

DOCKET SECTION

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

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POSTAL RATE AND FEE CHANGES, 1997)

Docket No. R97-1

REPLY BRIEF

OF

**NASHUA PHOTO INC., DISTRICT PHOTO INC.,
MYSTIC COLOR LAB, SEATTLE FILMWORKS, INC., AND
MERCK-MEDCO MANAGED CARE, L.L.C.**

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ARGUMENT

**I. THE POSTAL SERVICE HAS FAILED TO REFUTE THE EVIDENCE
AGAINST THE FIRST-CLASS NONSTANDARD SURCHARGE;
THEREFORE, THE SURCHARGE SHOULD BE ELIMINATED OR
SIGNIFICANTLY REDUCED**

In its Initial Brief (page V-63), the Postal Service tries to justify the First-Class nonstandard surcharge as if it applied to all mailpieces which cannot be processed on letter automation equipment. It does not. The Postal Service poses the novel argument that the nonstandard surcharge is not based on nonmachinability, but non-letter automatability. USPS Initial Brief, p. V-63. This Postal Service argument reveals its present confusion regarding the basis for the surcharge.

Further, Dr. Haldi's testimony exposes flaws in this argument. *See* NDMS-T-1, pp. 8-17, Tr. 24/12881-90. The evidence is clear that many letter-sized pieces defined as "nonstandard" are in fact processed routinely on letter automation equipment. This was the point of Dr. Haldi's Christmas Card experiment (LR-NDMS-1), and was

confirmed upon cross-examination of Postal Service rebuttal witness Sheehan (Tr. 33/17417-21). Despite the record, the Postal Service asserts that it is “still reasonable to assume” that poor aspect ratio letters are handled manually. USPS Initial Brief, p. V-63. Indeed, while all nonstandard pieces are subject to the surcharge at the present time, only a small percentage of nonstandard pieces cause the Postal Service to incur additional handling costs. This justification for the surcharge has all but disappeared.

Both the Commission and the Postal Service in prior dockets have consistently characterized nonstandard mail as **nonmachinable** (*i.e.*, mailpieces that incur greater handling costs because they cause malprocessing and/or require **culling and manual processing**). The Postal Service has not made any showing in this proceeding that mailpieces first defined as nonstandard in Docket No. MC73-1 remain nonmachinable, while substantial evidence indicates that most such mailpieces are now machinable. Thus, when the Postal Service argues (USPS Initial Brief, p. V-63) that NDMS evidence showing all nonstandard flats can be processed on the FSM 1000 is “irrelevant,” it is trying to effect a subtle but dramatic change in the basis for the surcharge.

In every prior docket in which the nonstandard surcharge has been recommended, it has been based upon a determination or an assumption that “nonstandard” mail is not machinable. That is no longer true. Therefore, no current basis exists for the requested surcharge.

A. **The Postal Service Fails to Justify the First-Class Nonstandard Surcharge Based on the Commission's Original and Long-Held Reason for Permitting the Surcharge**

NDMS challenges the very *raison d'être* for the First-Class nonstandard surcharge. Insofar as the First-Class nonstandard surcharge has received little adversarial attention since its adoption a generation ago, NDMS invites the Commission to examine the Postal Service's justification for the surcharge. This analysis begins with a review of the Commission's original justification for establishment of the surcharge.

When the surcharge classification was first established 25 years ago, the Commission stated that:

the Postal Service has presented substantial evidence that mail larger or smaller than the design standards of **processing equipment** costs more to handle.... In addition, **mechanization** requires that some definition of maximum size be specified for purposes of **machine design** and procurement.... This is especially true since the Postal Service anticipates eventually moving to a fully **mechanized** system. [*Op. & Rec. Dec.*, Docket No. MC73-1, p. 25-26 (emphasis added).]

The Commission stated that “mail that is too small or **flimsy** tends to jam the **mail processing machines** and damage other mail. Oversize pieces, on the other hand, can be handled without detriment to **machines** or other mail because they can be **culled** [manually] from the mailstream, but the cost of [manual] handling is greater.” *Id.*, p. 25, fn. 1 (emphasis added).

The Commission made it clear that the surcharge reflected then-current design standards of **mail processing equipment**. Although the Commission mentions too-small

pieces, the only criteria defining nonstandard mailpieces are maximum size and aspect ratio. (DMCS section 232.)¹ Thus, it is only with respect to (i) “bad” aspect ratio letters run on letter machinery and (ii) pieces that exceed the maximum size design standards for mail processing equipment now (including both letter and flat processing machinery) that validity of the nonstandard surcharge should be tested.

Machinability on letter processing equipment was the key to determine which mailpieces incurred greater handling costs in the 1970s, when the current definition of nonstandard was created, because the Postal Service’s only processing equipment was letter equipment. The term used by the Commission, “mechanization,” then meant letter processing equipment, but now the term applies to flat sorting equipment (with the term “automation” generally used with respect to letter equipment). (Tr. 11/5825) Clearly, the Commission’s 1973 term “mechanization” should be viewed today as referring to both flat and letter processing equipment. There certainly is no justification for limiting it to letter automation, as the Postal Service impliedly proposes.

In Docket No. R84-1, the Postal Service’s evidence for the nonstandard surcharge examined the “potential machinable range” for acceptable dimensions of mail pieces by looking at both (i) **letter sorting machines** (LSMs) and (ii) **Multi Position**

¹ Minimum mailability requirements are found at DMCS section 6020, which establishes that most mailpieces must have a minimum size of 3.5 inches by 5 inches, or they are nonmailable. Consequently, no mailpieces are subject to the First-Class nonstandard surcharge because their dimensions are smaller than the minimum; they are simply nonmailable. Thus, minimum standards are wholly irrelevant to the reason for the surcharge, are not specified in the definition of a nonstandard piece, and the Postal Service does not in this case refer to minimum size specifications as a justification for the surcharge.

Flat Sorting Machines (MPFSM), “taken together.” USPS-LR-D-9, p.2 (entitled “Nonstandard Surcharge”) (emphasis added). The position of the Postal Service in Docket No. R84-1 is diametrically inconsistent with the Postal Service’s new view that machinability refers only to letters. In that same docket, the Commission characterized “standard pieces” as “those that can be machine processed.” *Op. & Rec. Dec.*, Docket No. R84-1, p. 330.

The Commission continued to focus on the difference between mechanized and manual mail handling in Docket No. R87-1, when discussing the nonstandard surcharge. The Commission noted nonstandard “pieces are either too small or too large to be **machine processed**, must be [manually] culled from the mailstream for that reason, and therefore incur additional [manual] handling costs.” *Op. & Rec. Dec.*, Docket No. R87-1, p. 449.

In Docket No. R90-1, the Postal Service’s evidence continued to characterize the surcharge as based on the fact that pieces which do not meet the “standard” size or aspect limitations are handled **manually**. “These [nonstandard] criteria define the non-machinability characteristics which require a piece to be strictly handled in **manual operations**.” USPS-LR-F-160, Nonstandard Surcharge Cost Update, p. 1 (emphasis added).

The fact that a nonstandard piece had to be handled **manually**, rather than handled on letter or flat machines, historically has been the *sine qua non* of the nonstandard surcharge.

In the current docket, the Postal Service has made no effort to demonstrate that nonstandard letters jam letter sorting machinery, or that one-ounce-and-under flats (“flimsies”) jam or otherwise adversely affect flat sorting machinery, or that these nonstandard pieces are regularly culled from the mailstream and processed manually. It is submitted that the Postal Service has failed to demonstrate a continued justification for the surcharge based on the definition of nonstandard mail that the Commission set in Docket No. MC73-1, and that both the Commission & the Postal Service have subscribed to since.

In this docket, with respect to letters, the cross-examination of Postal Service witness Sheehan (Tr. 33/17380-439), who is an operations expert, proves that letters which have a “too long” aspect ratio are handled just as all other letters on letter automation equipment. *See* NDMS Initial Brief, pp. 32-33. With respect to letters that are “too tall” or “too square,” based on the testimony and evidence of Dr. Haldi (NDMS-T-1, pp. 11-12, Tr. 24/12884-85; LR-NDMS-1) and the cross-examination of Postal Service witness Sheehan (Tr. 33/17408-09), it has been demonstrated that, at worst, a relatively small but unknown number of these letters can “tumble” during processing. *See* NDMS Initial Brief, pp. 32-33. No evidence has been presented that the Postal Service makes any effort to cull nonstandard letters from the mailstream and sort them manually.

As to height and length requirements, any mailpiece which exceeds the dimensions of a nonstandard letter simultaneously exceeds the dimensions of a letter, (*i.e.*, it is either a flat or a parcel); therefore, it should not and would not be processed

on letter automation equipment. To say that flats cannot be processed effectively on letter sorting equipment is simply irrelevant to the issue of the surcharge. *See* USPS Initial Brief, p. V-63. Once a piece exceeds the height and length of a letter it becomes a flat, and is handled on flat processing equipment. Under the Commission's stated test, the issue is whether "mail larger or smaller than the design standards of processing equipment [in this case, Flat Sorting Machines] costs more to handle." *Op. & Rec. Dec.*, Docket No. MC73-1, p. 25.

With respect to flats, witness Sheehan had no disagreement with the Postal Service's 1997 Comprehensive Statement on Postal Operations that the new FSM 1000s² process flawlessly "virtually all" previously nonmachinable flats. *See* Tr. 33/17400-03. Witness Sheehan agrees that the FSM 1000 can readily process these "nonstandard" flats. The record contains no evidence that flimsies present any problem on the FSM 1000s that have been widely deployed and are being deployed nationwide.

With respect to pieces (flats and parcels) which are too thick to be letters but are within the letter height and length maximums (6 1/8" by 11 1/2"), witness Sheehan observed that such pieces were "processed in a letter case," and handled as manual

² The FSM 1000 is not a new flat sorting machine. It was discussed in Docket No. R94-1 and has been deployed for some time, with full deployment expected soon. The minimum and maximum size specifications for a flat on an FSM 1000 are as follows:

Minimum Height 3.94"	Maximum Height 12"
Minimum Length 3.94"	Maximum Length 15.75"
Minimum Thickness 0.007"	Maximum Thickness 1.25"

(Response of USPS Witness Moden to TW/USPS-T4-5, Tr. 11/5926-27.)

letters. Tr. 33/17411-12, 17434. Clearly, the Postal Service's cost proxy of an average parcel weighing 4.3 ounces should not be used to determine the mail processing costs of such lightweight, otherwise letter-shaped (except too thick) pieces.

To sum up, the record in this docket demonstrates that few "too tall" "(too square)" aspect ratio letters are not automatable, few flats are nonmachinable on the FSM 1000, and the few parcels subject to the surcharge (under 7 percent of total First-Class nonstandard pieces) are generally handled like manual letters. Technology has eclipsed the justification for the First-Class nonstandard surcharge.

B. The Postal Service Justification for the First-Class Nonstandard Surcharge Appears to Be Changing at the Eleventh Hour and the Fifty-ninth Minute

Several arguments in the Postal Service Initial Brief make a desperate, last-ditch attempt to justify the nonstandard surcharge. The Postal Service states that the basis for the increases is Library Reference H-112, and Exhibit USPS-43A, which updates a fatally-flawed cost study of what the Postal Service calls 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." USPS Initial Brief, p. V-16 (emphasis added).³

³ It is undisputed that **the Postal Service's cost study does not measure the relevant costs** — which are, of course, the costs of handling one-ounce-and under nonstandard pieces. While the proxies it uses to represent such costs have been accepted by the Commission in the past (although not without misgivings), the Commission has admonished the Postal Service that using such proxies was less than satisfactory. The Postal Service barely acknowledges this defect, and has made no attempt to cure it.

The Postal Service states that its “preference [is] that the surcharges, to the greatest extent possible, reflect the estimated additional mail processing **and delivery costs** incurred by nonstandard First-Class Mail pieces.” USPS Initial Brief, p. V-17 (emphasis added). This reference to “delivery costs” is highly misleading. The Postal Service has not now (nor has it ever) sought to justify or calculate the surcharge based on unstudied, unproven, and perhaps nonexistent differences in delivery costs. No Postal Service witness has attempted to identify or quantify whether nonstandard pieces give rise to any additional delivery costs. The fact that the nonstandard surcharge is in no way based on delivery costs is actually acknowledged elsewhere by the Postal Service. USPS Initial Brief, p. V-17, fn. 21. This reference to delivery costs so as to identify and shoe-horn in a new, non-record justification for the surcharge, must be rejected out of hand.⁴

It is in the third section of its Initial Brief dealing with the First-Class nonstandard surcharge (page V-61) that the Postal Service hints at its second novel theory to defend the surcharge: “[e]limination of the surcharge also would reverse the trend of rewarding mail piece design which results in utilization of **the most efficient**

⁴ The Postal Service also quotes the Commission’s Opinion and Recommended Decision in Docket No. R90-1 that “[h]istorically, the [nonstandard] surcharge has been imposed to recover the added cost of processing nonstandard pieces.” USPS Initial Brief, p. V-17, quoting V-15, para. 5034. These “added” costs are the additional costs that arise from nonstandard pieces being unable to run on mechanized equipment, and therefore must be processed manually. As the Postal Service pointed out in that docket, nonstandard “criteria define the **non-machinability** characteristics which require a piece to be strictly handled in **manual** operations.” USPS-LR-160, p. 1 (emphasis added).

mail processing technologies....” USPS Initial Brief, p. V-61 (emphasis added.) Since letter automation is the most efficient mail processing technology, this argument appears to call for a nonstandard surcharge on all pieces which cannot be run over letter automation, including some letters and **all flats**. If this is the Postal Service’s argument, it is another, new, non-record justification for the surcharge. The Postal Service is not proposing, however, a flat-shaped surcharge. It is proposing a nonstandard surcharge. The only flats which are surcharged are those one-ounce-and-under. This surcharge cannot be justified based on the average processing costs of flats being higher than the average processing costs of letters any more than it should be rejected because the average revenue of flats is higher than the average revenue of letters.

As the Commission has stated from the beginning, the surcharge is based on evidence that mail which is “larger or smaller than the design standards of processing equipment costs more to handle.” *Op. & Rec. Dec.*, Docket No. MC73-1, p. 25. Flats are clearly within the design standard of flat processing equipment and light-weight flats are clearly within the design standard of new flat sorters. Flats cannot run on letter sorting machines, but they can and do run efficiently on mail processing equipment.

The Postal Service states that “[eliminating the surcharge would arbitrarily shift the burden of the extraordinary processing costs (associated with nonstandard 1-ounce parcels containing such items [sic] rolls of film) to the mailers of clean, automation-

compatible mail.” USPS Initial Brief, V-61. This single assertion raises at least three thorny problems for the Postal Service.

First, the record contains no evidence whatsoever that any “extraordinary” processing costs are associated with processing nonstandard one-ounce-and-under parcels containing rolls of film. Witness Daniel states that she has no cost information whatsoever as to the cost of handling any one-ounce-and-under piece. USPS-ST-43, p. 2. Indeed, the only record evidence on this point was the cross-examination of witness Sheehan, quoted above, that such too-thick but otherwise letter-shaped pieces are handled as manual letters.⁵ The processing cost of a manual letter is stated by witness Daniel to be 20.54 cents, only about 8.8 cents more than a single-piece letter at 11.74 cents. Exhibit USPS-43C. Such a cost difference can hardly be described as “extraordinary.”

Second, the only “automation-compatible” mail are letters. Again, the Postal Service seems to be trying to justify its position because letters are less expensive to handle than nonletters, so all nonautomation letters, by implication, should be surcharged. But that is not the definition of nonstandard mail.

Third, the same point that the Postal Service is making, that nonautomation letters drive up the total costs of First-Class letters, could be said of hand-addressed single-piece mail, but there is no proposal to impose a nonstandard surcharge on this mail.

⁵ Even if not processed as manual letters, these uncontainerized rolls of film in envelopes are well within the thickness capability of the FSM 1000.

The Postal Service then argues that the surcharge is justified because “[p]ieces 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.” USPS Initial Brief, p. V-63. This is nonsense. What the Postal Service fails to mention is that a flat of any weight whatsoever, “definitely cannot be handled on letter automation equipment. This fact might be highly relevant to the imposition of a surcharge on all flats, if one were to be proposed. But it is wholly irrelevant to any justification for the First-Class nonstandard surcharge.

If it were shown that flimsies could not be processed on existing flat sorting machines scheduled for widespread deployment during the Test Year, then the Postal Service might have been able to meet the test set out in Docket No. MC73-1, that flats failed to meet the “standards of processing equipment” and therefore “cost[] more to handle.” *See Op. & Rec. Dec.*, Docket No. MC73-1, p. 25. This is also the basis on which the Postal Service has relied consistently in the past to impose the nonstandard surcharge.

The Postal Service Initial Brief attempts to show that nonstandard piece sorting on the FSM 1000 is much more expensive than standard letter sorting on letter sorting machines. The comparison is made between “just one pass” on an FSM 1000 costing a reported 6.4 cents, and “total mail processing cost” for a “First-Class Basic Automation letter” of 5.3 cents. USPS Initial Brief, p. V-63. It is interesting to note that the rate category of letters (Basic Automation letters) that the Postal Service has

chosen to compare with flat processing does not provide a meaningful comparison.⁶

For example, according to the Exhibit USPS-29C, the mail processing cost of a single-piece letter is 11.74 cents. There is no reason whatsoever for the processing costs of single-piece flats to compare favorably with automation letters. The real question is, for example, whether 0.8 ounce nonstandard flats are more expensive to handle than 1.2 ounce flats. Since the record demonstrates that they are “virtually” identical, the Postal Service has been forced to shift to its fall-back position.

When all of the arguments advanced in its Initial Brief are analyzed, the Postal Service presents a ringing endorsement for a surcharge to be placed on all nonautomation letters. But that is not what it has requested, and this is not what the First-Class nonstandard category has ever been. If these comparisons could ever be relevant, they would apply only to a First-Class non-letter automation surcharge; not the First-Class nonstandard, single-piece or presort surcharge. A surcharge for one-ounce-and-under single-piece First Class mail, for example, cannot be justified for the reason that single-piece mail is more expensive to process than automation letters. The Postal Service should not be permitted to escape the paucity of its case on the record by shifting its ground at the fifty-ninth minute of the eleventh hour. The Postal Service’s justification does not relate to the nonstandard surcharge as presently and historically constituted and should be disregarded.

⁶ DMM E140 identifies the criteria for Basic Automation letters. Many standard single-piece letters do not meet these standards.

C. **In the Alternative, the First-Class Nonstandard Surcharge Should be Significantly Reduced**

As discussed in the preceding section, technology has overtaken the surcharge. The case for eliminating the surcharge seems overwhelming. In the alternative, however, should the Commission be unwilling to eliminate the surcharge at this time, it should be reduced substantially until the basis is re-established. The Postal Service's requested surcharge should be reduced for three reasons: (i) rate shock; (ii) the Postal Service's reliance on totally inappropriate proxies; and (iii) the absence of reliable data on this record.

1. **Rate Shock Considerations Support a Lower Surcharge**

In its Initial Brief, the Postal Service not only defends the imposition of the First-Class nonstandard surcharge, but also its requested increases (i) from the current 11 cents to 16 cents for **single-piece** mail (based on a 74 percent passthrough of alleged costs of 21.59 cents), and (ii) from 5 to 11 cents for **automation** mail (based on a 73 percent passthrough of alleged costs of 15.16 cents). The Postal Service acknowledges that basing rates on the "full impact of [witness Daniel's] refined cost estimates might trigger considerations of 'rate shock,' demonstrating the advisability of imposing 16 cent and 11 cent surcharges, a passthrough of nearly three-fourths of the identifiable cost difference...." USPS Initial Brief, p. V-18.

NDMS agree with the Postal Service that increasing the surcharge for single-piece mail by **100 percent** from the current 11 cents to 22⁷ cents (based on an alleged cost of 21.59 cents), and increasing the surcharge for automation mail by **220 percent** from the current 5 cents to 16 cents (based on an alleged cost of 15.16 cents), would constitute staggering and wholly unacceptable **rate shock**.

NDMS appreciate the fact that the Postal Service is not urging rates based on its so-called “refined cost estimates.” Nevertheless, NDMS challenges the Postal Service requested increases in the surcharge to 16 cents for single-piece mail and to 11 cents for presort, because those rates also constitute unacceptable rate shock (a **45 percent** increase for single-piece mail and a **120 percent** increase for presort mail), and also because they do not in any way reflect the cost of handling such nonstandard pieces.

2. The Commission Cannot Rely on the Postal Service’s Inappropriate Proxies to Justify Its Requested Rate Increases

For the reasons set out above in section I.A., NDMS challenge even the current levels of the surcharge, at 11 cents for single-piece mail and 5 cents for presort, because these levels also do not reflect the actual additional costs of handling such nonstandard pieces.

In her supplemental testimony, witness Daniel (USPS-T-43) revised certain data pertaining to the surcharge which had been previously filed in LR-H-112.

⁷ The astonishing magnitude of witness Daniel’s calculated surcharge cost is evident from the **cost** alone being only 1 cent less than the **rate** which would apply if the piece weighed more than one ounce and therefore was not “nonstandard.”

Nevertheless, since she did not know the costs for any under-one-ounce pieces, she continued to utilize as cost proxies the three cost differences which had been used previously: the difference between average letter mail processing unit costs (11.74 cents) and

(i) the average mail processing cost of all First-Class **letters** processed manually (20.54 cents), to develop a proxy cost for nonstandard letters (8.8 cents);

(ii) the average mail processing cost of all First-Class **flats** (32.43 cents), to develop a proxy cost for nonstandard flats (20.69 cents), and

(iii) the average mail processing cost of all First-Class **parcels** (74.08 cents), to develop a proxy cost for nonstandard parcels (62.34 cents).

She then weighted the three cost differences by the respective nonstandard volumes of each shape of mail. As revised, for single-piece nonstandard mail, these percentage shares were letters — 18.3 percent; flats — 77.4 percent; and parcels — 7.6 percent.

These proxies are inappropriate for the following reasons. The letter proxy does not apply because all available evidence indicates that nonstandard letters (*i.e.*, those with an aspect ratio that is too low or too high) are processed routinely on the current automated letter sorting equipment. The flat proxy does not apply because all available evidence indicates that nonstandard flats (flimsies) are processed routinely and flawlessly on the current generation of flat sorting machines. As explained previously, the parcel proxy is not applicable because, as witness Sheehan testified, lightweight (otherwise letter-shaped) parcels receive manual processing as nonstandard letters.

3. The Postal Service's Data Justifying a High Surcharge Are Unreliable

As noted previously, witness Daniel weighted her inappropriate proxy cost data by the respective nonstandard volumes by shape. With respect to nonstandard letters, witness Daniel assumed that 100 percent are processed manually. Witness Sheehan admitted, however, that **nonstandard letters** which are "too long," can, are, and will be processed readily on existing automation equipment, as discussed *supra*. He also admitted that nonstandard letters which are "too high" ("too square") will likely be processed on automation equipment, with considerable success. A small, unknown percentage of these letters may "tumble" and require being re-run on automation, or be processed manually. Nonstandard letters processed successfully on automation have a cost difference of zero. The percentage of nonstandard letters which are "too long" versus those which are "too tall" ("too square") is not known. Nor do we know the percentage of "too tall" ("too square") letters that are likely to tumble. Thus the volume data are highly infirm. Perhaps 5 to 10 percent of nonstandard letters are processed manually, if that. Yet, witness Daniel assumes that 100 percent of these letters are processed manually. The NDMS Initial Brief uses a generous 25 percent figure for purposes of illustration. If the nonstandard surcharge is not abolished, the Commission needs to revise witness Daniel's formula to take into account that the preponderance of nonstandard letters are routinely processed on automation equipment at zero additional costs. The portion of final cost for nonstandard letters should be a small fraction of what witness Daniel computes.

Witness Sheehan also admitted that letter-sized pieces which would be letters but for their thickness, probably 90 to 100 percent of all **nonstandard parcels**, are processed manually as nonstandard letters. In the Postal Service's formula, these pieces should have a cost difference of about 8.8 cents, not 62.4 cents, as witness Daniel assumes. Adjusting this number would reduce the calculated additional cost of nonstandard pieces dramatically.

The remaining pieces are **nonstandard flats**, which are 73.1 percent of the total nonstandard volume. Despite the Postal Service's understandable desire to retain a surcharge which would generate significant revenue without virtually any corresponding cost, the Postal Service has not demonstrated any reason to surcharge these pieces now that the FSM 1000s are deployed. If the FSM 1000 can successfully process troublesome polybags, it can handle successfully "virtually all" generally enveloped First-Class one-ounce-and-under flats. With the FSM 1000, and the new (next) generation flat sorting machines, there will be virtually no manually processed flats within the Postal Service.

The Postal Service deems the fact that these flats are machinable to be completely and totally "irrelevant." USPS Initial Brief, p. V-63. With all due respect, the fact that these flats are machinable is highly relevant to understanding their actual processing cost, and determining whether they should be singled out and made to pay a surcharge. The Commission must address a threshold question: is it really "irrelevant" that nonstandard flats are successfully machinable?

As demonstrated in the NDMS Initial Brief, once appropriate and necessary revisions are made to witness Daniel's costs, the range of the nonstandard surcharge should not exceed 3-4 cents.

D. The Postal Service Has Not Even Attempted to Counter Certain Elements of Dr. Haldi's Testimony Supporting Elimination of the Surcharge

In its Initial Brief, the Postal Service mentions several points from Dr. Haldi's testimony without attempting to contest or rebut them. These points, and other points made in Dr. Haldi's testimony that the Postal Service does not even refer to in its Initial Brief, deserve attention.

The Postal Service Initial Brief, pp. V-61-62,⁸ observed that Dr. Haldi had linked the nonstandard surcharge to the proposed elimination of the heavy-piece discount. Dr. Haldi noted that, since the Postal Service sought to eliminate a discount which affected a relatively small volume of presorted First-Class Mail, a surcharge that affects a relatively small volume of nonpresorted First-Class Mail could also be eliminated.

⁸ The Postal Service's only criticism has to do with Dr. Haldi's interpretation of witness Fronk's stated reasons for recommending discontinuance of the heavy-weight presort discount.

The Postal Service Initial Brief, p. V-61,⁹ cites Dr. Haldi's observation that "[e]limination 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."

The Postal Service Initial Brief, p. V-62,¹⁰ points out that "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."

The Postal Service Initial Brief, p. V-64,¹¹ stated that "[n]otwithstanding the fact that no reliable estimate of costs by ounce increment is available in this docket for First-Class 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.

⁹ The Postal Service's Initial Brief attempts to counter Dr. Haldi's assertion by arguing about other possible effects of eliminating the surcharge, but Dr. Haldi's analysis is not rebutted or contested in any way.

¹⁰ The Postal Service goes on to argue that, notwithstanding the record evidence in this docket, it is still reasonable to assume that letters with poor aspect ratios are handled manually. It only cites witness Daniel's cost model in support. USPS Brief, pp. V-62-63. As the NDMS Initial Brief pointed out, witness Daniel's assumptions about manual processing have been contradicted by the record. *See* NDMS Initial Brief, pp. 28-29, 31-33.

¹¹ There is no rebuttal to Dr. Haldi's analysis. The Postal Service appears to wonder why it should be criticized for requesting an increased surcharge in circumstances where it has done virtually no work or conducted no meaningful study that would support it.

A key point in Dr. Haldi's testimony, confirmed by Postal Service rebuttal witness Sheehan (USPS-RT-16), is that the very justification for the nonstandard surcharge needs to be re-evaluated. *See* NDMS-T-1, pp. 8-16, Tr. 24/12881-89; Tr. 33/17378; NDMS Initial Brief, pp. 21-24. The Postal Service Initial Brief has virtually ignored this admission by its witness.

In addition to the specific points mentioned above, Dr. Haldi expressly addressed another reason militating against a nonstandard surcharge: the fact that First-Class flats and parcels are both profitable products that make excellent contributions to Postal Service cost coverage, even without the nonstandard surcharge (NDMS-T-1, pp. 31-35, Tr. 24/12904-08). Such matters call into question broader issues of fairness and equity. The Postal Service has elected not to address these matters, and the testimony of Dr. Haldi stands entirely unrebutted before the Commission on these important points.

E. The Postal Service is Incorrect in Certain Criticisms It Makes of Dr. Haldi's Testimony

NDMS offered testimony and argument for the proposition that the nonstandard surcharge should be eliminated by the Postal Service for policy reasons. *See* NDMS-T-1, pp. 31-43, Tr. 24/12904-16. The Postal Service not only filed no direct testimony regarding the policy reasons underlying the requested surcharge; it failed to file any

rebuttal testimony on this point.¹² In its Initial Brief, moreover, it presents virtually no argument on this question. Instead, in response to Dr. Haldi's policy arguments, the Postal Service retorted with its own one-line policy arguments in its Initial Brief. For example:

Dr. Haldi testified that eliminating the nonstandard surcharge would materially simplify the rate structure of First-Class Mail, with a negligible loss of revenue and a reduction in the arbitrariness of this part of the rate structure. *See* NDMS-T-1, pp. 37-38, 45, Tr. 24/12910-11, 12918. As pointed out, *supra*, the Postal Service apparently does not contest those facts. *See* USPS Initial Brief, p. V-61.

The Postal Service, although acknowledging the validity of Dr. Haldi's "simplification of structure" testimony, also argues that elimination of the surcharge "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." *See* USPS Initial Brief, p. V-61. In theory, of course, this would appear to provide some support for a surcharge (assuming a valid study showing that nonstandard pieces are not processed by automation). The evidence of record, however, again rebuts the Postal Service's contention, primarily for the reasons set forth at pages 15-16 and 36-42 of Dr. Haldi's

¹² Rebuttal witness Sheehan, who purported to address only questions related to letter-size mail in his testimony, did address policy-related questions to some extent, but the effect of his testimony, in view of his admissions that many nonstandard pieces are automatable, was to further demonstrate the invalidity of the Postal Service's cost study underlying the requested surcharge. *See* NDMS Initial Brief, pp. 31-34.

direct testimony. *See* Tr. 24/12888-89 and 12909-15. There is **no effective incentive now** for mailers with respect to the surcharge; the Postal Service makes virtually no effort to publicize the existence, it neither collects nor maintains documentation evidencing underpayment or overpayment of the nonstandard surcharge, and it **does not even sell an 11-cent stamp**. For the Postal Service to argue now that elimination of the surcharge would remove an incentive is somewhat meaningless, in the absence of evidence that an effective incentive even exists.

II. DR. HALDI'S PROPOSALS REGARDING PRIORITY MAIL SHOULD BE IMPLEMENTED

In its Initial Brief, the Postal Service responds to four of Dr. Haldi's proposals regarding Priority Mail. A "not-invented-here" syndrome can be observed, as the Postal Service objects to all four. First, the Postal Service opposes Dr. Haldi's proposal to raise the maximum weight of First-Class Mail to 13 ounces, arguing that a large gap between First-Class Mail rates and Priority Mail rates is not problematic. USPS Initial Brief, pp. V-105-106. Second, the Postal Service opposes Dr. Haldi's method for projecting After Rates volume and revenue for each rate element within Priority Mail. *Id.*, pp. II-3-5 and V-106-109. Third, while not directly opposing Dr. Haldi's proposal to not mark up distance-related transportation costs, the Postal Service claims that Dr. Haldi has not provided enough information to gauge the effects of his proposal. *Id.*, pp. V-109-111. Finally, the Postal Service opposes Dr. Haldi's proposal to maintain uniform rate increments between the unzoned rates. *Id.*, pp. V-111-113. None of the Postal Service's objections to Dr. Haldi's proposals deserves credence, and the NDMS proposed rates for Priority Mail should be recommended.¹³

¹³ In addition, United Parcel Service filed an Initial Brief, which aside from a Supplemental Brief filed under seal, summarizes the arguments regarding Priority Mail found in UPS witnesses' testimony regarding the fees for delivery confirmation and their proposed parcel surcharge. NDMS dealt with UPS's arguments in the NDMS Initial Brief, at pp. 59-63.

A. The Maximum Weight of First-Class Mail Should Be Increased

The Postal Service, on brief, opposes Dr. Haldi's proposal to change the maximum weight of First-Class Mail from 11 ounces to 13 ounces, thereby narrowing the rate gap between First-Class Mail rates and Priority Mail rates, which would stand at \$0.57 if all the Postal Service's proposed rates were implemented.¹⁴ The Postal Service asserts that its requested \$0.57 rate gap was not excessive for three reasons: (1) Priority Mail has a two-day service standard between a greater number of origin and destination post offices than First-Class Mail; (2) Priority Mail is sorted separately from First-Class Mail; and (3) Priority Mail offers customers pickup service and would offer delivery confirmation, while First-Class Mail will not. USPS Initial Brief, pp. V-105-106. The first two factors, as well as pick-up service, have existed for many years. Never before has any of them been proffered as a justification for a large rate gap. Only delivery confirmation is new, but it is unclear how this untried and unproven service justifies a large rate gap. Also, once again the Postal Service is attempting to tout Priority Mail's preferential-sounding name and impressive service standards, while ignoring the overwhelming evidence in this docket that Priority Mail's actual service is worse than that of First-Class Mail,¹⁵ and does not justify an excessive

¹⁴ The only other party to take a position on this issue, the intervenor from Englewood Cliffs, New Jersey, David B. Popkin, supports Dr. Haldi's proposal to raise the maximum weight of First-Class Mail, stating that a wide rate gap between 11-ounce First-Class Mail and 12-ounce First-Class Mail (sent as Priority Mail) would be illogical and anomalous. DBP Initial Brief, pp. 4-5, para. 45.

¹⁵ For example, over 11 quarters from FY 1995 to 1996, the Postal Service failed to deliver 7.5 percent of Priority Mail within three days, regardless of service

rate gap. *See* NDMS-T-2, pp. 60-65, Tr. 20/10353-58.¹⁶ In view of actual performance data, the fact that Priority Mail is routed separately from First-Class Mail means that Priority Mail is separated to receive worse service. No mailer cares how his mail is separated or sorted. What counts is service, and receiving worse service does not justify a large rate gap. Neither offering a prospective optional delivery confirmation service, nor a pick-up service with a separately-charged fee that the Postal Service requests be increased by 67 percent to \$8.95 justify a large gap. None of the Postal Service's reasons for requesting rates which result in a \$0.57 rate gap is convincing.

The Postal Service also attacks Dr. Haldi's proposal for offering a more reasonable relationship between the rates for First-Class Mail and those for Priority Mail by stating that Dr. Haldi "continues to imply" that "cross-subsidization" exists between the two-pound rate and the 3- to 70-pound rates, and that no evidence of such a

standards. Over the same period, the Postal Service failed to deliver 6.2 percent of First-Class Mail within three days. Since service standards provide that all Priority Mail and First-Class Mail are to be delivered within three days, this is a valid apples-to-apples comparison. *See* NDMS-T-2, p. 63, Tr. 20/10356, ll. 5-13.

¹⁶ The Postal Service Initial Brief contains other examples of statements made and positions taken which directly contradict the sworn interrogatory responses of Postal Service witnesses. With regard to Priority Mail service performance and value of service, for example, the Postal Service states at IV-38: "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 First-Class and Priority Mail performance data presented by Postal Service witnesses in this and prior dockets have unequivocally shown that Priority Mail delivery performance is much worse than that of First-Class Mail, regardless of stated service standards. *See* discussion at NDMS-T-2, pp. 60-65, Tr. 20/10353-58.

subsidy exists on the record. USPS Initial Brief, p. V-106. As Dr. Haldi demonstrates in this case with regard to charges made by witness Clifton, the terms “subsidy” and “cross-subsidization” are economic terms with very precise definitions. *See* VP/CW-RT-1, p. 25, Tr. 32/17307. Nowhere on the record did Dr. Haldi suggest that a cross-subsidy exists between two-pound-and-under Priority Mail and 3- to 70-pound Priority Mail. In fact, the terms “subsidy” and “cross-subsidy” never appear in Dr. Haldi’s testimony on Priority Mail. For cross-subsidization to occur, the two-pound rate would have to be set below cost, which Dr. Haldi never alleged, and which is clearly false. That the Postal Service would use these terms so improperly indicates a desire to confuse, rather than to clarify.

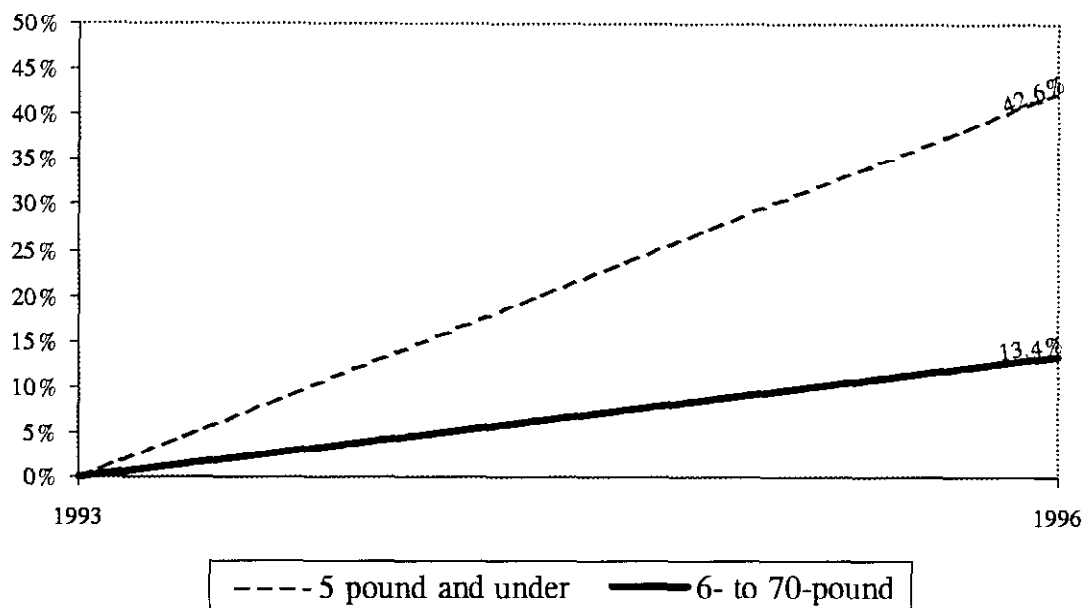
As NDMS has demonstrated, in Docket No. R94-1 the Commission artificially reduced the two-pound-and-under rate, and was therefore forced to increase substantially the zoned rates by \$1.30 per piece. *See* NDMS Initial Brief, pp. 53-57. What has been made very clear by the evidence in this docket (and has been conceded by Postal Service witness Sharkey (USPS-T-33)) is that the Priority Mail two-pound-and-under rate requested by the Postal Service has again been reduced artificially to mitigate the widening rate gap between First-Class Mail rates and Priority Mail rates.¹⁷

¹⁷ The Postal Service also maintains that an artificially low two-pound-and-under Priority Mail rate is justified because it is “most likely to contain monopoly protected letter mail.” USPS Initial Brief, p. V-106, *citing* response to NDMS/USPS-T33-5, Tr. 4/1950-51. This argument directly conflicts with the Postal Service’s response to interrogatories which admits that there is no evidence whatsoever of how much Priority Mail at any weight level is protected by the monopoly. *See* NDMS/USPS-T33-17, Tr. 4/1965.

See response to NDMS/USPS-T33-5, Tr. 4/1950-51. According to the Postal Service's Priority Mail rate design witness, this reduced rate for two-pound-and-under Priority Mail made higher rates for the remainder of Priority Mail "a mathematical imperative." Response to NDMS/USPS-T33-6(b), Tr. 4/1952. The Postal Service's argument that the increased \$0.57 rate gap is not a problem can only be viewed as part of its strategy to favor two-pound-and-under Priority Mail with lower-than-indicated rates. See USPS Initial Brief, p. V-105. While the Postal Service may be skeptical of Dr. Haldi's analysis (deeming it "designed" to show that zoned Priority Mail rates are too high, USPS Initial Brief, p. V-106), the Postal Service's customers know too well that heavyweight Priority Mail has been overburdened, as evidenced by a comparison in the chart below of the rates of growth for zoned and unzoned Priority Mail from FY 1993 (Base Year in Docket No. R94-1) to FY 1996 (Base Year in Docket No. R97-1). (NDMS-T-2, p. 24, Tr. 20/10317, and response to USPS/NDMS-T2-10, Tr. 20/10441.)¹⁸

¹⁸ See also the comparison of Priority Mail rates with those of competitors, contained in the response to USPS/NDMS-T2-25, Tr. 20/10461-77.

**Priority Mail
Rate of Volume Growth Between 1993 and 1996**



Completely absent from the Postal Service's case in this docket is any real justification for maintaining the breakpoint at 11 ounces. The Postal Service presents no evidence challenging Dr. Haldi's volume projections for 12- and 13-ounce First-Class Mail, nor any reason why adjusting the breakpoint to reduce the size of the rate gap would result in any negative effects whatsoever. Aside from its virtually automatic opposition to any proposals that do not originate from within the Postal Service, the Postal Service's only reason for opposing a change to the breakpoint seems to be that reducing the rate gap would remove the pressure on the Commission to rubber stamp the Postal Service's unjustified, lower-than-indicated rate for two-pound-and-under Priority Mail.

B. An Alternative Procedure for Priority Mail Volume and Revenue Projections Is Necessary

In its Initial Brief, the Postal Service also discusses Dr. Haldi's proposed method for projecting After Rates volumes. Initially, the Postal Service discusses OCA witness O'Bannon's method of analyzing the Postal Service's After Rates volume projections in Standard Mail B parcel post together with Dr. Haldi's method for projecting After Rates volumes in Priority Mail, stating that the two methods are "theoretically the same." USPS Initial Brief, pp. II-3-5. Later, the Postal Service treats Dr. Haldi's proposal separately. *Id.*, pp. V-106-109.

The Postal Service admits that both witness O'Bannon (OCA-T-200) and Dr. Haldi point out flaws in the Postal Service's projection methods.¹⁹ Most notably, the method for projecting cell-by-cell volumes completely ignores the effect of differing rate changes on volume. USPS Initial Brief, p. II-4. The Postal Service asserts, however, that these significant flaws are "not particularly critical," and are outweighed by aggregate effects. *Id.*, p. II-5. It points to some minor problems with witness O'Bannon's approach (*e.g.*, he does not take cross-price effects into account), and cites the fact that in the circumstances of this case Dr. Haldi's approach and the Postal Service's approach produce similar aggregate results, to "prove" to the Commission

¹⁹ OCA witness O'Bannon analyzes the Postal Service's method for projecting After Rates volumes in Standard B parcel post, and finds that "a better system of estimating the volume resulting in each cell from that particular cell's rate change needs to be found." See OCA-T-200, p. 14, Tr. 25/13487. Unlike Dr. Haldi, witness O'Bannon does not submit his own cell-by-cell volume projections for Standard B parcel post.

that the Postal Service's methodology "seems to have worked adequately in the past." *Id.*, p. II-5.

In fact, the Postal Service has failed completely to address the substance and significance of the testimony of both OCA witness O'Bannon and Dr. Haldi. By pointing out minor flaws, and using curious labels (*e.g.*, "Dr. Haldi's self-rebutting testimony," USPS Initial Brief, p. II-5) and half-hearted endorsements of its own approach ("the proportional distribution method **seems to have worked adequately** in the past," *id.*, emphasis added), the Postal Service tries to avoid, rather than to address, these fundamental criticisms of the manner in which it projects After Rates volumes for individual rate cells.²⁰

The Postal Service claims that Dr. Haldi "overlooked the history surrounding this issue," and that "the Commission has previously considered this suggestion and found it lacking in merit" (USPS Initial Brief, p. V-107). As the Postal Service knows quite well, Dr. Haldi never before has proposed any alternative method for projecting After Rates volumes for Priority Mail. No such proposal was made in Docket No. R94-1, nor in any other docket. In Docket No. R94-1, on remand after the record had closed, in an appendix to its memorandum in support of reconsideration, Nashua/District Photo did call the Commission's attention to the gross anomalies produced by application of the Postal Service's inherently flawed method. As the Commission noted at that time, there was not enough record evidence to support

²⁰ The disaggregation of volume projections to "each unique rate element" is mandated by Section 54(j)(3) of the Commission's rules of practice.

devising a new volume projection methodology to correct the recognized flaws inherent in the Postal Service's methodology.

In the current docket, however, Dr. Haldi has presented extensive testimony in support of his proposal, as well as actual volume projections for both the Postal Service's and NDMS's proposed Priority Mail rates. With a developed record in support of Dr. Haldi's alternative projection methodology, the Commission can decide in this docket which method is most informative and which best conforms to the mandate of Section 54(j)(3) of the Commission's rules of practice: the Postal Service's procedure, which even the Postal Service describes as having merely "worked adequately" (USPS Initial Brief, p. II-5) (but which can actually be much worse), or Dr. Haldi's procedure, which takes into account the effects of disparate cell-by-cell rate changes on volume.

C. Distance-Related Transportation Costs Should Not Be Marked Up

The Postal Service also opposes Dr. Haldi's proposal not to mark up distance-related transportation costs. (Viewed in another way, Dr. Haldi's proposal is to reduce the passthrough of distance-related transportation costs from levels well over 100 percent down to exactly 100 percent.) Searching for any information that might help justify its opposition, the Postal Service claims that Dr. Haldi failed to address the Commission's concern in Docket No. R94-1 that removing the mark-up on distance-related transportation costs would **harm** Priority Mail sent to the close-in zones by presenting the effects of the proposal in isolation. USPS Initial Brief, pp. V-109-111.

It appears from this argument that the Postal Service has not even reviewed Dr. Haldi's proposed rates, which result in **reduced** rates for the close-in zones. The proof of the pudding, of course, is in the eating. In fact, Dr. Haldi compared his proposed rates with those of the Postal Service, and not only found that ending the mark-up to distance-related transportation costs did not raise rates to the close-in zones, but also explained why it did not do so, citing the effect on the per-piece rate element. NDMS-T-2, pp. 31-32, Tr. 20/10324-25.

The Postal Service claims in its Initial Brief that Dr. Haldi's comparison was inadequate because it did not show in isolation the effects of a 100 percent passthrough of distance-related transportation costs on Priority Mail rate design. The Postal Service listed three aspects of Dr. Haldi's rates which were not held constant, none of which is of the slightest relevance to the Commission's concern that Dr. Haldi's proposal would raise rates to the close-in zones. First, the Postal Service claimed that because Dr. Haldi's rates reflect uniform increments between rates for unzoned Priority Mail, the effects of his proposal have not been presented "in isolation." Also, the Postal Service claims that because Dr. Haldi also proposes both a change in the breakpoint and an alternative method for projecting After Rates volumes, the Commission will be unable to determine whether Dr. Haldi's proposal will cause large rate increases to the close-in zones. USPS Initial Brief, pp. V-109-111.

First, Dr. Haldi's proposal to retain uniform increments for unzoned Priority Mail (by increasing the minimum rate from \$3.20 to \$3.30) slightly reduces the demand for minimum rated pieces, but for zone-rated pieces over 5 pounds, it most certainly

does not increase rates to close-in zones while reducing rates to more distant zones. The uniform increment proposal is totally unrelated to the treatment of transportation costs. Moreover, it is the Postal Service that has requested rates for Priority Mail that represent a break from current policy (*see* discussion, *infra*). Second, the only effect of Dr. Haldi's proposed change to the breakpoint is on the volume of minimum-rate Priority Mail which opts to cross over to ordinary First-Class Mail. It has absolutely no effect whatsoever on zoned rates.²¹ Third, Dr. Haldi's alternative method for projecting After Rates volumes shows the effect that changes in individual rates have on volumes. Clearly, it does not change the proposed rates and it does not and cannot affect rates to close-in zones. The arguments of the Postal Service are thus spurious, and provide no meaningful reason to question Dr. Haldi's proposal.

In any case, this is a matter of applying mark-ups to costs, which is done at an **early stage** in both Dr. Haldi's and the Postal Service's rate design. Therefore, the Commission can compare Dr. Haldi's indicated rates (NDMS-T-2, Table C-6, Tr. 20/10406) with the Postal Service's indicated rates (*see* response to UPS/USPS-T33-39, Tr. 4/2032-33). This would eliminate from the comparison rate design decisions made at all later stages, such as whether uniform increments are set between rates for unzoned Priority Mail, and how the transition between zoned and unzoned rates is

²¹ As pointed out by Dr. Haldi, the breakpoint proposal is free-standing. It could even be adopted in conjunction with the Postal Service's proposed rates, and it would have the same effect described above.

effected.²² This comparison, which is probably the closest possible, given the fact that rate design involves so much discretion, also shows that Dr. Haldi's proposal would not disrupt the rates to the close-in zones.

D. Uniform Incremental Rates for 2- to 5- Pound Priority Mail Pieces Should Be Retained

In its Initial Brief, the Postal Service asserts that, in this docket, "the balance weighs in favor of a return to rates that more closely reflect underlying cost differences," so even rate increments for the unzoned rates are no longer justified. USPS Initial Brief, p. V-112. This principle is being applied by the Postal Service in the breach. As the Postal Service admits, its desire for an artificially low two-pound-and-under rate causes the Postal Service's proposed Priority Mail rates to deviate from the established practice of setting even rate increments for unzoned Priority Mail. USPS Initial Brief, p. V-112. Priority Mail rate design witness Sharkey acknowledges that "no explicit cost consideration" lies behind the \$3.20 two-pound-and-under rate. *See* response to NDMS/USPS-T33-5(a), Tr. 4/1950. It is thus inconceivable that the Postal Service's proposal to eliminate even rate increments by **artificially reducing** the two-pound-and-under rate could serve the purpose of "a return to rates that more closely reflect underlying cost differences." Such artificial, non-cost-based adjustments

²² In addition, both Postal Service witness Sharkey and Dr. Haldi have provided the Commission with detailed workpapers describing in detail their rate design methodology — witness Sharkey at Exhibit USPS-33, and Dr. Haldi at NDMS-T-2, Appendix C, Tr. 20/10393-10411.

to rates are the path away from cost-based Priority Mail rates the Postal Service unconvincingly purports to advocate.

III. THE STANDARD A RESIDUAL SHAPE SURCHARGE REQUESTED BY THE POSTAL SERVICE SHOULD NOT BE RECOMMENDED

Notwithstanding protestations of the Postal Service — significantly, the only party to attempt to defend the requested Standard A residual shape surcharge on brief — its proposal for a Standard A residual shape surcharge should be not be recommended.²³

A. Contrary to the Implication in the Postal Service Initial Brief, the Requested Surcharge Is Not Responsive to the Commission's Request

The Postal Service asserts on brief (USPS Initial Brief, p. V-159) that its requested Standard A residual shape surcharge was offered in direct response to the Commission's expressions of concern and requests in Docket No. MC95-1 that the Postal Service propose distinct Standard A parcel rates. Therefore, to understand the genesis of this surcharge, one must look to the specific problem that the Commission sought to have redressed by the Postal Service in requesting separate parcel rates:

The Commission agrees that UPS has pinpointed a serious equity problem by identifying the fact that the **average revenue** for the proposed Standard Mail regular parcels **is less than the average cost** for those pieces. Other mailers are covering the **shortfall in revenues** for parcels. This is a situation that cannot be allowed to exist permanently. This issue has been troublesome to the Commission. Two of the sitting Commissioners have dissented because the Commission failed to establish a surcharge to recover a higher share of attributable costs from Bulk Rate Regular parcel mail....²⁴

²³ As with the NDMS Initial Brief, Merck-Medco Managed Care, Inc. joins in Section III of this brief.

²⁴ The Commission also observed that flats and parcels do not form a homogeneous grouping of mail, but this observation was based exclusively on the existence of a substantial revenue/cost shortfall (estimated by United Parcel Service ("UPS") witness Luciani in Docket No. MC95-1 to be 9.9 cents for the proposed

Action is warranted to comply with the mandates of the Act and to **avoid unreasonable discrimination**, but the question is what action to take and when to take it. In response to Notice of Inquiry No. 2, UPS presents four alternative rate designs. Each design is projected to **eliminate the cost coverage problems** and **eliminate cross subsidies**. [*Op. & Rec. Dec.*, Docket No. MC95-1, paras. 5559, 5561 (emphasis added).]

Throughout the remainder of the Commission's discussion in Docket No. MC95-1, the Commission focused on the failure of third-class parcels to cover their costs, referring to the need for "100-percent cost coverage for parcels" (para. 5564), "the current, below-cost situation" (para. 5566), "the existing cross-subsidy" (para. 5567), and the "below cost-rate problem" (para. 5569). The Commission urged "the Postal Service to develop expeditiously a comprehensive parcels proposal with supporting information. The **below cost-rate problem** cannot be allowed to stand for an unreasonable and unwarranted period of time." *Id.*, para. 5569, emphasis added.

The Commission's diagnosed problem requiring redress was clear: the "**below cost-rate problem**."

In this docket, however, the Postal Service has deliberately decided to disregard — and direct attention away from — the precise problem identified by the Commission. Postal Service witness Moeller (USPS-T-36) announced that "the '**difference between revenues and costs**'" incurred by parcels "is **not relevant** to the rate design" underlying the residual shape surcharge (Tr. 6/2816-17, emphasis added), because now, in the view of the Postal Service, "[t]he point of the surcharge isn't to assure cost

Standard A Regular, and 6.8 cents for the proposed Standard A ECR). *Op. & Rec. Dec.*, Docket No. MC95-1, paras. 5529, 5560.

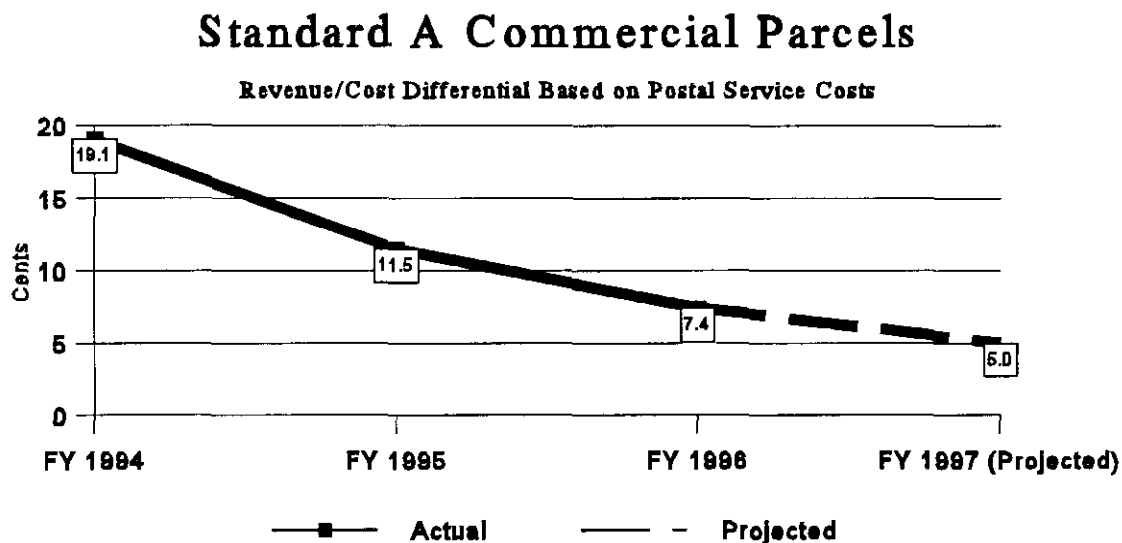
coverage **or that the revenues exceed the costs**; it is to recognize cost differences between these two groupings of mail.”²⁵ (Tr. 6/2948, emphasis added.)

The question that demands an answer is: why does the Postal Service witness proposing the Standard A parcel surcharge called for by the Commission choose to deny any relevance whatsoever to the only reason given by the Commission for seeking the proposal in the first place? It is suggested that the Postal Service’s decision to direct attention away from the Commission’s stated concern regarding a “below cost-rate problem” is due, at least in part, to its awareness of recent cost and revenue trends which show that since the Commission looked at this issue in Docket No. MC95-1, the below cost-rate problem is greatly reduced and perhaps fading away altogether.

As can be seen from the chart below, **using the Postal Service’s own cost data for so-called Standard A “commercial”** (Regular and ECR), the three-year trend is significantly downward, from **19.1** cents in FY 1994, to **11.5** cents in FY 1995, to **7.4** cents in FY 1996. Projected to FY 1997, the Interim Year (for which cost data are not yet available), the so-called “problem” for both commercial subclasses together may have shrunk to as little as **5.0** cents, only one-half of the amount of the surcharge requested. It is true that it is impossible to demonstrate the likelihood of this

²⁵ The Postal Service Initial Brief demonstrates its continued disregard of the below cost-rate problem, and exclusive reliance on Postal Service witness Crum’s (USPS-T-28) cost data. These cost data purportedly show that Standard A parcels incur higher costs than flats as the new justification for the surcharge. See USPS Initial Brief, p. V-159. Of course, witness Crum’s analysis of costs alone, apart from any analysis of the revenue generated by parcels, does not address the Commission’s concern regarding a “below cost-rate problem.”

projection, but the trend has been downward for three years. Even if the 7.4 cent differential were to persist in FY 97, the requested 10 cent surcharge is still excessive.



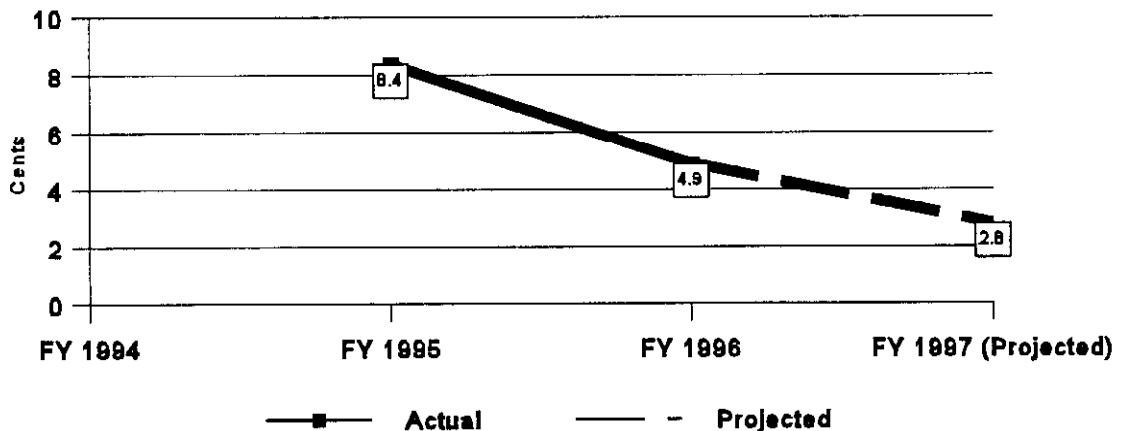
Sources: Cost differentials were derived from data in USPS-T-28, Exhibit K, Tables 1 and 3; and the attachments to the response to NDMS/USPS-T28-18, Tr. 5/2232, 5/2234; and the response to DMA/USPS-T28-1, Tr. 5/2176-77. See NDMS Initial Brief, p. 78.

Note: The FY 1997 projection is based on the FY 1994-FY 1996 trends calculated as follows: the percentage decrease in the revenue/cost differential between FY 1994 and FY 1995 was 60 percent. The percentage decrease in the revenue/cost differential between FY 1995 and FY 1996 was 64 percent. The average of these two percentages, 62 percent, was applied to FY 1996, resulting in a projected FY 1997 differential of 5.0 cents.

The trend for **Standard A Regular** (the subclass used by NDMS) parcels has also been examined (but data for FY 1994 are not available to show a three-year trend). Again, using the Postal Service's own cost data, the FY 1995 level of 8.4 cents decreased in FY 1996, to 4.9 cents. Projected to FY 1997, the "problem" for Standard A Regular parcels may be as little as 2.8 cents, a small fraction of the 10 cent surcharge requested.

Standard A Regular Parcels

Revenue/Cost Differential Based on Postal Service Costs



Sources: Cost differentials were derived from data in LR-PCR-38 (Docket No. MC97-2), Table 3; USPS-T-28, Exhibit K, Tables 1 and 3B(1); and the attachments to the response to DMA/USPS-T28-1, Tr. 5/2176-77. See NDMS Initial Brief, pp. 77-78.²⁶

Note: The FY 1997 projection is based on the FY 1995-FY 1996 decrease of 58 percent. This percentage applied to the FY 1996 differential results in a FY 1997 differential of 2.8 cents.

Furthermore, it must be remembered that these revenue/cost differential data are based directly on Postal Service cost estimates. None of the above data incorporate the analyses of Dr. Haldi (NDMS-T-3), Parcel Shippers Association witness Jellison (PSA-T-1), or Recording Industry Association of America and Advertising Mail Marketing Association witness Andrew (RIAA, *et al.*-T-1), all of which demonstrate how Standard A parcel costs have been overstated by the Postal Service.

²⁶ The reference to a 44.6 cent FY 1995 Standard A Regular parcel revenue on page 78 of the NDMS Initial Brief is a typographical error. The correct number is 46.6 cents, as appears on page 77, and as implied by the calculation on page 78.

Based on the Postal Service's own cost data, the only problem identified by the Commission as requiring correction seems to have substantially decreased since Docket No. MC95-1, when the only docket evidence of a Standard A Regular parcel revenue deficiency was United Parcel Service witness Luciani's (UPS-T-4) 9.9 cent Test Year After Rates projection. (Postal Service cost data indicate that witness Luciani overstated the per piece revenue shortfall by 1.5 cents.)

B. The Postal Service Could Not Rehabilitate its Requested Parcel Surcharge in its Initial Brief

1. The Postal Service's Filings Contain No "Wealth of Information"

The Postal Service notes in its Initial Brief, p. V-158, that it "has provided a wealth of information to respond to the Commission's concerns raised in Docket No. MC95-1" regarding the need for Standard A parcel rates. Of course, as discussed below, that wealth of information included no direct, supplemental, or rebuttal testimony directly responsive to the Commission's only concern, the existence of a "below cost-rate problem." But the poverty of the Postal Service's filing is even more sweeping. Important, highly pertinent data were requested by the Commission, but never filed by the Postal Service.

The Commission stated in Docket No. MC95-1 that it was of "particular importance [that] information that is normally required and used in analyzing the **potential effect** of rate changes on **revenues** and **volumes** is not available." *Op. &*

Rec. Dec., para. 5563, (emphasis added). Yet, on the record of this docket, such information is still unavailable, as discussed below.

The Commission stated in Docket No. MC95-1 that “[by] allowing the Postal Service to complete its analyses of parcel costs and **market characteristics** before imposing separate rate treatment, the Commission expects that it will be able shortly to adjust the rates for parcels to eliminate the current, below-cost situation, with a minimum of disruption to mailers.” *Id.*, para. 5566 (emphasis added). Although the Commission’s language regarding completion of such analyses indicates that a study was underway, no such analysis of market characteristics was ever filed in this docket.

The Commission expressed its unwillingness to impose a parcel surcharge until the Postal Service put forth evidence addressing the fact that: “[i]ndustry representatives pointed out on rebuttal that their ‘parcel’ products are quite distinct from other parcels and, in many ways, more similar to flats in handling and cost characteristics. They question whether a generic parcel surcharge or rate increase would be fair.” *Id.*, para. 5562. The Postal Service’s rate design has not accounted for the facts that: (i) many parcels (as well as flats “prepared as parcels”) have shapes that *are far more like the shapes of flats than the shapes of other parcels*, or (ii) the definitions of a parcel (or residual shape piece) vary widely between the DMM and IOCS criteria, the requested DMCS language, and the rural carrier route criteria. The Commission’s concern was never addressed by the Postal Service.

The Commission expressed concern that “machinability may have a more significant impact on costs than shape.” *Id.* It did not want to impose a parcel

surcharge before this matter was addressed. The Postal Service presented no record evidence that shape is a dominant cost influence in mail handling, or that parcels are systematically more costly to handle than flats at every weight increment, or that identified the different procedures (and resultant costs) for machinable and nonmachinable parcels.

As noted above, the Commission did not want to impose a parcel surcharge until it received “the necessary studies relating to costs, shape and weight.” However, the Commission’s observation in Docket No. MC95-1 that these studies still “have not been carried out, despite Commission requests” remains true in this docket. *Id.*

The Commission did not want to act without the necessary information in Docket No. MC95-1. It still lacks the necessary information. The Commission should not impose a surcharge based upon the incomplete record evidence in this docket.

2. The Postal Service’s Proposal Violates the Act

The Postal Service asserts that the requested surcharge will “promote more cost-based rates.” USPS Initial Brief, p. V-160. From the standpoint of users of Standard A Regular mail, this claim of cost-based rates cannot be accurate since the requested surcharge is based on the costs of products in **other subclasses** (*e.g.*, Standard A ECR, Nonprofit, and Nonprofit ECR), and it is on this **mixed subclass** basis, and this basis alone, that the Postal Service presents its parcel surcharge costs.

The rate design underlying the Postal Service’s requested surcharge fundamentally violates 39 U.S.C. section 3622(b)(3), which requires “that **each** class of

mail...bear the direct and indirect postal costs attributable **to that class**...plus that portion of all other costs of the Postal Service reasonably assignable **to such class**....”

(Emphasis added.) The Postal Service Initial Brief acknowledges that (b)(3) is “the most critical provision of the Act” regarding rate design. Citing NAGCP v. United States Postal Service, 462 U.S. 810 (1983), the Postal Service observed:

Most essentially, the [U.S. Supreme] 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**. [USPS Initial Brief, p. IV-14 (emphasis added).]

Yet, as explained below, the Postal Service’s rate design underlying its requested residual shape surcharge plainly violates the principle that rates proposed are not based solely on the costs of the “particular subclass” but are rather based on the costs of these other subclasses as well.²⁷

The Postal Service has selected four separate shape-based groupings (which are currently not even rate categories) from **four separate subclasses** of mail:

- DMCS Section 321.2 — Standard A Regular subclass;
- DMCS Section 321.3 — Standard A ECR subclass;
- DMCS Section 321.4 — Standard A Nonprofit subclass; and
- DMCS Section 321.5 — Standard A Nonprofit ECR subclass.

²⁷ The Postal Service’s requested Standard A residual shape surcharge, by relying on the costs of shape-based groupings from **four separate subclasses**, also constitutes “undue or unreasonable discrimination among users of the mails,” especially when viewed from the perspective of Standard A Regular mailers. See 39 U.S.C. section 403(c).

The Postal Service then combined and averaged costs across all **four separate subclasses** and used combined volume data to calculate a parcel/flat cost differential presented as the sole basis for this requested surcharge, which would apply across all four subclasses.²⁸

NDMS use Standard A Regular mail, and send parcel-shaped pieces. If a surcharge is to be imposed upon their parcels, it must be based upon the costs of Standard A Regular Subclass parcels. Legally, it may not be based upon the combined costs and volumes of Standard A ECR Subclass parcels, Standard A Nonprofit Subclass parcels, or Standard A Nonprofit ECR Subclass parcels.²⁹ Otherwise, the direct and indirect attributable costs of all four subclasses are imposed on the parcels in each subclass. Even if the Commission were to view the Postal Service's evidence in this docket regarding the "below cost-rate problem" — the only reason for separate parcel rates identified by the Commission — in the most favorable light to the Postal Service, no basis exists for imposing a surcharge of more than the 4.85 cent revenue deficiency that the Postal Service has calculated for Standard A Regular parcels.³⁰ (The Postal

²⁸ Under such a contrived approach, a future increase in Standard A Nonprofit ECR parcel costs would inexorably lead to an increase in **multi-subclass** parcel costs (which may be recouped from an increase in the **cross-subclass** parcel surcharge).

²⁹ Under the Postal Service's proposal, Standard A Regular parcels are being asked to pay a larger surcharge than can be justified by the costs of Standard A Regular parcels, in order to reduce below cost-rate averaging within other subclasses. This cannot be tolerated.

³⁰ If the Postal Service's requested 28 percent passthrough were applied to this figure, the surcharge would be 1.4 cents. Such a passthrough would "mitigate the

Service has not challenged or rebutted this calculation. These precise costs are even cited in the Postal Service Initial Brief, p. V-175.) Even the dissenting Commissioners in Docket No. MC95-1 wanted only a 5 cent surcharge when the UPS evidence posited a 9.9 Standard A Regular revenue/cost differential. Therefore, certainly, no surcharge larger than 5 cents should apply to Standard A Regular parcels.

Quite apart from the impact on Standard A parcel mailers in this docket, the Postal Service's proposal raises a much larger issue that could create untold havoc in the future for rate design. The Postal Service characterizes this proposal as de-averaging, resulting in more cost-based rates, USPS Initial Brief, p. V-160, but the reality is quite different. Subclasses are created to facilitate independent calculation of costs and rates, but the Postal Service's rate design treats the four subclasses involved as if they did not exist, and as if rates were to be based on class-wide costs. This is not the law. This rate design would have been problematic in Docket No. R94-1; now, following reclassification, it is even less defensible. The Postal Service has cited no precedent where the Commission combined costs from multiple subclasses to devise a rate of any type. NDMS can identify no prior instance where the Commission has based the rates charged to one subclass on the costs incurred by another subclass.

impact of the potential increase in rates on customers." USPS-T-36, p. 13.

3. The Postal Service's Requested Surcharge Shows that Some Mailers Are More Equal than Others With Respect to Rate Shock

The Postal Service states that its Standard A rate design is “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.” USPS Initial Brief, p. V-120. The Postal Service even asserts that its requested surcharge reflects sensitivity “to the impact of the effective rate change on mailers.” *Id.*, p. V-160. NDMS respectfully submit that such claims of mailer-friendly rates are unjustified in light of the record evidence.

Although concerns about rate shock may have mitigated some rate increases, the Postal Service evidently has chosen not to show any sensitivity to Standard A minimum-weight parcel mailers like NDMS. **These mailers face rate increases of more than 50 percent on their parcels.**³¹ The Postal Service has shown far greater sensitivity to Standard A ECR Basic mailers (the Postal Service requested a 9.3 percent increase, rather than the 12.7 percent increase which would have resulted had it retained 100 percent passthroughs of the costs avoided by destination entry, Tr. 6/3109-11). On brief, the Postal Service continued to defend its request for a lower passthrough with the argument that a higher passthrough (such as the current passthrough) “would conflict with the rate design’s goal of limiting [Standard A] rate

³¹ Notwithstanding this over-50-percent increase in rates, NDMS’ Standard A mail will continue to receive the lowest service standard commitment of any class of mail. Tr. 2/490.

increases to 10 percent.” USPS Initial Brief, p. V-177. However, in this docket, as regards Standard A parcel rates, the Postal Service did not demonstrate any concern over whether it met its “goal” of limiting Standard A rate increases to 10 percent. Likewise, the Postal Service was not concerned about keeping increases within 20, 30, 40, or even 50 percent on minimum-weight DSCF-entered parcels of the types often sent by NDMS, which would have their rates increased by 55.6 percent.

4. The Postal Service’s Requested Surcharge Is Neither Fair Nor Equitable

The Postal Service alleges that the requested surcharge promotes fairness and equity. USPS Initial Brief, p. V-160. The Postal Service blithely states that “[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.” *Id.*, p. 161, (citing Tr. 6/2741.) The Postal Services’ position appears to be that, since unfairness is inevitable, unfairness is not unfair — a curious argument.

In its discussion of fairness, the Postal Service also cites witness Moeller for the proposition that the requested surcharge (no matter how ill-crafted)³² must be “more compatible with fairness and equity than is the alternative, which is the absence of any surcharge....” *Id.* The record in this docket proves otherwise.

³² See DMA/USPS-T36-3, Tr. 6/2740, the interrogatory that witness Moeller was responding to when he made the statement cited by the Postal Service Initial Brief at p. V-161.

5. The Postal Service's Claims Notwithstanding, It Has Not Demonstrated the Desirability of this New Classification Under 39 U.S.C. Sections 3623(c)(2) and (c)(5)

Under 39 U.S.C. sections 3623(c)(2) and (c)(5), for all proposed classifications, the Commission must consider, *inter alia*:

(c)(2) the desirability and justification for special classifications and services of mail...; and

(c)(5) the desirability of special classifications from the point of view of both the user and of the Postal Service.

The Postal Service surprisingly goes so far as to say that its requested residual shape surcharge is “desirable” to mailers. USPS Initial Brief, p. V-161. In light of the two statutory requirements quoted above, this could be a strong argument in favor of the Postal Service’s request **if it were true**. The only authorities cited by the Postal Service, however, are the testimony of postal witness Moeller, plus one interrogatory response by witness Moeller. **Not one mailer** has filed testimony in support of this proposal. **Not one mailer** has supported this proposal on brief. Witness Jellison (PSA-T-1) states that **the surcharge is even opposed by Standard A mailers who allegedly would benefit from it** (Tr. 24/13027). The Postal Service feels it is a better judge of mailers’ interests than the mailers themselves.

The Postal Service Initial Brief’s perception of the attraction of “simplicity” to Standard A mailers (USPS Initial Brief, pp. V-121, V-161) is equally without evidentiary support. There is no evidence that Standard A mailers would prefer a single parcel surcharge. Indeed, Dr. Haldi proposes a reduced parcel surcharge for parcels entered, *inter alia*, at a DSCF. Such discounts would enable mailers to avoid

imposition of the surcharge where their dropshipment enables the Postal Service to avoid the incurrence of the extra mail processing and transportation costs that are alleged to be the basis for the surcharge. No mailer would seek simplicity of structure over a destination entry discount that would provide relief from a 55.6 percent rate increase.

6. Cost Data Supporting the Surcharge Are Not Credible

The Postal Service describes witness Crum's analysis as conservative. USPS Initial Brief, p. V-162. Every other party which examined his analysis found that it lacked credibility. Dr. Haldi testified:

The **IOCS-based cost study** sponsored by witness Crum exhibits **remarkable, virtually unbelievable, cost differences for parcels of similar weight**. Are these cost differences based on real cost-driving characteristics? Or do they simply illustrate the futility of relying exclusively on IOCS tallies to study parcel costs?

On the one hand, if the substantial cost differences developed by witness Crum are real, they need to be investigated in order to identify cost-drivers and quantify their impact. But no information is forthcoming on this important issue. Witness Crum appears indifferent to potentially important questions raised by his own study.

On the other hand, if the cost differences are spurious, and amount to nothing more than statistical outliers caused by small sample size, of course they should be disregarded. But how much weight can the Commission, or anyone else for that matter, give to a study if it produces **statistically meaningless results** and literally **begs to have disregarded the important differences which it surfaces?** [Tr. 23/12155, (emphasis added).]³³

³³ See also testimony of Dr. Haldi (NDMS-T-3):

The **data** supplied by witness Crum raise **troubling questions**.

See also testimony of witness Jellison (PSA-T-1), Tr. 24/12965-66 and 12973; and testimony of witness Andrew (RIAA, *et al.*-T-1), Tr. 22/11662-64, 11667-74.

7. The Postal Service Has Not Met its Burden of Proof

As for the Postal Service's criticisms of Dr. Haldi's analysis of possible unintended consequences resulting from the requested surcharge (USPS Initial Brief, pp. V-170-73), they demonstrate a misunderstanding of the respective roles of NDMS and the Postal Service regarding this issue. The Postal Service is the party requesting a new surcharge. The Postal Service has the burden of demonstrating — to the satisfaction of the Commission — (i) that it has examined the prospective impact of the surcharge, and (ii) that this impact has been taken into account in developing a specific proposal. The Postal Service has not met this burden.

The burden is not on Dr. Haldi to convince the Commission that the unintended consequences he explores in his testimony will result, although he has made an

Parcels with a comparatively low unit mail processing cost have a comparatively high delivery cost, and variations in unit cost appear **uncorrelated, or even inversely correlated**, with weight differences....are these cost differences meaningful at all? Do these cost differences **reflect real characteristics that differ among the various shapes of different parcels?** Or do they represent nothing more than statistical variation arising from small sample size?

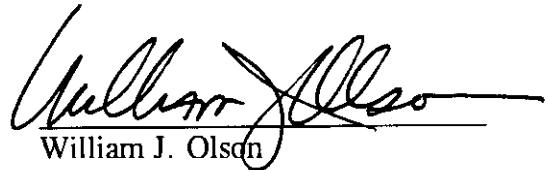
The cost differences are so enormous as to render the data worthless. Some unit costs appear to be several standard deviations from the average. If they reflect real, shape-driven causality (*e.g.*, rolls, spheres or other unusual shapes), then the Commission and the Postal Service need to know far more about them, and mailers deserve to have them quantified in a statistically reliable manner. [Tr. 23/12166 (emphasis added).]

excellent case that every mailer which can repackage his parcel as a flat will no doubt seek to do so. The burden is on the Postal Service to demonstrate that it has already examined these possibilities, and is able to discount them for specific reasons **based on the record in this docket**. The Postal Service has not met this standard. As noted previously, the Postal Service has not submitted any market study whatsoever, which is where such a fundamental question should have been addressed.

CONCLUSION

A review of the initial briefs filed by all other parties, including the Postal Service, confirms that the NDMS positions are sound, and that the Postal Service's request with respect to the First-Class nonstandard surcharge, Priority Mail and the proposed Standard Mail A parcel surcharge should be modified or rejected as set forth in Dr. Haldi's testimony. As set forth in NDMS Initial Brief, and as further demonstrated above, the testimony filed in this proceeding by NDMS support their rate and classification proposals, which the weight of the evidence shows should be recommended by the Commission.

Respectfully submitted,

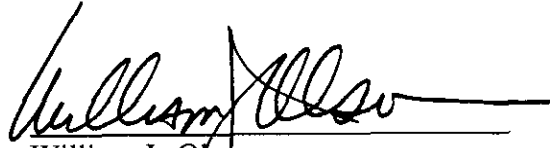
A handwritten signature in black ink, appearing to read "William J. Olson", written over a horizontal line.

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CERTIFICATE OF SERVICE

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



William J. Olson

April 10, 1998