category to "Qualified" in the BRM fee schedule, because this fee would apply to mail that uses the proposed Qualified Business Reply Mail (QBRM) postage rate.

1. Witness Schenk's BRM cost study determines the costs for the counting, rating, and billing functions underlying the BRM fee.

Witness Schenk presents the results of a new study of the costs of counting, rating, and billing for BRM. Witness Schenk estimates the costs for each of the three fee categories for BRM: (1) BRM that qualifies for Business Reply Mail Accounting System (BRMAS) processing, and therefore pays the two-cent "Pre-barcoded" fee, (2) non-BRMAS advance-deposit BRM, and (3) non-advance-deposit BRM. USPS-T-27 at 3. For each of these three types of BRM, witness Schenk determines the BRM incremental costs, above and beyond the BRM costs covered by the First-Class Mail postage rate. *Id.* at 1.

Witness Schenk used two new sources of information (the BRM Practices Survey and the BRMAS Cost Survey) in developing the BRM cost estimates. The BRM Practices Survey (LR-H-179) obtained information from a representative

---

[5] Direct Testimony of Leslie M. Schenk on Behalf of United States Postal Service, USPS-T-27. This study fills the gap left in Docket No. R94-1 when witness McCartney's cost study for Business Reply Mail Accounting System mail was determined to be unreliable. Docket No. R94-1, Tr. 10/4731-35. As a result, the current 2-cent fee for prebarcoded, BRMAS-qualified BRM is not based on recent cost data, but rather simply an extension of the fee established in Docket No. R90-1. PRC Op., R94-1, at V-149. That fee, in turn, was based on costs assuming widespread implementation of the BRMAS system, which has never occurred. *See* Tr. 19B/8941-49.

sample of 441 sites on the means of counting, rating, and billing BRM. USPS-T-27 at 8. These results were used to determine national estimates of current BRM-related practices. LR-H-179 at 10-12, 16-30.

In order to obtain information on productivity for BRMAS operations, and the time spent maintaining advance deposit accounts, the BRMAS Cost Survey was conducted at the five sites using the BRMAS program to sort, count, and rate the highest volumes per site. USPS-T-27, Appendices A and B. These sites run the most efficient BRMAS operations among current BRMAS sites, so they do not provide the average productivity across all facilities using BRMAS.[6/] USPS-T-27 at 14. While the survey results represent the best data available, *id.*, they also likely overstate the average BRMAS productivity for all facilities currently using BRMAS. The resulting cost estimate would be higher using the average BRMAS productivity. *See id.* at 10.

The productivity associated with sorting QBRM pieces in the BRMAS operation does not apply to all BRMAS-qualified mail. In fact, the BRM Practices Survey indicates that only 14.2 percent of all QBRM pieces are currently counted and rated in a BRMAS operation. LR-H-179, Table 13. This would be the applicable BRMAS coverage factor to use to model QBRM costs, assuming no

---

[6/] The BRMAS Cost Survey sites were selected to proxy the productivity under a new BRMAS program, assuming one were to be operational in the test year. USPS-T-27 at 9. The costs associated with BRMAS-qualified pieces, if a new BRMAS program were up and running in the test year, would have been overestimated had the average productivity of all sites currently using BRMAS been used. *Id.* Once it was determined that a new BRMAS program would not be operational in the test year, there was insufficient time available to conduct a new survey. *Id.* at 10.

changes in the test year. USPS-T-27 at 13. However, the introduction of Prepaid Reply Mail has been projected to cause 66 percent of QBRM volume to migrate to this new service. USPS-T-32 at 42-43. The resulting BRMAS coverage factor after this migration is taken into account is 5.87 percent. USPS-T-27 at 13.

The BRMAS productivity, as adjusted upward by the volume variability for the barcode sorter operation, is applied to this 5.87 percent of BRMAS volume, while the Docket No. R90-1 manual productivity, as adjusted upward by the volume variability for the business reply/postage due operation, is applied to the remaining volume.[7] The manual productivity is applied uniformly because of the lack of a study to determine the counting, rating, and billing costs when BRM is processed in a non-BRMAS barcode sorter operation. USPS-T-27 at 14; Tr. 3/822. The resulting attributable cost associated with a QBRM piece is 7.85 cents. Exhibit USPS-27C. The cost would be higher absent the volume variability adjustments.[8] It includes costs not only for counting, rating, and billing, but also for incoming secondary distribution in the BRMAS operation. USPS-T-27 at 13.

In order to derive an estimate of just counting, rating, and billing costs, an estimate of these distribution costs needs to be subtracted out. The incoming secondary cost for a nonpresort barcoded piece of First-Class Mail, or 2.31 cents,

---

[7] Exhibit USPS-27C; USPS-T-27 at 11. The Docket No. R90-1 manual productivity continues to apply because manual operations such as this one are not expected to change much over time. USPS-T-27 at 14.

[8] Applying the unadjusted productivities in Exhibit USPS-27C increases the weighted cost per piece from 7.85 cents to 9.84 cents.

provides that estimate.[9] Netting out this cost avoidance, the net volume variable cost for counting, rating, and billing of a QBRM piece is 5.54 cents.[10] Exhibit USPS-27C.

2. Witness Needham's Qualified BRM Fee Design Applies a Minimal Markup.

Witness Needham applies a minimal markup to this cost to produce the proposed 6 cent fee. USPS-T-39 at 18. While this is three times the current fee, the current fee is so low only because the Commission decided not to rely on the Postal Service's BRMAS cost study in Docket No. R94-1. If the Postal Service's proposed four-cent fee, based on its revised costs, had been recommended, then the proposed 6-cent fee would represent only a 50 percent increase. *Id.* Moreover, the overall increase faced by Qualified BRM mailers will be only 6 percent, because of the reduced postage rate proposed for Qualified BRM. *Id.* Finally, the proposed Prepaid Reply Mail provides an alternative to this 6 percent increase for some BRMAS mailers. *Id.* at 19.

---

[9] *Id.* at 14; USPS-T-25, App. 1, at 13 (adding column [8] costs for Incoming Secondary). *See* PRC Op., R94-1, at V-146 ("During BRMAS processing, the mail receives the functional equivalent of an incoming-secondary sort. If the BRM piece were not processed in the BRMAS system, it would receive an incoming-secondary sort identical to that of other automation-compatible pieces, not an average First-Class piece. For this reason, the cost of an automation-compatible piece is the proper figure to use in the BRMAS cost calculation.")

[10] Without the volume variability adjustment to the productivities, this cost would be 7.53 cents.

3. MPA witness Glick's alternative costing approach does not provide an accurate estimate of the cost for counting, rating, and billing Qualified BRM.

MPA witness Glick provides an alternative costing approach for BRMAS-qualified BRM, based on three changes to Postal Service witness Schenk's cost model. Each of these changes is flawed, and should not be adopted.

First, witness Glick's estimate of QBRM costs inappropriately includes a delivery cost avoidance of 2.74 cents. Tr. 27/15001. This cost avoidance is subtracted from witness Glick's estimate of distribution, counting, rating, and billing costs. Tr. 27/15003. However, delivery costs are not part of these BRM processing costs. Therefore, it is incorrect to subtract them out.[11/]

Moreover, the Commission has determined that BRM fees are intended to cover the costs related to the special service aspect of BRM, which involves the counting, rating, and billing of BRM. The other costs for BRM are covered by the First-Class Mail postage.

> The purpose of the BRMAS costing analysis is to measure the cost of the special service features, i.e. counting, rating and billing for BRMAS mail. It is not to measure other attributes of BRM, which may be common to other mail.

[11/] The delivery cost subtracted by witness Glick is distinguished from the distribution cost witness Schenk subtracts. The distribution cost is included in the weighted cost per piece estimate developed by witness Schenk, and adopted, with some modifications, by witness Glick. This distribution cost must be subtracted out to identify the counting, rating, and billing costs.

PRC Op., R90-1, Vol. 1, at V-434; *see also,* PRC Op., R84-1, Vol. 1, at 390. Thus, any delivery cost avoidance should be reflected in the applicable First-Class postage rate, if at all.

Witness Glick moves away from an estimate of the incremental cost underlying the business reply fee by subtracting delivery cost savings from his incremental cost estimate. These avoided costs relate to the delivery of First-Class Mail, and not to the counting, rating, and billing of BRM.

Clearly, witness Glick is not measuring the counting, rating, and billing costs that underlie the BRM fee. In fact, he admits that what he is

> really interested in is the cost of BRMAS-qualified BRM. Whether it's included in the 30-cent base for PRM or whether it's included in the fee I don't think for the *purpose of my testimony is important.*

Tr. 27/15028. Witness Glick thus appears to be trying to turn the Qualified BRM fee into a way to reflect those cost differences between BRM and other nonpresorted First-Class Mail that have not already been included in the Qualified BRM postage rate.[12/] This ignores the established purpose of the incremental fee, to cover the incremental costs related to the costing, rating, and billing for BRM. Because the subtraction of delivery cost savings moves witness Glick's results

[12/] Witness Glick does not include prebarcoding savings in his estimate only because those savings were already reflected in the costs underlying the Prepaid Reply Mail and QBRM postage rates. Tr. 27/15008. Witness Glick would include those cost savings in determining the Qualified BRM special service costs if there was no proposal for a lower postage rate for Qualified BRM. Tr. 27/15017.

away from an estimate of counting, rating, and billing costs, witness Glick's delivery cost adjustment is inappropriate.

Witness Glick's second change is to estimate the cost when QBRM is processed in a (non-BRMAS) barcode sorter operation. Because no study to estimate this cost had been conducted, witness Schenk used the cost for a manual sort. Witness Glick offers a cost estimate for QBRM sorted in a non-BRMAS barcode sorter operation. Tr. 27/15000, 15003. However, this cost estimate covers only the counting part of the BRM service. While the BRMAS operation provides counting, rating, and billing together, rating and billing must be done manually for BRM sorted on a non-BRMAS barcode sorter. Tr. 3/823. Witness Glick's analysis ignores these additional costs.

In addition, witness Glick's barcode sorter cost estimate is flawed. He develops an estimate of the cost of an automated sort of QBRM by applying the cost difference between a manual sort and a barcode sort for First-Class Mail to the cost for manually sorting QBRM. Tr. 27/15000. In particular, he uses Postal Service witness Hatfield's estimate of the manual sort cost at *automated* sites. USPS-T-25, App. 1, at 13.

Witness Glick however agrees that "the stream of BRMAS-qualified BRM that is processed manually is cleaner than the stream of 'more challenging pieces' at automated facilities . . . ." Tr. 27/15023. He also agrees that the mail processed in manual incoming secondary operations is cleaner at nonautomated facilities than at automated facilities, and that manual processing of this cleaner mail stream

leads to a higher productivity. Tr. 27/15022-23. He further confirms that QBRM pieces are sorted manually for reasons not related to problems with the pieces themselves. Tr. 27/15023. These circumstances imply that the unit cost at automated facilities is not a good measure of the unit cost of QBRM counted in a non-BRMAS barcode sorter operation.

Glick seemingly capitulates by suggesting a compromise position of using an average of the cost of a manual sort at a non-automated facility with the cost of a manual sort at an automated facility to develop the unit cost for a barcode sort. Tr. 27/15024. This position is, however, not fully explored or justified. Since no supportable estimate of the cost of counting, let alone rating and billing, QBRM in a non-BRMAS barcode sorter operation has been developed, the approach to estimating the attributable cost of QBRM presented in witness Schenk's Exhibit USPS-27C is the appropriate methodology to use.

Third, witness Glick applies a higher BRMAS coverage factor than witness Schenk. Witness Glick claims that "a more reasonable method for determining the attributable cost for Advance Deposit BRM would be to simply assume that Test Year mail flows will be exactly the same as Base Year mail flows." Tr. 27/15002. This approach is flawed. The introduction of the PRM service in the test year will certainly affect the BRMAS coverage factor, since those volumes most likely to be counted and rated in a BRMAS operation (i.e., those for high volume customers) will be the volumes most likely to migrate to PRM, as even witness Glick recognizes. Tr. 27/15011. Glick claims that high-volume BRMAS-qualified BRM

recipients are not necessarily more likely to be processed using the BRMAS system than low-volume recipients. Tr. 27/15012. This reasoning is faulty, and shows a lack of understanding of BRMAS operations and barcode sorter technology. BRMAS processing requires the assignment of barcode sorter stackers, which typically are assigned to the mailers receiving the highest volumes of mail. *See* Tr. 27/15031-32; Tr. 19B/8945-46.

4. Witness Glick's Fee Proposal Should be Rejected.

Witness Glick's alternative costing approach does not support a reduction in the Qualified BRM fee. Witness Glick produces a cost estimate of 1.28 cents. Tr. 27/15002. Based on this cost, he proposes to maintain the Qualified fee at two cents. *Id.* However, there is no basis for subtracting the 2.74 cents in delivery cost savings from the distribution, counting, rating, and billing cost total. Adding these costs back in produces costs of 4.02 cents. But because of the flaws in witness Glick's other cost modifications, discussed above, witness Schenk's cost estimate is the only valid estimate on the record. This cost estimate, with the minimal markup proposed by witness Needham, requires a fee of six cents.

5. Based on lower cost estimates, witness Needham proposes to lower the fees for other advance-deposit BRM and non-advance-deposit BRM.

Other Advance Deposit BRM pieces may or may not be automation compatible or have a ZIP+4 barcode, but, like QBRM, have the daily postage due deducted from an advance deposit account. The productivity estimate used in developing the non-BRMAS advance deposit BRM cost is that used in Docket No.

R90-1, as adjusted upward for the volume variability for the business reply/postage due operation. USPS-T-27 at 14-15; Exhibit USPS-27D. The net attributable cost of a non-qualified piece is $0.0701.[13/]

Based on this cost result, witness Needham proposes to lower the regular BRM fee from 10 cents to 8 cents. USPS-T-39 at 12, 19. Neither the cost nor the fee for non-qualified BRM has been challenged, and the Postal Service's proposal to lower the fee should be recommended.

Non-advance-deposit account BRM pieces may or may not be automation compatible or barcoded, nor do their recipients pay the postage due and per-piece fees through an advance deposit account. These pieces are delivered to the recipient upon payment of postage due, which is either (a) collected by the carrier delivering this mail or by box section clerks, or (b) deducted from a Postage Due account. USPS-T-27 at 3. In addition to the distribution, rating, and billing costs that other non-BRMAS BRM pieces incur, non-advance deposit BRM pieces incur costs associated with postage and fee collection. *Id.* at 15. The distribution of fee collection methods was determined from BRM Practices Survey results. LR-H-179, Table 5. The net attributable cost of a non-advance deposit BRM piece is $0.2250.[14/] Exhibit USPS-27E. Based on this result, witness Needham proposes to lower the non-advance deposit fee from 40 cents to 30 cents. USPS-T-39 at

---

[13/] If the productivity had not been adjusted for volume variability, the resulting cost would have been 9.12 cents.

[14/] If the productivity had not been adjusted for volume variability, the resulting cost would have been 24.61 cents.

12, 20. Neither the cost nor the fee for non-advance-deposit BRM has been challenged, and the Postal Service's proposal to lower the fee should be recommended.

6. Witness Needham's Proposed Increase in the Accounting Fee Reflects an Increase in Advance Deposit Account Maintenance Costs.

The productivity associated with the maintenance of the BRM advance deposit account was obtained from the results of the BRMAS Cost Survey. USPS-T-27 at 15; Exhibit USPS-27F. There is no reason to believe that the workload associated with the advance deposit account would differ between BRMAS-qualified and non-BRMAS accounts. USPS-T-27 at 15. The resulting test year cost for advance deposit account maintenance is $276.93. Exhibit USPS-27F. Based on this cost result, witness Needham proposes to increase the accounting fee from $205 to $300. She also proposes to treat the BRM permit fee like other permit fees, by increasing it from $85 to $100. No participant has opposed these fee proposals, and the Commission is urged to recommend them.

B. The Postal Service's Delivery Confirmation Proposal Should Be Recommended, and UPS's Alternative Proposal Should Be Rejected.

The testimonies of witnesses Plunkett, Sharkey, Treworgy, Lewis and Rios fully justify and explain the cost basis for delivery confirmation service, and compel the conclusion that the respective fee designs for Priority Mail and Standard (B) should be recommended as proposed by the Postal Service. Electronic delivery confirmation customers expect delivery confirmation to be provided with products such as Priority Mail at no additional charge, but only at an additional charge with

products such as Standard (B). The testimonies of witnesses Lewis and Treworgy show that delivery confirmation is not the sole intended use of the scanners, thereby disproving UPS witness Luciani's assumption to the contrary.

1. The Postal Service's testimony fully describes and justifies the proposed delivery confirmation service for Priority Mail and the Standard (B) subclasses.

The Postal Service proposes to offer a delivery confirmation service available for Priority Mail and Standard (B) mailers. The testimony of witness Treworgy (USPS-T-22) presents the volume variable costs related to delivery confirmation, and a distribution key for scanning-related infrastructure. The testimony of witness Sharkey (USPS-T-33) proposes a rate for Priority Mail that adjusts for revenues and volumes related to delivery confirmation, and delivery confirmation costs for delivery and information systems. The testimony of witness Plunkett (USPS-T-40) proposes a new classification and associated fees for delivery confirmation.

Witness Treworgy presents a distribution key for scanning-related infrastructure in USPS-T-22 appendix C, worksheet C-2. The distribution key is based on the carrier cost systems as a whole, specifically costs segments 6, 7, and 10. This distribution key was chosen because carrier scanner costs vary in proportion to the total number of carrier routes, as each route is assigned a scanner. $51,851,000 in volume variable scanner costs are distributed using this distribution key. USPS-T-22 at 18; Tr. 4/1255.

Witness Sharkey uses market research presented in LR-H-166, Priority Mail Delivery Confirmation Market Response Research, to determine Priority Mail

delivery confirmation volumes and then, using costs presented by witness Treworgy, determines the final after rates adjustment for Priority Mail volumes, revenue, and costs. Witness Sharkey verified the reliability of LR-H-166 during oral cross-examination. Tr. 4/2150. Witness Sharkey also pointed out during oral cross-examination that the base cost of Priority Mail delivery confirmation, $10 million, spread across all the potential billion Priority Mail pieces, amounts to one cent per piece, Tr. 4/2146-47. While from a pricing perspective this increase is relatively insignificant, it also reduces the cost coverage of Priority Mail. USPS-T-40 at 18-19.

Witness Plunkett, USPS-T-40, proposes fees and the fee structure for the new delivery confirmation service available to mailers of Priority Mail, Parcel Post, Bound Printed Matter, Special and Library Mail. USPS-T-40 at 16. He discusses both electronic and manual delivery confirmation, including the distinct needs that delivery confirmation will meet for both Priority Mail and Standard (B) retail and commercial customers.[15/] Witness Plunkett explains that if the Postal Service fails to meet customers' expectations by providing delivery confirmation, customers may be unwilling to use the Postal Service. USPS-T-40 at 17-19. Since most of the Postal Service's expedited package competitors already offer delivery confirmation as a part of the base product, the Postal Service is proposing to follow this marketplace standard. Witness Plunkett further explains that the fees

---

[15/] *Id.* at 16-18. Witness Rios provides further details on how customer expectations shaped different fee designs for Priority Mail and Standard (B), respectively. USPS-RT-10, Tr. 35/19030-38.

associated with Priority Mail delivery confirmation are only in place to cover costs and not to provide significant contribution. *Id.* at 18-20. For Standard Mail, the fees are designed to provide more substantial contribution because the Standard (B) subclasses, unlike Priority Mail, have markups that are well below the system average.[16/]

The proposed fees are consistent with the ratemaking criteria in the Postal Reorganization Act, 39 U.S.C. §§ 3622(b). USPS-T-40 at 20-21. The fees are fair and equitable, as they are consistent with customer preferences, and because customers have choices with respect to the use of delivery confirmation (Criterion 1). The value of a mail item with delivery confirmation is greater than without the additional special service, and as the perceived value of delivery confirmation increases so will its use (Criterion 2). In keeping with the proposed fee structure, delivery confirmation covers its costs (Criterion 3).[17/] No fee increase is involved in the proposal, and customers will still have all other special services available to them once delivery confirmation becomes available (Criteria 4 and 5). By offering two levels of service for delivery confirmation (manual and electronic), the proposed fees reflect the degree of mailer preparation (Criterion 6). Finally, by

---

[16/] USPS-T-40 at 19-20. Thus, even if one were to include all of witness Treworgy's costs in designing delivery confirmation fees, the Priority Mail delivery confirmation fees should not be as high as the proposed Standard Mail delivery confirmation fees. However, the Postal Service does not believe its treatment of base delivery confirmation should be changed.

[17/] As explained above, some costs are covered through Priority Mail rates.

offering only two levels of service, the delivery confirmation fee structure is not overly complicated (Criterion 7).

With respect to the classification criteria in 39 U.S.C. §3623(c), Criteria 1, 2, 4 and 5 seem especially relevant. USPS-T-40 at 21-22. Criteria 1 and 2 are satisfied by establishing the service as an optional one with two fees for each class tied to the costs associated with the two levels of service, and because as value to the sender and recipient increases, senders may be more likely to choose delivery confirmation as the means of confirming delivery. Delivery confirmation will not affect the speed of delivery (Criterion 4). The delivery confirmation proposals are directly responsive to Criterion 5 by responding to customer demand for delivery confirmation.

2. The alternative delivery confirmation proposals from UPS witness Luciani are consistent with the interests of the party he represents, but they lack merit and should be disregarded.

United Parcel Service witness Luciani, UPS-T-4, Tr. 26/14331-34, proposes that the fees and fee structure for Priority Mail delivery confirmation be the same as those proposed by witness Plunkett for Standard (B) delivery confirmation. Specifically, he proposes fees of 25 cents for Priority Mail electronic delivery confirmation and 60 cents for Priority Mail manual delivery confirmation. In addition, witness Luciani proposes that the entire volume variable portion of the carrier scanner costs be allocated to Priority Mail and Standard (B), using revenue as the distribution key. His fee proposal, however, is contrary to what the market research suggests is appropriate, UPS' own offerings, and the short and long range

plans of the Postal Service. His allocation of carrier scanner costs is based only on his own opinion about why the Postal Service purchased the scanners, Tr. 26/14408, which is contradicted by record evidence demonstrating how and why the scanners were purchased, and their intended uses and capabilities. USPS-T-22 at 1-4; Tr. 35/19015-26, 19033-34.

Witness Luciani argues that customers who do not use delivery confirmation service should not pay for the costs incurred in providing it. He then recommends that the fees associated with Priority Mail delivery confirmation be the same as those witness Plunkett proposes for Standard (B) delivery confirmation. As presented below, both witness Plunkett and rebuttal witness Rios (USPS-RT-10, Tr. 35/19030-38) justify for the Postal Service's proposed fee structure for Priority Mail delivery confirmation.

Witness Plunkett explains that in order to meet customer expectations regarding expedited delivery, the Postal Service proposes to provide delivery confirmation to electronic Priority mailers at no additional charge. USPS-T-40 at 18. He also states that most competitors of the Postal Service offer tracking, the cost of which is often recovered in the base rate of the product. *Id.* United Parcel Service confirms this statement in response to interrogatory USPS/UPS-T4-33a, by stating that currently for all of its products, UPS does provide a service for no additional charge which allows customers to retrieve electronically stored information regarding the status of their shipments. Tr. 31/16854. *See also*, Tr. 32/17137-42.

Witness Luciani's argument that the Priority Mail delivery confirmation fee structure should mirror that of Standard (B) electronic delivery confirmation is inconsistent with the fee structure United Parcel Service has historically offered. As UPS states in response to USPS/UPS-T4-33b, Tr. 31/16854, in the past UPS customers have been charged a fee for retrieving electronically-stored information regarding the status of their shipments for ground transportation delivery services, UPS's version of Standard (B). Hence, UPS's past fee structure included no fee for tracking for expedited parcels, but did have a fee associated with tracking for ground transportation services, a fee structure that conforms with that proposed by the Postal Service.

Witness Rios (USPS-RT-10, Tr. 35/19030-38) presents the business judgment behind the Postal Service's proposed fees and fee structure for delivery confirmation. She states in her rebuttal testimony and in oral cross-examination that commercial customers expect, and the marketplace demands, that delivery confirmation be provided at no additional charge for expedited package delivery services such as Priority Mail. Tr. 35/19036, 19047. Witness Rios also explains why it is fair that the cost associated with electronic delivery confirmation be spread over all Priority Mail users, those that use delivery confirmation and those that do not. She states that all Priority Mail users will reap benefits associated with delivery confirmation, as this special service will provide service and diagnostic information that will help the Postal Service identify and alleviate problems. Tr. 35/19036-37. In light of the minuscule effect on the Priority Mail

rates, as discussed above, her judgment regarding fairness is eminently reasonable.

Witness Rios also explains that the fee structure for Standard (B) delivery confirmation has a fee for base (electronic) delivery, rather than building it into the base Standard (B) rates, because bulk and non-bulk Standard (B) mailers want to apply delivery confirmation selectively. *Id.*

Witness Treworgy initially described the variety of purposes to which the delivery confirmation scanners will be devoted, notwithstanding witness Luciani's failure to appreciate it. Mr. Treworgy explains that the scanners will serve a variety of purposes, including delivery and collection management, service performance measurement, and mail item information acquisition. USPS-T-22 at 2 to 4; Tr. 3/1312. Witness Treworgy also notes that the scanners will be used for Express Mail, inbound international mail, certified mail, registered mail and insured mail. Tr. 3/1280.

Witness Lewis states that it was never the Postal Service's intention to use the scanners solely for delivery confirmation, and then specifically points to the fact that the scanner system's communications, memory, and architecture requirements go beyond those needed for delivery confirmation. Tr. 35/19019-26. The scanner system is the platform that will support a variety of identified and future applications and goes beyond supporting any specific product or products. He then presents numerous operations management and service management programs for which the scanner already has been or will be incorporated. The operational applications include the Vehicle Management Accounting System

(VMAS), Collection Box Management System (CBMS), Enhanced Street Performance (ESP), Carrier Emergency Alert, and Distribution and Transportation Networks. The service management applications include accountable mail, ADVANCE, service indicators, and on-demand pick-up and redelivery services. *Id.* at 19020-25.

Witness Luciani's assertions that the fee structure for Priority Mail delivery confirmation should emulate that of Standard (B), and that Priority Mail and Standard (B) should bear the entire volume variable costs of hardware that supports a wide variety of uses, should accordingly be dismissed as consistently lacking merit while predictably conforming to the interests of the party he represents. Accordingly, his proposal to allocate all volume variable scanners costs to Priority Mail and Standard (B) should be rejected. Since each route will be assigned a dedicated scanner, scanner costs vary in proportion to the number of carrier routes. Carrier scanner costs should therefore reflect the carrier costs system as a whole. USPS-T-22 at 18, and at appendix C, worksheet C-2.

C. The Postal Service's Proposed Insurance Fees and Bulk Insurance Classification Should be Recommended.

Postal Service witness Plunkett proposes insurance fee increases averaging 17.3 percent, which result in a cost coverage of 154 percent. USPS-T-40 at 3. While this is slightly higher than the 148 percent cost coverage recommended in Docket No. MC96-3, it is still well below the system-wide cost coverage proposed in this proceeding. Moreover, by proposing to make delivery confirmation available for the subclasses of mail that use insurance, the Postal Service has created a low

cost (no cost for users of Priority Mail who use electronic manifesting) ancillary service that, by providing senders with confirmation that insured articles have, or have not, been delivered, will make insurance a more valuable product.

With respect to Express Mail Insurance, the Postal Service proposes that the fee for each $100 of indemnity value in excess of $500 be increased to $1.00. *Id.* at 9. This will maintain the existing consistency with the incremental fee for General Insurance.

The Postal Service also proposes to create a bulk insurance classification for parcel mailers who use electronic manifesting, with a proposed 40-cent discount from the regular insurance fees.[18] Because of the electronic manifesting, this optional service would reduce window service costs for the Postal Service, as shown in library reference H-110. While the discount is based only on avoided window service costs, the proposal also might produce lower indemnity costs, as it would provide indemnity only for the lesser of the actual value of the article at the time of mailing or the wholesale cost of the contents to the sender, rather than always providing the actual value of the article. *Id.* at 8. This proposal will save

---

[18] *Id.* at 7-8. While implementation details were unavailable at the time of the filing, proposed rules have recently been published. These proposed implementation rules include a minimum quantity of 10,000 insured articles per year to qualify for the bulk insurance discount. 63 Fed. Reg. 12918 (March 16, 1998). As explained in the Postal Service's December 19, 1997, response to Notice of Inquiry No. 2, this minimum should not be added to the DMCS, because it is not a defining part of the proposed bulk insurance classification, and the Postal Service wishes to retain the discretion to lower, or even eliminate, the minimum as it gains experience with the new classification.

Postal Service costs and enhance the value of insurance service for larger customers, and has not been opposed by any participant.

Though no alternative proposals have been offered for insurance, the Office of the Consumer Advocate has suggested that the Postal Service needs to provide more information regarding the nature of postal insurance.[19] While the Postal Service will consider such concerns in managing its insurance product, the Postal Service does not believe that they should affect its classification and fee proposals in this proceeding. The Postal Service's proposals should be recommended.

D. The Postal Service's Post Office Box and Caller Service Proposals Satisfy the Statutory Ratemaking Criteria, and Are Superior to the Office of the Consumer Advocate's Alternative Proposal.

Postal Service witness Needham proposes new fees for post office boxes and caller service under the existing fee structure, which reflect the statutory criteria and improve the alignment between costs and fees. OCA witness Callow proposes an alternative fee structure which properly recognizes the value of aligning fees with costs. However, his proposed solution relies not on a measure of cost, but on a measure of revenue. Unnecessary fee changes would be imposed on post office box customers over a considerable period of time if the OCA's proposal were adopted, delaying and complicating movement towards a true cost-based fee structure. In rebuttal, witness Kaneer identifies the shortcomings of the OCA's proposal, while providing further insight into the Postal Service's fee

[19] Docket No. MC97-5, Initial Brief of the Office of the Consumer Advocate, at 14-16, and Docket No. R97-1, Office of the Consumer Advocate Trial Brief, pp. 34-35.

structure intentions. Witness Needham's proposed fees, unlike those of witness Callow, facilitate movement towards a cost-based fee structure. Accordingly, the Postal Rate Commission should recommend the fees proposed by the Postal Service.

1. Postal Service witness Needham's fee proposal reflects the statutory ratemaking criteria and focuses on aligning fees with costs.

Witness Needham proposes increases for all post office box fees other than the $0 fee available for Group E customers, as well as caller service fees and the fee for reserving a call number.[20/] The proposed post office box fees are designed to meet the statutory ratemaking criteria, but the increases are primarily directed at moving the cost coverage from under 100 percent to a more reasonable 114.7 percent. Tr. 32/17052-53. Even this cost coverage is well below the Docket No. R90-1 coverage of 132.8 percent, which the Commission set as a goal in Docket No. R94-1.[21/] Ignoring rate shock concerns, the proposed fee increases should be even greater.[22/]

[20/] USPS-T-39 at 58. The proposed fees reflect the box counts and per box cost estimates developed by Postal Service witness Lion, USPS-T-24.

[21/] In Docket No. R94-1, the Commission recommended fees that were higher than those proposed by the Postal Service, in order to reflect "higher costs and a desire to move toward the previous [Docket No. R90-1] markup" of 132.8 percent. PRC Op., R94-1, at V-159.

[22/] The Postal Service has also recently made Group E fees available to customers who are ineligible for carrier delivery and who are located within one-quarter mile of a post office. 63 Fed. Reg. 59 (March 27, 1998). This change is expected to reduce the Postal Service's projected revenue by $13.1 million. LR-H-329 at 17. Because of this revenue loss, the projected cost coverage falls to ($683,362,079 - $13,100,000) / $595,853,540 = 112.5 percent. USPS-T-39, WP 17 at 3.

Witness Needham's proposal also is designed to help the Postal Service move toward a more cost-based fee design. As presented by witness Kaneer, the Postal Service plans to propose regrouping facilities directly by cost, with the highest fees for the highest cost facilities, and the lowest fees for the lowest cost facilities. Tr. 32/16966-69. Assuming the resulting groups have costs that are evenly distributed, the fees will need to reflect a wide range of costs. While currently the fees for Groups A, B, and C are relatively close to each other, and the fees for Group D are far below, witness Needham's proposal spreads the fees more evenly. Thus, the proposed Group A fees move up quite a bit, because this group is designed for the highest cost facilities. The proposed Group B fees move up less than Group A, but more than Group C, to represent an upper middle range of costs.[23/] Group C moves up the least, because it represents a lower middle range of costs.[24/] Finally, Group D fees move up the most, both because they are currently below cost, and because they are so far below the current Group C fees. Thus, witness Needham proposes to improve the alignment of fees with costs, especially where current fees do not cover costs. USPS-T-39 at 65.

Witness Needham also proposes to amend the fee schedule by specifying a $0 fee for all box sizes in Group E. USPS-T-39 at 58. This change reflects the

---

[23/] As witness Needham states, "Group A and B fees are proposed to increase substantially, thereby reflecting their higher costs relative to Group C." USPS-T-39 at 65.

[24/] Witness Needham states: "Also, in an effort to recognize the similarities in Groups C and D with respect to costs and services, Group C proposed fee increases were kept substantially lower than those of Group D." USPS-T-39 at 65.

more current understanding of Group E as a customer-based fee group applicable to any customer who is ineligible for carrier delivery, rather than an office-based fee group designed for nondelivery offices. The change also is intended to provide the Postal Service with the discretion to assign fees to nondelivery facilities based on their cost and demand characteristics.

Witness Needham proposes uniform fees for caller service, because unlike post office box service, caller service costs are generally labor costs, and do not show much variation among different facilities. USPS-T-39 at 67. The Commission did not recommend a similar proposal in Docket No. MC96-3, but only because that case was a limited proceeding in which the Commission tried to minimize fee changes. PRC Op., MC96-3, at 83. The Postal Service believes this proposal for simplifying the caller service fees deserves the Commission's endorsement in this omnibus proceeding.

2. Witness Carlson's criticisms of the Postal Service box fee proposals ignore the low cost coverage for post office box and caller service.

Douglas F. Carlson, a Group C box customer, opposes the Postal Service's proposal for Group C box fee increases, arguing that the Postal Service has an added burden of proof to show why Group C box customers should face an increase above the 4.5 percent average rate and fee increase proposed in this proceeding.[25] Mr. Carlson also asserts, based on his own experiences, that post

[25] Direct Testimony of Douglas F. Carlson (DFC-T-1), Tr. 24/12796, 12808.

office box service does not provide him an "extremely high value of service".[26] Tr. 24/12813.

Mr. Carlson ignores the need to generate enough revenue from post office box fees to provide some contribution from post office box and caller service. The proposed Group C increases provide about $44.5 million of the total after rates contribution of $87.5 million.[27] With the loss of about half the contribution, the after rates cost coverage without Group C increases would drop to well below 110 percent, despite increases for Groups A, B, and D ranging from 32 to 53 percent.[28] Given the Commission's endorsement of a 132.8 percent cost coverage in Docket Nos. R90-1 and R94-1, the need for the proposed Group C fee increases is clear.

---

[26] Witness Needham's rebuttal testimony shows that local postal officials are trying to address Mr. Carlson's concerns. Tr. 32/17054-63. In any case, the proposed fee increases are based on a consideration of all the ratemaking criteria, and do not rely exclusively on a finding of an "extremely high value of service" for post office box and caller service. Tr. 32/17052-53.

[27] *See* Tr. 3/572 ((Col. 9 - Col. 4) + (Col. 3 - Col. 8), for all of the Group C box sizes) = $44.5 million (sum of revenue increases and cost decreases); WP-17 at 3, as revised 8/22/97 (total contribution = $683,362,079 - $595,853,540).

[28] USPS-T-39 at 59. The only exception is a 17 percent proposed increase for Group B, size 5. Mr. Carlson argues that the low cost coverage for post office box and caller service is caused by the below-cost fees for Group D boxes, and that Group C fees should not be raised to make up for these low fees. Tr. 24/12834. The Postal Service is proposing a 50 percent increase for Group D boxes following a 50 percent increase resulting from Docket No. MC96-3 less than a year ago. Group C boxes have had no fee increase for over 3 years. The Postal Service believes it is fairer for Group C box customers to face a moderate increase in order to provide a reasonable contribution for post office and box service than for Group D customers to face still larger increases than the Postal Service is already proposing.

3. OCA witness Callow's attempt to allocate post office box labor costs by CAG is seriously flawed.

OCA witness Callow argues that: ". . . my new cost allocation methodology, that distributes a portion of volume-variable post office box costs by CAG, better reflects costs in larger and smaller offices." Tr. 23/12349. Witness Callow, however, defines "larger" and "smaller" offices purely in terms of revenue and CAG level. Tr. 23/12371, 12413, 12415. Moreover, witness Kaneer shows that witness Callow's attempt to reassign certain "All Other" costs based on CAG is *seriously* flawed. Tr. 32/16959-65. The Postal Service's approach, which is to assign All Other costs evenly to all boxes, is simpler and more accurate. This approach, used in Docket Nos. R90-1 and MC96-3, should be adopted once again.

4. OCA witness Callow's cost homogeneity objective is not realized by his proposed CAG-based fee structure.

The Office of the Consumer Advocate and the Postal Service agree that aligning post office box fees and costs is a worthy objective.[29/] To that end, witness Callow proposes a new system of fee groups based on CAG-level. He argues: "Restructuring Fee Groups C and D based upon CAG produces more rent-homogeneous fee groups that better reflect cost in larger and smaller offices." Tr. 23/12349. However, there are several problems with the OCA's proposal. CAG groups are based on revenues, not costs. For example, a high CAG designation might be the result of a single large mailer who moved into the area precisely because costs were low. Tr. 32/16957. Moreover, as witness Kaneer has

[29/] Tr. 23/12349; Tr. 32/16949.

demonstrated, Tr. 32/16952-16959, the groups proposed by witness Callow do not meet his objective of generating homogeneous cost groups. Tr. 23/12293. *Indeed, the distribution of rental costs for these groups displays complete overlap,* as shown in Chart A of witness Kaneer's testimony. Tr. 32/16956.

Witness Callow claims that his CAG-based groups are more homogeneous than the existing groups. But he bases that claim on his finding that the cost averages for each CAG are closer to the average for their containing group, as proposed by witness Callow, than to the cost averages for the current Groups C and D. Tr. 23/12420-21, 12428. However, averages alone cannot make this point: one must be concerned with the variation within the designated groups, as compared to the variation between those same groups. Ideally, within-group variation would be minimal, with no group overlapping any other; accordingly, the between-group variation should be larger. The best way to make the point is to show the complete distribution of rental costs for the different groups side-by-side. This witness Kaneer has done in his Chart A. Tr. 32/16956. That chart leads to one clear-cut conclusion: the CAG groups are not cost homogeneous.

Witness Callow deals with the problem of "substantial fee increases" for some post office box customers by retaining the distinction between city and non-city offices (Groups C and D), and dividing each of those into three subgroups according to CAG. Tr. 23/12293. Thus, he creates six groups where now there are but two. He further estimates that at least two more rate proceedings will be needed before the city/non-city distinction can be dropped. Tr. 23/12365. This is

a step in the wrong direction in light of the Postal Service's plans for fee and cost alignment, as discussed below.

The Postal Service agrees with Callow about the need eventually to treat boxes the same at city delivery and non-city delivery offices. In particular, the unit costs of Group C boxes are only about 10 percent greater than the corresponding box size in Group D (USPS-T-4 at 27), but the fees are more than twice as much (USPS-T-39 at 59). Witness Needham's proposed fees mitigate this difference by raising Group D more than Group C. Witness Callow proposes an increase of only 25 percent for 69 percent of Group D boxes, even though these boxes currently do not cover costs. Witness Callow's proposal leaves over 4 million boxes covering only 60 percent of their costs, Tr. 23/12341 (or 58 percent of their costs using the Postal Service's cost methodology for All Other costs, Tr. 23/12381). Witness Needham's proposed fees recover about 69 percent of the costs for these boxes.[30/] Witness Callow's proposed fees not only slow this necessary adjustment, Tr. 23/12430-12433, but unnecessarily complicate the fee structure in the process. *See* witness Kaneer's section III, Tr. 32/16952-59. In particular, witness Callow provides a 40 percent increase to about 60 percent of Group C boxes, while limiting the increase to 25 percent for over 69 percent of below-cost Group D boxes. Tr. 23/12401, 12429-30. This will make it harder to merge these offices with offices with similar costs in Group D (as well as Group C). Tr.

[30/] Tr. 3/572 (sum of proposed fee revenues for all Group D box sizes divided by sum of proposed fee total costs for all Group D box sizes).

23/12338. Moreover, the relatively small Group D increases will make it harder for Group D boxes ultimately to cover costs.

The OCA proposal is a fruitless detour on the road to a goal the OCA ostensibly shares with the Postal Service: alignment of post office box fees with their costs. Introducing new groups and then eliminating them in the near future would sow confusion among post office box customers and complicate the fee structure unnecessarily. Moreover, because witness Callow's fee groups lack cost homogeneity, they would lead to inconsistent shifting of fees for some boxes. Boxes at high-cost facilities in witness Callow's proposed Group C-III would face no increase under his proposal, but then require large increases later as they move into a cost-based fee group. Similarly, boxes at high-cost facilities in witness Callow's proposed Group D-III would face only a 25 percent increase under his proposal, but would require very large increases later as they move not only to cover costs, but also into a cost-based fee group. Moreover, boxes at low cost facilities in witness Callow's proposed Group D-I would face a 100 percent increase under witness Callow's proposal, which is too high, given that the offices in Group D-I generally have below average or average costs, and fees for these boxes went up 50 percent less than a year ago. Tr. 32/17016, 17077-78. The Postal Service, moreover, would not be able to explain to Group D-I customers why their fees must be doubled, except by referring to an indicator of revenue.

The Postal Service agrees that cost homogeneity for the fee groups is desirable, but it makes no sense to introduce a new and more complex scheme that

does not exhibit improved cost homogeneity. Unfortunately, Callow did not consider any alternatives to structuring post office box fees other than CAG. Tr. 23/12356.

5. Rebuttal witness Kaneer illustrates the Postal Service's fee design intentions.

Witness Kaneer outlines a plan for a future fee structure that could eliminate heterogeneous fee groups by creating fee groups defined by costs. Tr. 32/16966-69. In Section V of his testimony, witness Kaneer illustrates how the alignment of post office box fees and costs might be achieved. Tr. 32/16966-69. In particular, the Postal Service plans to develop rental costs for individual facilities and then to define cost-homogeneous fee groups on that basis. OCA witness Callow has conceded that this would be better than the CAG-based approach. Tr. 23/12427. In addition, the Postal Service is considering the use of post office box capacity utilization at individual facilities to modify the fee structure. *See* Table 2a, Tr. 32/16968. This could be used to stimulate demand at facilities where these assets are relatively unused, and to encourage expansion where utilization is high. Tr. 32/16966.

To show how this approach would work, witness Kaneer also provides a list of 80 facilities that are candidates for transfers from one fee group to an "adjacent" group, either higher or lower (*see* his Exhibit C page 3, Tr. 32/16987). Facility candidates for transfer have relatively high rent and high utilization in the case of a move up, and relatively low rent and low utilization in the case of a move down. Tr. 32/16970. The overall revenue impact would be minimal if these

transfers were effected. Tr. 32/16970-71. The Postal Service maintains that it has the authority to implement changes such as transferring these 80 facilities since changes are required only in the Domestic Mail Manual. However, larger changes to the fee structure, such as a capacity-based discount or surcharge, would have to be submitted to the Postal Rate Commission for approval. Tr. 32/16968; 32/17042-43.

6. Prior proceedings have established in the DMCS a fee structure for post office box service that provides the Postal Service with limited flexibility to apply fees as costs and demand considerations warrant.

In Docket No. MC96-3, the Postal Service requested that the Commission remove language from the DMCS limiting three fee subgroups to city delivery offices, and one fee group to non-city delivery offices. Instead, Groups A through D were to consist of "semi-annual fees at offices that offer any carrier service." Docket No. MC96-3, Request, Attachment B at 4-5. Thus, the Postal Service proposed "to combine the existing fee groups I and II and replace them with four new fee groups: A, B, C and D." Docket No. MC96-3, USPS-T-7 at 2. Witness Needham later stated that her testimony "proposes to merge existing Groups I and II to emphasize the similar nature of the delivery service in these fee groups." *Id.* at 17. In presenting the new, merged fee structure, witness Needham explained that "[t]he four groups [A through D] are designed so that fees can be set, starting in part with this proposal, to reflect different levels of costs and demand for the variety of delivery offices." *Id.* at 19, n.10.

In Docket No. MC96-3 rebuttal testimony, Postal Service witness Taufique stated that the Postal Service's proposal in that proceeding "is designed to begin taking differences in costs and demand into account." Docket No. MC96-3, Tr. 10/3650. He suggested a "framework that ranks postal facilities based on factors such as capacity utilization, cost of providing the service, population or population density, per capita or household income, presence of competitive providers and the level of service, such as lobby access hours." *Id.* Witness Taufique concluded by asking for "feedback and suggestions from interested parties, including the Commission." *Id.*

In its Docket No. MC96-3 Initial Brief, the Postal Service clearly stated its longer term plans:

> while in this proceeding all non-city delivery offices are being maintained as a separate group (Group D), in the future the Postal Service's proposal would allow non-city delivery offices with high costs or demand to have higher fees than some city delivery offices. Thus, the Postal Service's proposal prepares the way for possible future reforms, such as that presented by Postal Service witness Taufique (USPS-RT-2 at 14), or using CAG level to group offices, as the OCA might prefer. *See* Tr. 5/1590.

Docket No. MC96-3, Initial Brief of United States Postal Service at 56.

Counsel for the OCA claimed to be surprised by witness Kaneer's testimony:

> The Postal Service surprised us very, very, late in the proceeding by this testimony which is 180 degrees from the testimony of witness Needham that we've been studying and addressing up to this point.

Tr. 32/17030. The OCA should not have been surprised since the Postal Service long ago expressed its intentions.[31/]

In its Recommended Decision, the Commission adopted the Postal Service's proposal, stating that "Group I will be merged with Group II, and the categories renamed A, B, C, and D." PRC Op., MC96-3, at 61. There would be no reason to rename the fee groups without a recognition that Group A, B, and C fees could apply to non-city delivery offices, and Group D fees could apply to city delivery offices. The pre-MC96-3 Group names I and II drew a line between city and non-city delivery offices that the renaming eliminated.

Similarly, the history of Groups A and B shows that they are not limited to the current locations listed in the DMM. In Docket No. R90-1, Postal Service witness Larson proposed the creation of two new post office box and caller service fee groups "intended to include offices and boxes located in very high cost and high cost areas." Docket No. R90-1, USPS-T-22 at 10. She also described

---

[31/] The OCA's knowledge of the Postal Service's intentions is shown in two of its own interrogatories. First, the body of OCA/USPS-T39-20 reads: "Please refer to Docket No. MC96-3, rebuttal testimony of witness Taufique (USPS-RT-2), at page 14. Witness Taufique states, 'A comprehensive consideration of the demand, supply, and cost differences of post office boxes could evolve into local adjustments to prices at each facility depending on market factors'". Tr. 3/644. Second, in the response to OCA/USPS-T39-4(d), the Postal Service states: "As was indicated in the course of Docket No. MC96-3, the Postal Service is interested in re-grouping post office box fee using economic data that are more recent than the late 1980's. However, no decisions have yet been made regarding how best to do this. As implied by this interrogatory, there is a potential for moving offices or ZIP Codes from Group C to Group B." Tr. 3/626. Thus, given these two interrogatory responses, witness Kaneer's rebuttal testimony should not be seen as a surprise when re-states postal intentions that have been a matter of record at least since MC96-3.

research which determined, for purposes of that proceeding, that the very high cost group would apply to Manhattan, and the high cost group would apply to areas of New York City other than Manhattan, and the business districts and some surrounding areas of Boston, Philadelphia, Washington, Chicago, Los Angeles, San Francisco, and Honolulu. *Id.* at 10-11. The Commission's Recommended Decision simply listed in the DMCS the two new fee groups (IA and IB), and provided the relevant fees, without identifying the particular locations affected. The particular locations, with some modifications concerning particular ZIP Codes, have been provided in the DMM. DMM § D910, Exhibit 5.3. In Docket No. R94-1, the Commission did not mention the particular locations in Groups IA and IB, instead stating that "[f]ees for boxes in Delivery Group I post offices are further categorized by Fee Groups IA, IB, and IC, which reflect higher rents in higher cost areas." PRC Op., R94-1, at V-158.

7. *The Postal Service has limited flexibility in applying Fee Groups A through D to its many facilities.*[32/]

The Postal Service therefore believes that it has the discretion to change the particular ZIP Codes that would pay Group A and B fees, as long as the new locations have "very high" or "high" costs, without first obtaining a Recommended Decision from the Commission. The Postal Service also believes that Group D fees can be applied to city delivery offices, and Groups A through C fees can apply to

[32/] Such flexibility would be exercised through the Postal Service's normal procedures for receiving input from the public, including *Federal Register* notice. 39 C.F.R. § 111.3.

non-city delivery offices. Changes in the fees for these groups, new discounts or surcharges, the addition or subtraction of fee groups, changes in the nature of the fee groups, or major changes in the assignment of facilities that alter the bases for the existing fees and classifications should be presented to the Commission for a Recommended Decision before they could be implemented by the Postal Service.

In summary, the Postal Service has proposed post office box and caller service fees in this docket that are reasonable and that meet the criteria of the Postal Reorganization Act. The recommended fees are also a step in a longer run plan to align fees with post office box costs directly. OCA's CAG-based fee groups would unnecessarily reshuffle facilities into fee groups having *no* significant relationship to post office box costs. The Commission should accordingly recommend the Postal Service's proposed fees, and not change the classifications.

E. The Registered Mail Fee and Classification Proposals Are Necessary to Cover Incremental Cost and Simplify the Fee Schedule.

The Postal Service has proposed increases to the registered mail fees averaging 51 percent. USPS-T-39 at 73. These increases are needed to approach coverage of incremental costs, *id.* at 79, which witness Takis shows are over 61 percent more than volume variable costs for registered mail service. USPS-T-41 at 31; Exhibit USPS-41B. The proposed cost coverage of 159.7 percent,[33/] based on volume variable costs only, is appropriate given the high value of service

[33/] USPS-T-39, workpaper WP-17, at 4.

provided registered mail, and the inclusion of insurance for all registered mail with monetary value. No party has opposed the Postal Service's fee proposal.

The Postal Service also proposes a classification change to include insurance with all registered mail with any pecuniary value.[34/] USPS-T-39 at 73. This complements the proposal, in Docket No. MC96-3, to include insurance with all registered mail valued above $100. The Commission recommended that proposal, because it would avoid customer misperceptions that registered mail automatically includes insurance, and would simplify the administration of registered mail service and the sales activity of postal clerks. Docket No. MC96-3, PRC Op., at 129-30.

These reasons apply to the Postal Service's proposal in this case. Even a customer with private insurance benefits from postal insurance, moreover, since the Postal Service is the insurer of first resort. Tr. 3/575. In addition, the incremental insurance fee for articles valued up to $100 is quite small. Tr. 3/592, 684. Any negative impact on customers thus would be limited, and easily outweighed by the benefits of getting insurance, avoiding misunderstandings, and having a simpler, faster transaction. This proposal also enhances product image, since registered mail can be presented to customers as an insured product, consistent with their expectations. Tr. 3/575, 717. The proposal also pursues administrative simplicity, since the transaction will no longer need to include a discussion of whether the customer needs insurance. Tr. 3/592. The Commission

---

[34/] Witness Needham also proposes to eliminate the offering of insurance for articles with no monetary value, since insurance has no value for such articles. USPS-T-39 at 78.

is urged to recommend both the Postal Service's proposed fees, and its proposal to include insurance with all registered mail articles with monetary value.

F. The Postal Service's Proposal for Return Receipt Service Reflects the High Demand for This Service.

The Postal Service proposes to increase the fees for return receipt service by an average of 31.6 percent, resulting in a cost coverage of 147 percent. The Postal Service has also proposed a classification change that will allow customers purchasing delivery confirmation service to obtain return receipt information. USPS-T-40 at 11. When implemented, this change would allow Priority Mail and Standard Mail users to obtain return receipt service at a much lower total cost than currently.[35/]

There are two major reasons for the Postal Service's proposed fee increases. First, the before rates cost coverage for return receipt service has fallen to only 111 percent.[36/] A substantial increase in return receipt fees is needed just to return to the 133 percent cost coverage that was established in Docket No. R94-1,

---

[35/] This assumes that the delivery confirmation fee resulting from this case is lower than the certified mail fee (and the other fees for accountable services that are a prerequisite for return receipt service). The return receipt information would be based on an electronically stored image, rather than a green card, when obtained in conjunction with delivery confirmation service. USPS-T-40 at 16.

[36/] USPS-T-40, WP-13, Return Receipts, column 9 divided by column 2. Tr. 31/16509.

the last time the Commission fully considered a cost coverage recommendation as part of an omnibus rate proceeding.[37]

Second, compelling demand evidence, when considered in light of the product's fee history, indicates that the current fees do not reflect the high value that customers place on return receipts. The addition of a check off box on the return receipt form to indicate whether the delivery address is the same as the address on the mailpiece also justifies some increase in the cost coverage, as suggested by the Commission in Docket No. MC96-3. PRC Op., MC96-3, at 112. Thus, the 133 percent cost coverage should receive a moderate increase to 147 percent.[38]

Douglas F. Carlson opposes the Postal Service proposal on the grounds that return receipt service is poor. Tr. 24/12813-19. He instead urges the Commission

---

[37] In Docket No. R94-1, the Commission recommended the proposed fees, which produced a 133 percent cost coverage. PRC Op., R94-1, at V-167; Docket No. R94-1, Exhibit USPS-11F, at 7. Note that the 125 percent cost coverage resulting from Docket No. MC96-3 was based on the Postal Service's failure in that limited proceeding to present "evidence comparing the current relationships between value and contribution of its various products", rather than a decision that 125 percent is an appropriate cost coverage for return receipt service. PRC Op., MC96-3, at 111.

[38] As witness Plunkett points out, a 147 percent cost coverage would still be well below the proposed systemwide coverage, and thus would be justified even if return receipt did not provide a high value of service. Tr. 32/17119. Nonetheless, the Postal Service maintains that return receipt service provides high value, as the Commission has agreed. Tr. 32/17117.

to defer any increase in the cost coverage for return receipt service until the Postal Service completes a study of the quality of return receipt service.[39]

Witness Plunkett's direct and rebuttal testimony demonstrate the absence of significant quality problems with return receipt service, and support the proposed increase in its cost coverage.[40] The increasing use of this service as a proportion of First-Class Mail volume, as shown in Exhibit USPS-RT-20A (Tr. 23/17129), shows that customer satisfaction with return receipt service has been high.[41] This demand evidence likely indicates customer satisfaction with the quality of return receipt service better than any study of quality would. Tr. 32/17177. The low number of customer complaints received by the Postal Service over the past three years also suggests that the quality of service has met customer needs and

---

[39] Tr. 24/12820. In some statements in his trial brief Mr. Carlson suggests that the return receipt fee should not receive a higher than average increase, or even be increased at all. Douglas F. Carlson Trial Brief at 1, 9 (section D heading, but not text). As discussed above, holding the fees at or near their current levels would lower the cost coverage from that established in Docket No. R94-1. The Postal Service strongly opposes such a result, since even accepting Mr. Carlson's testimony, there is no evidence that return receipt service has deteriorated since Docket No. R94-1.

[40] USPS-T-40, at 11-16, and USPS-RT-20, Tr. 32/17113-29, respectively.

[41] The Postal Service is concerned about the quality of return receipt service, and has established a special services management office that can focus attention on improvements to this service. Tr. 32/17122, n.5; 17176. The Postal Service, moreover, is working on a revised return receipt form that will not only add a check off box, as described above, but also reorganize the form and clarify it so that the delivery employee will be more likely to provide all requested information correctly.

expectations.[42] For all these reasons, the Postal Service's proposed return receipt fees should be recommended.

G. The Proposed Increase for Special Handling Fees is Required to Set Fees That Cover Costs.

The Postal Service proposes to increase special handling fees by 220 percent in order to cover costs. The test year cost is more than three times the cost from the test year for the preceding rate case, Docket No. R94-1. While the Postal Service would certainly prefer a much more moderate fee increase, the § 3622(b)(3) requirement that fees cover costs leaves the Postal Service with little discretion.

On February 19, 1998, the American Beekeeping Federation, Inc. moved for leave to intervene in Docket No. R97-1, and filed its Brief in Opposition to Special Handling Rate Increase. The ABF Brief includes three exhibits. Exhibit 1 is an

---

[42] Tr. 31/16888; Tr. 32/17121. The crux of Mr. Carlson's argument is that the high value of return receipt service can be established only if in every instance the return receipt form is fully completed in exact compliance with postal regulations. (see DFC-T-1, pp. 17-24). The Postal Service's position, expressed in the rebuttal testimony of witness Plunkett, is that most customers do not measure value in this way, but instead make an intuitive assessment as to whether they are satisfied with the outcome of a transaction based on what they paid and whether their expectations were met. Tr. 32/17156-59. In many cases, expectations may be limited to acknowledgment that their mail has been received. They are not necessarily concerned about return receipt features such as the date of delivery, or the signature and printed name of the recipient. This is not to say that these features are not valued by some subset of return receipt users, but they are incidental features that are of limited importance to customers who are concerned primarily with the core feature of return receipt service: notification of delivery. Tr. 32/17149-50. The demand and complaint evidence presented by the Postal Service shows that customers generally have been satisfied with the quality of return receipt service. Tr. 31/16505; Tr. 32/17157-61, 17177.

Affidavit of Binford Weaver, identified as a co-owner of B. Weaver Apiaries, which produces package bees for sale to the public. Exhibit 2 consists of several pages that witness Needham purportedly provided during a public address to the Queen and Package Bee Breeders meeting in January, 1998. Exhibit 3 consists of the section of witness Needham's testimony on special handling service. Exhibits 1 and 2 have not been subject to cross-examination, and are not in the evidentiary record. Factual statements in the ABF Brief that rely on these exhibits also are not in the evidentiary record, and therefore cannot be the basis for a Commission recommendation on the appropriate special handling fees.

While ABF's brief asserts that the evidence in support of the Postal Service's special handling fee proposal "consists almost entirely of the testimony of Susan Needham," in fact critical evidence underlying the proposal is the cost information provided by Postal Service witnesses Alexandrovich and Patelunas.[43/] As summarized in connection with Presiding Officer's Information Request No. 8, unit costs for special handling have increased by 244 percent between FY 1993, the base year in Docket No. R94-1, and FY 1996, the base year in this proceeding.[44/]

[43/] Exhibits USPS-5B at 2 (base year), USPS-15F at 2 (test year before rates), and USPS-15I at 2 (test year after rates).

[44/] Tr. 31/16497. (1,858.2/540.1) - 1 = 244 percent. Using witness Alexandrovich base year costs of $1,136,000, instead of the higher FY 1996 CRA costs of $1,245,000, cost per piece would have increased from $5.40 in FY 1993 to $16.96, for a 214 percent increase. Including Postal Service special handling volumes (Tr. 31/16499-500), cost per piece would still have increased from $5.39 to $13.85, for a 157 percent increase.

Moreover, witness Alexandrovich has explained why costs have increased. As special handling fees have increased, generally only the most costly special handling pieces, containing honeybees and day-old poultry, have continued to use this special service. Tr. 31/16432. These remaining special handling pieces require manual processing and costly expedited transportation. *Id.* There is also a need for large amounts of window service when these special handling parcels are accepted into the postal system, and delivered to the recipient. Tr. 31/16436, 16438. Finally, as special handling parcels have become rare, experience with these transactions at postal facilities has diminished, so processing might not be as efficient as in earlier years. Tr. 31/16433, 16437. Thus, it is not surprising that the Postal Service might incur costs of $15 to $25 for a special handling parcel. Contrary to ABF's implications, ABF Brief at 2, the Postal Service does not believe that special handling fees cannot reliably be based upon the data systems costs and volumes for special handling that have been presented in this proceeding.[45]

---

[45] ABF requests that the Commission defer any increase in special handling fees until the Postal Service completes a special study of special handling costs. ABF Brief at 2. While the Postal Service may in the future undertake a special review or cost study in order to gain a better understanding of recent cost increases for special handling service, no special study is underway, and such a study would take a considerable time to complete. ABF's request that the Commission defer any increase until the Postal Service completes such a study would result, in the interim, in the recommendation of special handling fees that unlawfully do not cover the best available estimate of costs. In any case, it is likely that such a study or review would confirm that providing special handling for honeybees and day-old poultry is relatively expensive compared to other postal products, given the labor intensive nature of special handling service for such shipments. It thus would be incorrect to assume that the current special handling fees cover the costs of special handling for such shipments.

ABF claims that "it strains credulity that . . . Special Handling volume declined 72% from 1995 to 1996 yet Total Special Handling Costs as shown in Exhibit 2 are increasing." ABF Brief at 2. In fact, from 1995 to 1996 costs declined as fast as volume.[46] The stability of unit costs in 1995 and 1996 suggests that the costs, while much higher than the costs in the last rate case, are not anomalous.

In order to cover these costs, witness Needham was required to propose a large increase in special handling fees. Section 3622(b)(3) of Title 39 requires that "each class 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." As a special service, special handling is a "type of mail service" that must cover its attributable costs. ABF's request that the Commission consider the ECSI value of bees in setting the special handling fee is of no avail, because that criterion does not override this requirement that the fees for each special service cover its costs. *See* ABF Notice of Intervention at 2.

ABF claims that there is no alternative to parcel post with special handling for shipping bees. ABF Brief at 3. However, the DMM allows bees to be shipped without special handling if they are sent Priority Mail.[47] DMM § C022.3.7.

---

[46] Tr. 32/14634. Using Witness Alexandrovich's base year costs, Exhibit USPS-5B at 2, costs declined faster than volume in FY 1996.

[47] Similarly, day-old poultry may be sent without special handling if sent at the First-Class Mail rate. DMM § C022.3.1f.

Thus, mailers currently have an option to continue sending bees and poultry without paying the increased special handling fees.

H. The Postal Service Proposes a Two-Cent Fee to Fill the Shell Classification for Stamped Cards Resulting From Docket No. MC96-3.

The Postal Service proposes a 2-cent special service fee for stamped cards, in addition to the proposed 21 cents postage. USPS-T-39 at 87. This proposal provides a fee for the shell classification recommended by the Commission in Docket No. MC96-3, and implemented thereafter. Witness Needham proposes a two-cent fee to cover the manufacturing costs for stamped cards, and provide a markup to reflect the high value to customers of an attractive card that provides both stationery and pre-affixed postage.[48]

In Docket No. MC96-3, the Commission would not recommend a fee for stamped cards because the manufacturing costs underlying the fee proposal were also included in the costs underlying the postage rate applicable to stamped cards. PRC Op., MC96-3, at 142. In this proceeding, however, witness O'Hara has

---

[48] *See* Tr. 3/594, 608, 679. While test year cost and volume data result in a calculated 254.3 percent cost coverage for stamped cards, the proposed two-cent fee should not be lowered. That cost coverage is based on a test year after rates volume growth (28 percent above FY 1996 CRA volume (Tr. 13/6993)) that is not reflected in test year manufacturing costs. USPS-T-39 at 89; *see* USPS-T-39, workpaper WP-17 at 4, revised November 20, 1997. Witness Needham's best estimate of stamped card costs in this proceeding, using the FY 1996 CRA volume, is almost exactly one-cent. *Id.* In Docket No. MC96-3, stamped card manufacturing costs were determined to be 1.175 cents. PRC Op., MC96-3, at 133. Given a one-cent rounding constraint, a two-cent fee is needed to ensure cost coverage. This is especially so because the Postal Service has not included any window service costs for stamped card sales in the costs underlying the proposed fee, as recommended by the Commission in Docket No. MC96-3. *Id.* at 144.

removed manufacturing costs from total Single Postcard costs in determining the cost coverage for the Cards subclass.[49] Adding a stamped card fee as part of an omnibus rate proceeding also addresses the Commission's concern about changing a rate commonly used by household mailers in a more limited proceeding. PRC Op., MC96-3, at 143. The Commission therefore should recommend the Postal Service's proposal for a two-cent fee.

Intervenor Douglas F. Carlson proposes to eliminate the stamped card special service classification, and include manufacturing costs with other stamped card costs in determining a postage rate for stamped cards. Tr. 24/12802-03. Mr. Carlson's complex methodology for determining the postage rate for stamped cards accepts the view that the manufacturing costs for stamped cards should have one markup, based on the value of the preprinted postage, while the mail processing costs for stamped cards should have another. Both markups are applied in determining the postage rate for stamped cards. Tr. 24/12801. The Postal Service believes that the Commission should not adopt the unprecedented use of two markups to derive one postage rate. Instead, consistent with the current DMCS rate and fee structure for stamped cards, one markup should be used to derive the postage rate, and the other should be used to develop a special service fee.

Mr. Carlson's proposal moreover would reverse the Commission's recommendation less than a year ago that "Stamped Card users should pay

---

[49] Exhibits USPS-30B and 30F, p.1, as revised September 19, 1997. Witness Patelunas also subtracted manufacturing costs from total Cards costs for the test year before rates. USPS-T-15, Appendix D.

separately for the card as well as the postage." PRC Op., MC96-3, at 142. It would also undo the movement toward comparable treatment for stamped cards and stamped envelopes, so that the postage rate is unaffected by the purchase of the stamped item, and additional costs related solely to the special characteristics of the stamped item are recovered through a special service fee. This approach has worked well for stamped envelopes, and is appropriate for stamped cards also. The Commission therefore should reject Mr. Carlson's proposal to eliminate the special service classification for stamped cards.

I. The Postal Service's Simpler, More Cost-Based Stamped Envelope Fee Structure Should Be Recommended.

The Postal Service is proposing to simplify the fee structure for stamped envelopes, and to make the structure more cost-based. While different fees have been established for different types of envelopes, costs actually are fairly close to each other for most types of envelopes.[50] Witness Needham therefore proposes the same fees for all types of envelopes except hologram envelopes and, when sold in units of 500, plain banded envelopes.[51]

---

[50] Library Reference H-107 at 45-47.

[51] In a supplemental response to David B. Popkin's interrogatory DBP/USPS-66(a), filed October 15, 1997, witness Needham clarified the stamped envelope proposal as presented in the requested fee schedule, as well as her testimony. Witness Needham specified that the printing charge has been included directly in the proposed fees for printed bulk stamped envelopes, rather than stated separately, as in the current fee schedule. Witness Needham's supplemental response also attached a simplified restatement of proposed Fee Schedule 961, for the Commission's consideration. Attachment 1 to Supplemental Response to DBP/USPS-66(a).

Because of the cost averaging, the proposed fees actually decrease by 1.3 percent on average, and would decrease the cost coverage to only 118.3 percent.[52] This cost coverage is well below the historical cost coverage for stamped envelopes recommended in prior rate cases. The Postal Service expects to propose higher fees in the future to increase the cost coverage. Nonetheless, the proposed fees are moderate, and simplify the fee schedule. They should be recommended by the Commission.

J. The Commission Should Adopt the Proposed Reorganization of the Special Services Section of the DMCS, But Should Defer Wording Changes Until a Later Proceeding.

In response to the Commission's suggestions in Docket No. MC96-3 that the clarity and organization of the Special Services section of the DMCS should be improved, witness Needham proposes to group the special services into seven categories in the DMCS: addressing, delivery alternatives, payment alternatives, accountability and receipts, parcel handling, stamped paper, and money orders.[53] The sections also are renumbered into a 900 series, providing a parallel structure with the remainder of the DMCS. *Id.* Some non-substantive, editorial changes are suggested.

In Notice of Inquiry No. 2, the Commission also presented a new numbering system and editorial revisions for the special services provisions in the DMCS. In its December 19 comments in response to this Notice of Inquiry, the Postal Service

---

[52] USPS-T-39, workpaper WP-17 at 4, as revised November 20, 1997.

[53] USPS-T-39 at 102. *See* PRC Op., MC96-3, at 159-60.

expressed its concern that some of the Commission's edits involve substantial rewording, and thus may have substantive effects. The Postal Service asked the Commission to defer any changes other than grammatical corrections until a later proceeding, when the purpose of substantial rewording could be better explained. The Postal Service also noted that it is reviewing many of its special services, and that rewording of the special services section of the DMCS generally should wait until the Postal Service has an opportunity to consider its needs to propose substantive DMCS changes for the special services in future cases.

K. The Commission Should Recommend the Requested Surcharges for Hazardous Medical Materials and Other Hazardous Medical Materials.[54/]

The Postal Service has requested that the Commission recommend two new surcharges, $0.50 for Hazardous Medical Materials (HMM) and $1.00 for other Hazardous Medical Materials (OMHM), as those materials are defined in the Domestic Mail Manual (DMM). The proposed surcharges 1) recognize the costs of handling and cleaning up spills from such materials; 2) improve the alignment of prices with costs; 3) conform to industry standards; and 4) provide a means of improving postal data. USPS-T-42 (witness Currie) at 1.

The Postal Service presents evidence of the special methods and procedures used by carriers who handle and transport such material to manage the risks of transporting hazardous material, the regulatory framework that guides such

[54/] While not a special service, discussion of the hazardous materials surcharges is included in the section as a matter of convenience.

handling – including the postal regulations that follow the industry directions, how the regulatory framework has evolved to impose greater costs on carriers in the past decade or so, and the present postal handling environment and how it imposes costs on the Postal Service. *Id.* At 1-14.

The Postal Service supports its request by noting that the surcharges will promote classification criterion 1 (39 U.S.C. §3623) by imposing the additional costs caused by the affected OMHM and HMM mail only on the responsible mailers, rather than having mailers of other types of material also bear the costs.[55] USPS-T-42 at 16. The ability to transport material through the mail is of considerable value to the sender and recipient, since for many people other options are less convenient and/or most costly (criterion 2). *Id.* As compared with the potential for prohibiting the transport of the affected materials through the mail, the proposed classifications may also be desirable to mailers notwithstanding the surcharges.

With respect to the pricing criteria, the value of service is also relatively high, since the ability to send these types of materials through the mail provides considerable convenience while lowering overall cost, although more so for HMM than for OMHM mail, since the former tend to travel via First-Class, Priority, or Express Mail. *Id.* at 18. As noted above, alternate means of sending and receiving

[55]The inability at this time to quantify costs caused by HMM and OMHM mail is offset by several factors, including the relatively nominal charges as compared with other carriers (*see* USPS-T-42 at 13-15), the apparent ready availability of mailer alternatives (*see* Tr. 30/16357), and the fact that better quality data will be available at the next rate cycle (USPS-T-42 at 1; *see also,* Tr. 30/16327 - 30).

the materials subject to the proposed surcharges are available from private sector providers at reasonable cost (criterion 5). *Id.* Offsetting the additional costs imposed by HMM and OMHM mail promotes fairness and equity by spreading these costs over the responsible mail, rather than all mailers.

Witness Currie testifies to his belief that the effect on mailers of the affected materials, who are expected to pay $2.00 to $3.00 per postage, is acceptable.[56] Moreover, affected firms may simply pass the cost on to their customers, Tr. 30/16374, for whom the percentage increase when measured against the total transaction cost would most certainly be less than that asserted in the LabOne testimony.[57]

In conclusion, the Postal Service has requested modest surcharges based on the ready understanding that HMM and OMHM impose a variety of costs on the postal system arising from the risk inherent in the handling of such materials, and the extra handling, clean-up, and training costs that are necessarily incurred. If the surcharges are adopted, more complete information would also be available to

---

[56]LabOne, *et al.*'s assertions that their mail pieces average much less in postage per piece do run counter to this argument; however, those assertions are specific only to the firms appearing under LabOne's umbrella and cannot be generalized to other firms or to the overall volume of HMM mail. *See, e.g.*, Tr. 30/16359 (witness Bourk is only knowledgeable of his firm's mail); *cf.*, *id.* at 16351 (Bourk has no knowledge whether other firms have been equally successful as his at managing risk through proper packaging).

[57]For reasons of commercial sensitivity, the cost to insurance companies for a single test kit does not appear in the record. *See, e.g.*, Tr. 30/16374.

make any necessary adjustment to the fees at the next rate cycle, if not sooner.[58]

[58]Better cost data would also be available should only the classification changes be adopted at this time. *See, e.g.,* Tr. 30/16328-30.

VII. CLASSIFICATION CHANGES PROPOSED IN THIS DOCKET ARE CONSISTENT WITH THE CRITERIA OF THE ACT AND THE POSTAL SERVICE'S AND COMMISSION'S COMMON GOAL OF IMPROVING CLARITY AND CONSISTENCY OF THE DMCS.

This filing proposes the elimination of the Standard (A) Single Piece subclass to avoid the introduction of anomalous rate relationships. Witness Moeller explains that, if the Postal Service retained this subclass, its rates would exceed those for First-Class, despite the superior service offered by First-Class Mail. Witness Moeller

This filing also responds to the Commission's suggestion, initially raised in Docket No. MC96-3, that "broader improvements in the organization, format, and editorial presentation of the underlying DMCS, similar to those considered in the previous reclassification cases" be introduced. Docket No. MC96-3, Notice of Inquiry No. 1 Regarding Potential Improvements in the Organization and Structure of DMCS Provisions Related to Various Special Services (hereinafter "Notice"). In its response to the Notice in Docket No. MC96-3, the Postal Service responded favorably to the Commission's suggestions for improvement, but recommended deferring consideration of such proposals in order to avoid being hastened by the procedural deadlines of that proceeding.

After the conclusion of Docket No. MC96-3, the Postal Service undertook to develop a comprehensive review of the organization and diction of the DMCS. The proposed classification changes address the Commission's suggestions for improvement. The special services schedules are reorganized into subject matter groupings, which represents an improvement over the existing sequence. The Postal

Service has also introduced organizational headings[1] to identify the logical relationships among the special service products. To facilitate ease of reference, the special services sections are also proposed to be renumbered in a 900 series. The prior numbering system, which consisted of a combination of the acronym "SS" followed by numbers, was cumbersome. By contrast, the new proposed 900 series extends the numbering system of the remainder of the DMCS to the special services provisions.

The proposed classification changes also serve to promote clarity, consistency, and conciseness. Specifically, the Postal Service has proposed numerous editorial improvements and changes in diction to remove internal inconsistencies as well as foster consistency with the Domestic Mail Manual. Gender-specific references are also proposed for elimination in the text of the DMCS. Separate rate schedules are developed for Parcel Post Rate categories to promote simplicity and ease of use, particularly since discounts for intra-BMC and DDU and SCF entry are not uniform across all rate cells. Repetition of the definition of stamped cards is eliminated, consistent with the classification for stamped envelopes, and the Postal Service proposes a new name for the cards subclass to replace its current, unwieldy name.

---

[1] These include: Addressing, Delivery Alternatives, Payment Alternatives, Accountability & Receipts, Parcel Handling, Stamped Paper, and Postal Money Orders.

CONCLUSION

For the reasons stated above, the rates for postal services, fees for special services, and the modifications of the domestic mail classification schedule proposed by the United States Postal Service are supported by the evidentiary record and are in accord with the applicable provisions of the Postal Reorganization Act. The proposals of other parties which differ from the Postal Service's have been shown to be unacceptable.

WHEREFORE, the Postal Service requests that the Postal Rate Commission recommend under 39 U.S.C. § 3624(d) the rates and fees and changes in the domestic mail classification schedule requested by the Postal Service in this Docket.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Anthony F. Alverno

Richard T. Cooper

Susan M. Duchek

Kenneth N. Hollies

Eric P. Koetting

Scott L. Reiter

Anne B. Reynolds

David H. Rubin

Michael T. Tidwell

475 L'Enfant Plaza West, S.W
Washington, D.C. 20260-1137
April 1, 1998

CERTIFICATE OF SERVICE

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

Daniel J. Foucheaux, Jr.

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260–1137
April 1, 1998