DOCKET SECTION

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

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

REPLY BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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TABLE OF CONTENTS

I. REVENUE REQUIREMENT

A. The Postal Service's Program-Oriented Revenue Requirement Embodies and Promotes Sound Management Policies

As outlined in the Postal Service's Initial Brief at 32-37, the proposals in the instant proceeding reflect the balanced integration of financial and other policies adopted by the Board of Governors and specific management objectives. These Board policy choices have shaped the revenue requirement in the Postal Service's Request. At the heart of that revenue requirement lies a collection of program expenses in the test year which are considered critical to the Postal Service's future plans for operations and service. These are combined with other sound policies, including marketing and pricing strategies calling for moderate, below-inflation increases in rates and fees, a policy of equity restoration made possible through recovery of prior years' losses, and a choice among funding options oriented toward moderate, more frequent rate adjustments, timed in accordance with the Board's continuous evaluation of financial and operating conditions. Formulating this revenue requirement has also involved trading off, to a degree, protection against unforeseen events normally accomplished through the assessment of a reasonable amount included for contingencies. In the instant case, the Postal Service has included an unprecedented low contingency factor of only one percent.

In developing its revenue requirement, the Postal Service has conformed to the Commission's rules, and has been guided in part by the views expressed by the Commission in its most recent Opinion in Docket No. R94-1. Based on projections for Fiscal Year 1998, the Postal Service has proposed the lowest price increases overall in Postal Service history, coming after one of the longest periods of rate stability, and on the heels of a period of unprecedented successes, both financially and operationally. USPS–T–9, at 2.

While a number of factors contributed to this success, certainly one of those was postal management's reaction to the immediately previous period of significant losses. *See id.* The seriousness of that situation was discussed at length in the last omnibus rate case, both in the Postal Service's and other parties' testimonies, by the Commission in its Opinion, and by Commissioner LeBlanc in his dissenting opinion.[1] That the Postal Service took those concerns to heart cannot be overemphasized.[2]

Board of Governors Resolution No. 95-9 was a direct outgrowth of the concerns expressed by the Commission in Docket No. R94-1, and it has been a significant factor in the Postal Service's success.[3] It directed the Postal Service to *plan for* net incomes that *equal or exceed* the amount recommended by the Commission for recovery of prior years' losses (RPYL), not simply in the test year, but throughout the rate cycle. When that could no longer be accomplished, management was directed to either cut costs or increase revenues. Management has followed the Board's directive. Net incomes have exceeded the RPYL amount for the last three years. Management, however, projected that this trend would not continue into FY 1998. Significant factors in this determination were several Board decisions to authorize

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[1] PRC Op., R94-1, at II-16–34; Dissenting Opinion of Vice Chairman LeBlanc.

[2] *See* MOAA Brief at 5-6; Joint Brief of AMMA, DMA, MOAA, ADVO, SMC, NDMS, Val-Pak, and Carol Wright Regarding Revenue Requirement at 8 (hereinafter in this section "Joint Brief").

[3] *See* USPS–T–9, at 39-42.

major programs involving capital investments and ongoing operating expenses in FY 1998. As a consequence, the Board of Governors exercised its prerogative to file this case.

In the last omnibus rate case, the Commission expressed its opinion that the Postal Service had caused an undue increase in accumulated net deficits by waiting too long to file. PRC Op., R94-1, at II–27-28; Dissenting Opinion at 2. In this case, that criticism has been turned on its head. Doubts have been expressed as to whether, based on actual results so far, the Postal Service "really needs the money" in FY 1998.[4]

In large part, the most critical reactions by participants in this case to the Postal Service's Request have resulted from the convergence of several factors: a largely historical, hypothetical test year, which was selected for sound policy reasons, but which tends to complicate evaluation of the Postal Service's revenue requirement; the particular timing of filing the Postal Service's Request in FY 1997; and the lack of precise anticipation by the Postal Service of recent financial results, as revealed in actual operating data made available during the course of the proceedings. These conditions have prompted a loud hue and cry, reflected mainly in the briefs of two participants (OCA and ANM), who complain that favorable financial trends invalidate

[4] Several parties maintain that there should be no rate increase at all, *e.g.*, OCA, ANM, ALA. The immediate practical problem with this approach, aside from issues of interference with the prerogatives regarding the financial management of the Postal Service, is that, if indeed the question were to be answered in the negative, one likely consequence would be a subsequent filing based on a later test year, and higher rates than those that have been requested in this proceeding. *See* Joint Brief at 3, 8-9.

the foundation of the Postal Service's revenue requirement. It would be a mistake, however, to be misled by the view that the financial "trends" postulated by these participants can wash away the justification for the Postal Service's revenue requirement without taking account of the fundamental nature of its constituent parts. The operation of the roll-forward process, as influenced by the effects of changed inputs on the results of the model, will establish a substantial part of the accrued cost basis for the revenue requirement. The main sources of increased revenue need in the test year in this proceeding, however, will come from the major program expenses, and their associated cost reduction estimates, as reflected in Postal Service testimony and supporting documentation in the record. In this respect, there will likely be an inclination to regard the estimation of program expenses as merely an extension of the process of forecasting accrued costs through rolling forward costs from the base year. Based in part on the dialog that has taken place on the record so far on this topic, furthermore, there will at the least be a tendency to factor prior years' program experience into "predicting" program expenses in the test year, or adjusting those inputs in the Postal Service's case. As we argue more extensively below, however, this would be a mistake on at least two grounds.

First, the primary programs outlined in Postal Service testimony represent major Board policy commitments. Depriving the Postal Service of the source of funds to carry out those programs by virtue of a forecasting exercise would interfere with the management function. Second, the implementation of those programs is itself a part of the management process. Any "prediction" of how much program money will be spent in the test year based on evaluation of the history of the same or similar program experience, without heeding the only testimony on the record competent to represent management plans and actions, and to comment on the uniqueness of the test year operating and management environment, would be defective.

It should be understood, however, that in making these statements, the Postal Service is *not* contending that any consequence of adjusting cost estimates in the test year that has the effect of reducing funds available for expenses estimated in the Postal Service's revenue requirement would be prohibited. Revisions to accrued cost estimates resulting from corrections of errors, or even changes to other inputs that are supported on the record are not necessarily outside the scope of the Commission's authority. Nevertheless, the Postal Service must take the position that any result that interferes with management by disabling it or impeding it, through reliance on a forecast that does not take full account of management prerogatives, would be *ultra vires.*

The courts have drawn firm lines between the ratemaking authority of the Commission and the management authority invested in the Postal Service and the Board of Governors.[5] One should not intrude on the other. More specifically, the Commission does not manage the Postal Service; nor can it exercise its authority to impede, constrain, or interfere with the legitimate exercise of management

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[5] *See National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810 (1983); *Newsweek, Inc. v. United States Postal Service*, 663 F.2d 1188 (2d Cir. 1981); *Governors of the United States Postal Service v. Postal Rate Commission*, 654 F.2d 108 (D.C. Cir. 1981); *Mail Order Association of America v. United States Postal Service*, 2 F.3d 408 (D.C. Cir. 1993).

prerogatives. In this regard, the Postal Service submits that any reductions of the revenue requirement that affect the operation of the Postal Service's financial, operating, or other policies, in ways that are inconsistent with the policies of the Act, will be carefully evaluated and challenged if necessary.

B. The Postal Service Has Properly Estimated Test Year Accrued Costs and the Attacks on those Estimates Are without Legal or Factual Merit

The attacks that have been launched at the Postal Service's test year cost estimates generally fall into two categories. The first set of claims is that past trends or current partial-year actuals contradict test year estimates. The second set of claims is that the program costs included in the revenue requirement should be reduced or disallowed. For the reasons set forth below, all of these attacks must be dismissed by the Commission.

1. The record does not support conclusions about test year cost estimates based on projections of partial-year results.

The OCA asserts that "the Postal Service in all probability will earn a significant profit during the test year." OCA Brief, First Section at 2. It further states: "Any reasonable projection of Postal Service earnings for the test year to-date ... indicates a probable profit in excess of $1 billion." OCA Brief, Second Section at 25. "The facts demonstrate that the Postal Service will earn profits in the test year ...." OCA Brief, First Section at 13.

No record evidence is cited for these statements, and there is none. The Commission cannot base its recommended decision on probability and speculation, but on actual evidence on the record of this docket. Nowhere on the record of this case can one find the fact or amount of alleged net "profit" projected by the OCA for the test year.

a. Spurious comparisons with the budget process do not invalidate the estimates.

Attempts to compare test year projections and the budget are based on a several fundamental misunderstandings. The test year is a hypothetical construct estimating costs underlying the calculation of rates that will allow the Postal Service to function not only in the test year, but well beyond it as well.[6] This is particularly true given the timing of this particular case. The budget, on the other hand, is not necessarily a projection of costs, but a plan for operating the Postal Service in a given year. The test year and the budget do not necessarily reconcile, because they are developed at different times, using different methodologies and data, to varying degrees. Therefore, attempting to evaluate the test year by looking at current results for the fiscal year or by speculating as to whether certain funds will actually be spent this year misses the mark as a reasonable means to evaluate the test year estimates on which the rates are based.

[6] In another context, the Commission has observed: "The test year here, as generally, is a procedural device whose purpose is to keep the record of a rate case within manageable bounds, and to allow the financial condition of the regulated firm to be more readily compared for alternative sets of rates within the same time period, and from one time period to another. One of its prime objectives is to ensure, as far as practical, that the proposed rates are based on an analyzed time period that is representative of the time that they will actually be in effect. In this, as in most ratesetting environments, it is understood that rates will be in effect for a period longer than the test period. This does not, by itself, render the test period unrepresentative." PRC Op., R87-1, Vol. 1, at 8-9.

Aside from total lack of record evidence, the OCA's arguments in this regard confuse the test year revenue deficiency and the Postal Service's projected budgetary loss. For instance, the OCA makes the unfounded accusation that "the Postal Service stubbornly continues to project a loss of $2.4 billion despite mounting contrary evidence." OCA Brief, Second Section at 26. The $2.4 billion revenue deficiency includes the contingency and RPYL. Moreover, the part of the revenue deficiency that represents the operating loss estimated for the test year and the budget projection for FY 1998 cannot be expected to be equivalent, given the different times at which they were estimated and the different methodologies used to produce some of the underlying components.

The OCA's attempt to crosswalk the Postal Service's FY 98 operating budget to the rate filing to show that "the Postal Service's own figures tend to recognize that the rate filing overstates the actual deficit in $500 million range" is misplaced. *See* OCA Brief, First Section at 41. As explained above and documented on the record, the rate filing and the FY 98 operating budget are not comparable, because they were developed at different times, using different processes and methodologies, and some different assumptions.

Making comparisons is very difficult, and without proper care, could lead to the wrong conclusions. For example, the OCA argues that the difference between the operating budget and the rate case due to the higher rates reflected in the fourth quarter should be $700 million or less because the summer months are a low volume period. OCA Brief, Second Section at 40. This seems plausible enough on the surface, but only if one is unfamiliar with the details surrounding the development of the operating budget. As Mr. Porras testified, the effect on the operating budget of implementing rates for the last four months of the fiscal year was in the neighborhood of $900 million. Tr. 35/18671. Although this number has been questioned as being high, Mr. Porras testified that it was indeed based on detailed volume estimates. Tr. 35/18673. Although it is often generalized that Quarter IV is a low-volume period, there are differences based on types of mail. The plan spread for FY 1998 was based on actual PQ IV FY 97 volume which was higher than normal for Standard Mail (A). In addition, Standard (A) rates are proposed to increase by amounts which are greater than the overall average rate increase. Finally, one must consider the lag structure of the forecasting equations, under which volume reaction to a price increase is not instantaneous, but is phased in over time. The combination of these factors resulted in the fourth quarter's having a greater effect on the plan than an observer might assume without understanding the details.

The Postal Service has never said that its rate case estimates are the most current projection of its FY 1998 finances, but rather that they remain reasonable for the purposes of determining rates. Further, Mr. Porras' testimony acknowledges a net $195 million reduction in expenses, which would reduce the before rates test year loss reflected in the filing to $1.197 billion ($1.392 less $.195).

b. Partial-year results do not provide a reasonable basis for supporting changes in test year estimates.

The OCA argues that, since only $56 million had been spent on ADP Supplies and Services as of Accounting Period (A/P) 5 out of a total estimate of more than

$1.0 billion, it is unlikely that these expenses will be incurred this year. This argument should not be relied on by the Commission as the basis for any adjustments in estimated program expenses.

First, as witness Porras pointed out, it is possible that some expenses related to ADP services are being charged to another cost component. He stated: "When we do the rate categories, we tie in the total expenditures of the project under ADP. When you're looking at a line in terms of our current performance, that may not be the total program cost. You have to go pull it out of supplies and services, and I don't think we're looking at the same thing ...." Tr. 35/18696. Indeed, it is possible that some of the ADP supplies and services costs have been charged to miscellaneous supplies and services (component 177), which reflects actual expenses of $572 million through A/P 7. Second, it is unlikely that much, if any, of the additional $298 million for the Year 2000 Software Program would be reflected in actual expenses through A/P 7, since this increase was only recently authorized. Third, the amount charged for ADP supplies and services has more than doubled through A/P 7, to $116 million, indicating that these costs are beginning to accelerate. Finally, the preliminary income statement for A/P 7 shows that the growth in Headquarters expenses (which include most of the program cost increases) over the same period last year (SPLY) is accelerating, having increased to 26.1 percent over SPLY for A/P 7, versus 22.2 percent in A/P 6, and with year-to-date growth of 18.9 percent. Thus, the available latest information does not, as the OCA argues, support a finding that program expenses have been overestimated.

c. Past attempts by the Commission to make projections based on historical trends and partial-year results have failed.

As detailed in the rebuttal testimony of witness Porras, changes and mis-estimates made by the Commission in Docket No. R90-1 resulted in a combined revenue shortfall and cost overrun of $1.628 billion in the FY 92 test year. Tr. 35/ 18589-91. This was despite the fact that the Commission had the benefit of much later actual data than the Postal Service did when it prepared its filing.

Similarly, on May 24, 1994, during the litigation of Docket No. R94-1, the Commissioners testified at the House of Representatives Oversight Hearings regarding the Postal Service's financial situation. Commissioner LeBlanc testified as follows:

> The Postal Service's rhetoric is that things are not as good as they would like for them to be, but they will soon get better due to the benefits of reorganization and modernization. I certainly hope so, but it is my view that the Postal Service could hardly be worse off financially and I see nothing on the horizon that will significantly improve its present position. For example, if present trends continue, our figures indicate a possible loss in the range of $2.4 billion for 1994 alone.[7]

The Postal Service had estimated in its filing that it would incur a net loss of $1.3 billion for FY 1994 and its operating budget for that year reflected the same amount. Despite the fact that the Commission had the benefit of half of the FY 1994 actual data, which is approximately the same amount of actual data it has today for FY 1998, its year-end projection of a $2.4 billion loss was significantly in error compared with the actual FY 94 net loss of $913 million. The Postal Service estimate of $1.3

[7] Oversight Hearings on the U.S. Postal Service–1994, One Hundred Third Congress, Serial No. 103-40, at 457.

billion was much closer, despite the fact that it was developed much farther in advance. Based on its experience using trends to project year-end results, the Commission should exercise great caution in attempting to forecast year-end results for FY 1998 based on trends.

2. The reductions in, or elimination of, program expense estimates which the Commission is urged to make are insupportable in fact and in law.

As noted above, much of the criticism of the revenue requirement is in the nature of second-guessing postal management on its plans and commitments. It is suggested that certain expenditures either are inappropriately included in the revenue requirement, or have been overestimated. These criticisms must be rejected.

Any determination that, due to current spending levels, some amount of these expenditures ought to be excluded from the revenue requirement is illogical, incomplete, and off base, or more precisely, beyond the scope of the Commission's ratemaking authority. It is incomplete, because it is based only on limited knowledge concerning current operations. It is off base, because it deals with the question of "how is the Postal Service doing" in relation to its operating plan for the current year; this is a question for Postal management in operating the Postal Service. The only appropriate question for the Commission concerns estimation of the Postal Service's revenue requirement on which rates for the future must be based. Speculation and trends based on recent spending levels do not in any way answer the question actually before the Commission: how much revenue does the Postal Service *require*? The question is not how much does the Commission believe the Postal Service might actually *spend*, based only on incomplete information about the current fiscal year. It cannot and may not be disputed that the full amount needed to fund these programs is *required revenue*. Without this revenue, management's ability to finance and operate these programs could be jeopardized.

a. The criticisms are based on an unjustified expansion of the role of these proceedings.

While there is a role for the Commission to determine that the Postal Service has properly documented and supported its revenue requirement estimates, many of the criticisms that have been leveled at the Postal Service are essentially challenges to financial and operating policy decisions that have already been made by postal management and the Board of Governors, as discussed above. As such, they extend far beyond the review appropriate in these proceedings and must accordingly be rejected.

The OCA in its Brief, boldly passes judgment, *seriatim*, on various program expense estimates, indicating those to which it objects and those which pass its muster. *See* OCA Brief, Second Section at 32-41. The decisions to spend postal funds for these programs, however, how much to spend, and whether to include those expenses in the revenue requirement are matters reserved to postal management.

Similarly, discussions as to whether the Postal Service could have financed these programs through means other than a rate increase, such as borrowing, are irrelevant to the process before the Commission. *See* ANM Brief at 8. That decision is also reserved for Postal management and the Board of Governors, and it has already been made. The programs, or more precisely, the operational expenses associated with those programs, will be financed through a small rate increase. That choice having been made, it is not within the Commission's authority to examine the current year's budget and speculate as to exactly how much of, and precisely when, those funds will be spent. The Commission's review of the revenue requirement is limited to whether the programs have been properly calculated within the revenue requirement for the test year. There is no significant dispute as to the calculation of those amounts.

b. The record demonstrates that the estimated expenses are accurately included in the revenue requirement.

The primary consideration in evaluating these criticisms must be that the program expenditures are expected to occur. As Mr. Porras testified, almost all of the projected expenses are based on signed contracts or other commitments that will occur, and for which the Postal Service will incur significant expenses.[8] Although questions have been raised as to whether these expenditures will actually occur in this fiscal year as projected in the test year, these questions are based on nothing more than speculation and an attempt to project trends that are not necessarily capable of projection.[9]

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[8] Even in a case where a program has not yet been approved by the Board, one must plan for the expenses associated with it. Tr. 35/18709-10. If the expenses associated with that program are excluded by the Commission from the revenue requirement, then the Board's ability to approve that project and know that there will be funds from operating revenues to finance it will be compromised. This the Commission clearly may not do.

[9] In this regard, some have objected that the Postal Service is asking the Commission to look beyond the test year and that it may not do that. Again, that (continued...)

c. Program expense estimates are not negated by past performance and the record demonstrates why they must be included in test year cost estimates.

The OCA and others argue that history proves that the estimated program expenses will not be incurred in the future. OCA Brief, First Section at 7-15. Mr. Porras, however, explained why history is a poor indicator of the future in this regard, as discussed in detail below.

The matter is quite simple: The Postal Service has plans to spend a large amount of money on programs during FY 1998. These have been approved by management and the Board. Budgets have been authorized; contracts have been signed; and processes are in place. According to the OCA, the Commission should ignore these facts, and assume for ratemaking purposes that the Postal Service will not do what it is planning and trying to do. Such an assumption is not appropriate, unless it can be demonstrated that the Postal Service does not intend to incur these

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[9] (...continued)
argument is based on a fundamental misunderstanding of the difference between the revenue requirement and operating results. The amount needed to fund the programs has been included in the test year. There is no need to look beyond the test year. The amounts included are amounts that are planned to be spent on these programs this year. The amounts are in the budget as well as in the revenue requirement. Whether every last penny budgeted and required as part of the rate change actually ends up being spent this year is not only something that cannot be known, but is irrelevant to recommending rates, which will last beyond the test year and are needed to support these programs. Tr. 35/18608.

The answer to this theoretical conundrum surely cannot be that the Postal Service should have used a later test year. The absurdity of this logic is superbly discussed in MOAA's Brief and in the Joint Brief. It will be sufficient to say at this point that when those charged with representing the public interest make arguments whose logical consequence is a larger rate increase than the Postal Service sought, something is truly wrong.

expenses. There is no evidence provided by any participant that the Postal Service does not intend to implement these programs. All that the participants can dispute is whether or not the Postal Service can in fact do what is trying to do as quickly as it has planned. This is not a matter subject to adjudication before the Commission, since it is critically tied to management prerogatives with which the Commission may not interfere.

ANM argues that "the Postal Service would have to lose over $2 billion in remaining accounting periods of the year," and "has offered no credible evidence that it will incur losses of this magnitude during the remaining accounting periods." ANM Brief at 3. The OCA states: "One wonders, and the record is silent, as to how the Postal Service expects its earnings to deteriorate so quickly from a year-to-date net income of $1.1553 billion through A/P 5 to a loss of well over $1 billion for the test year." OCA Brief, First Section at 8.

The Postal Service has provided credible evidence that its program expenses are likely to increase dramatically during the second half of the test year, resulting in losses large enough to come close to a $1.2 billion loss. Mr. Porras testified that the Postal Service will incur an unprecedented amount of program related expenses during the second half of the this fiscal year, including $300 million of previously unplanned expenses for Year 2000 software fixes. He explained that "a lot of those programs have contracts signed already," that "we now have processes in place to have managers accountable," that "the way they're set up is that the moneys are going to be spent between now and the end of the year," and that "I think we're going to be very close to that number". Tr. 35/18607. He reiterated this point, as he continued to be asked about it:

> So, today my bottom line is the program managers are going to expend this money. We have the processes in place to let them do that. I think it's going to get done.

Tr. 35/18691.

> It goes back to our discussion or the discussion I had earlier and part of what was in Mr. Tayman's testimony and mine that we have a lot of programs, a lot of investment monies and a lot of that is being planned to be spent in the remainder of the year, the latter part of the year. We have some major, major projects and programs that we have underway. Some of those started a year ago. Some started a little bit later. We have contracts in place. We now have program mangers responsible for these particular programs. They have told us—we have gone back and talked to them—that they are going to spend these monies and this plan reflects those particular assumptions.

Tr. 35/18681.

> I'll go back and repeat some of the same things I've said. A lot of these projects and programs today, we now have contracts in place. I mean, contracts have been signed. We're gearing up to spend the monies.

Tr. 35/18701.

> In the past, I would have said to you, I don't think we can spend this money. Today, I cannot do that. I'm looking at a totally different organization today. We are doing what we said.

Tr. 35/18691

> I mean we've got these things in place to get them done. I'm saying to you from my knowledge of what I have seen over the last couple of years, the processes are in place, that these can be spent.

Tr. 35/18736-37.

ANM and the OCA argue that history does not support Mr. Porras's assertions that this money will be spent. The only relevant question, however, is whether postal management *intends* to spend these funds, and the testimonies of Mr. Porras and Mr. Tayman demonstrate more than adequately that it does. Arguments about whether the expenditures are possible, likely, probable, or guaranteed are irrelevant to the issues properly before the Commission. *See* Tr. 35/18738.

It has also been observed that the Postal Service has never experienced the kind of expense growth (11 percent over the same period last year) that is estimated to occur during the remainder of this fiscal year to reach a $1.2 billion loss. Tr. 35/18683-84. But, the record shows that FY 1998, like years in which there were OBRAs and substantial inflation (*see* Tr. 35/18693), is not a "normal" year. In this regard, both the OCA and ANM argue that history is instructive. Their argument is that because losses for Quarter IV in FYs 1997 and 1996 were better than plan, the Postal Service is not going to incur large losses during Quarter IV of FY 1998. The record shows, however, that there are particular reasons why the Postal Service did better than plan in FYs 96 and 97, and that there were non-recurring favorable variances that will not carry forward into the test year. Tr. 9/4397-404. The major difference between these years and FY 98 is, in fact, the unprecedented increase in expenses for other programs. As reflected in LR H-10, the total increase reflected in other programs is $2.5 billion for FY 98, versus only $1.1 billion in FY 1997.

ANM also argues that, because the Postal Service is doing better than plan, "spending levels would have to be far higher than even the levels approved by Postal management in October—*after* the outset of the rate case," and it claims that "[n]either Mr. Porras nor any other witness has explained why the Postal Service's projected spending needs have skyrocketed so much during this relatively brief period." ANM Brief at 4. No one has asked this question, because the answer is obvious. Spending needs have not changed at all. ANM does not understand, or is unwilling to accept the fact, that the FY 98 annual budget does not change just because actual results might vary from plan in any given accounting period. The budgeted annual amount is *still authorized to be expended*, and budget holders will be doing everything possible to expend authorized program funds before the end of the year. It is not uncommon for budgets to exceed plan during the latter part of the year, thereby making up for early underruns and equaling the total budget at year end. Budget control for programs typically applies to the annual total or in some case a multi-year total, not to individual accounting periods. It should be noted that large Quarter IV losses and unfavorable variances to plan are possible and did in fact occur in FYs 93 and 94.

d. There is no factual or legal basis for a distinction between costs allegedly within the control of the Postal Service and those outside of its control.

The OCA contrasts program expenses that are "wholly within the control of the Postal Service as add-ons to its base operating costs" with expenses caused by inflation, such as COLAs, implying that only the latter are legitimate expenses. This is a false dichotomy. It is simply untrue that all of the program expenses are "wholly within the control of the Postal Service as add-ons to its base operating costs." As witness Tayman explained, the other program "category also includes changes in expenses not directly linked to operations, such as interest, depreciation, and corporate-wide personnel costs, such as annuitant costs and workers' compensation. The impact of accounting and reporting changes and other miscellaneous adjustments that cannot be easily separated into other categories are also reflected in this column." USPS-T-9, at 14. The amounts involved are detailed in LR H-10, which shows that a significant portion of the other program increase relates to items that are not simply discretionary "add-on" costs, as stated by the OCA. For example, depreciation and disposition of property, which resulted mainly from previous capital investment decisions, contributed more than $400 million of the increase. Corporate-wide personnel and interest costs, such as workers' compensation, annuitant costs, unemployment compensation, and repricing of annual leave, added approximately $375 million of the increase. Finally, the OCA disregards the fact that a significant portion of the program cost increases result in cost reductions which reduce costs by $931 million for the test year. Curiously, the OCA does not object to a reduction for Mail Transportation Equipment Centers, but does object to an increase for the Year 2000 Software Program. OCA Brief, Second Section at 30-31, 33-37. Both, however, are within control of the Postal Service, and both are based on estimates of program managers.

Most importantly, to the extent costs are within the control of the Postal Service, *i.e.*, result from affirmative policy choices made by postal management, the Commission may not legitimately interfere with the exercise of that authority by eliminating expenses associated with such policies from the revenue requirement.

e. The OCA's challenge to the Year 2000 Software program is unjustified.

The Year 2000 Software program is not a new program, as the OCA implies. OCA Brief, Second Section at 35. In this instance, the Postal Service has provided an update to its original estimate, as it has provided updates for other known changes. Although the OCA acknowledges that the "Year 2000 program, in general, is certainly an important program," it claims that "witness Porras offered no detail to support his assertions" that the Postal Service will spend more on this program in the test year. Quite the contrary, Mr. Porras explained that an outside expert on the year 2000 problem developed the estimates reflected in the rate case. Tr. 35/18638.

Moreover, LR-H-10 provides an explanation of the purpose of the program and an estimate of test year expenses.[10] If the explanation of the program and the estimate for it was sufficient to support the original estimate, it is unclear why it would be inadequate as support for the updated information provided by Mr. Porras, based

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[10] LR-H-10, at page 26, provided the following explanation of this program.

> YEAR 2000 SOFTWARE — The Year 2000 program has been established to assess the impact of the year 2000 on USPS mainframe, client/server, workstation-based systems, and to develop and implement solutions for the applications software, operating environments (systems software, hardware, network), Database Management Systems, user interfaces, and data. Based on industry benchmarks, the program manager developed cost estimates reflecting the use of approximately 100-150 highly skilled contractors. Costs were estimated to be $42.990 million in various supplies and services accounts for FY 1998.

LR-H-10 also included the following entries at page 3 of Exhibit B:

	Seg. 16 S&S	Total
Year 2000 Software	42.990	42.990

All that has changed is that witness Porras has provided updated cost figures based on the advice of outside consultants.

on the latest information available to him. It is also worth noting that after numerous discussions during oral cross-examination of how the Year 2000 estimate was developed, no one, including the OCA, asked for further details to be provided for the record.

In its Docket No. R94-1 Opinion, the Commission addressed the issue of the appropriateness of using judgment and informed opinion by program managers and other experts to determine the cost impact of its programs. The Commission observed that "some of these inputs, admittedly, are the products of judgment, so that their 'ultimate source' is an informed opinion rather than a quantitative measurement. This is unobjectionable, provided that opinion evidence is the best (or only) kind available, the source of the opinion is identified, and the judgment based conclusion is sponsored and made available for adequate testing on the record." PRC Op., R94-1, at II-7. These tests were met with regard to the Year 2000 program, as well as all of the other programs.

f. There is no basis for the OCA's allegation that the Postal Service has withheld information concerning changes in programs.

The OCA argues, based on information provided by the Postal Service concerning changes in the Augmented Sales Force program, Tr. 9/4484, 4508-10, that "the Postal Service was making wholesale adjustments to its other programs without informing the Commission about any updates," and that "tracking the planned and redirected expenditures is like watching a shell game." OCA Brief, Second Section at 39. It is, however, preposterous to leap to the conclusion that wholesale changes have been made to other programs because the funds related to one small program were re-evaluated. Moreover, Mr. Porras's testimony contains information about several major program changes that have occurred since the Postal Service filed its Request. It is the OCA that is playing a shell game by leaping to the unsupported conclusion that because one small program was being re-evaluated, the revenue requirement and the total cost of programs reflected in the Postal Service's Request are somehow no longer reasonable.[11]

g. ANM's argument that the Commission should disallow certain program costs is flawed.

ANM argues that the "kinds of spending projects that the Postal Service is supposedly undertaking cannot generate losses recoverable from ratepayers." ANM Brief at 5. ANM bases this argument on two seriously flawed assumptions. ANM misrepresents the meaning of witness Porras' testimony comparing the costs and the benefits of the programs reflected in the revenue requirement. ANM contends that witness Porras testified that *all* programs have benefits that are equal to or greater than their costs. *Id.* (emphasis in original). ANM can not provide a citation, however, because Mr. Porras never made that statement. Indeed, Mr. Porras explained that some programs, such as those related to infrastructure, safety, or service, have costs that do *not* cover their tangible or quantifiable benefits, and that other programs may

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[11] It is apparently difficult for the OCA to appreciate that managing the Postal Service and its budget is a complex process. In this regard, the Postal Service has explained: "The FY 1998 operating budget is not comparable to the Docket R97-1 rate filing because of timing differences" and "operating budget targets involve negotiation, judgment, linkage to and support of operating goals, and the tactical allocation and re-allocation of resources to organizational units and programs." Response of United States Postal Service to OCA/USPS-120 in this Docket, and to OCA/USPS-75 in Docket MC 96-3.

result in cost avoidances, as opposed to cost reductions. He stated: "We have got a lot of infrastructure type projects you may do to support your organization for the future — a facility type project of replacement because of safety and health and all those kind of things, you may get a negative present value." Tr. 35/18614-15. "You have got others to improve service. Call Centers, for example,.... You may not be able to look at an ROI because it's a service improvement in terms of customer satisfaction.... Maybe customers will use the Postal Service more, but you can't quantify that. I can't sit here and say revenue will go up one percent, or this is going to happen, so we call that an infrastructure investment." Tr. 35/18615-16. "I'm saying there's going to be investments that you're not going to get a return, you have to do them for safety and health and other reasons." Tr. 35/18618 (*e.g.*, asbestos removal).

Second, ANM complains that the Postal Service has overstated its costs by expensing programs that should have been capitalized, writing off capitalized items too quickly, and/or picking FY 98 as the test year because it is an atypically high cost year. ANM Brief at 5-6. ANM attempts to supports its claims by citing witness Porras as having admitted that the Postal Service is expensing too much in the test year. It suggests that neither witness Porras nor witness Tayman has verified the Postal Service's compliance with generally accepted accounting principles ("GAAP"). ANM Brief at 6. A careful reading of the pages cited by ANM (Tr. 35/18611-13), however, reveals nothing to support ANM's position that these unspecified costs should be spread out over a longer period. Witness Porras actually responded as follows: "Now we follow generally accepted accounting principles, and these are laid out to us in particular financial accounting standards. We follow those completely. You don't have a choice." Tr. 35/18610. "I could not do what you said to do. These are operating expenses associated with these programs. You can't do that. That is just making up mathematics." Tr 35/18613. In fact, one has to look no farther than the Report of Independent Auditors found in the Postal Service's audited financial statements to see that the Postal Service has consistently complied with generally accepted accounting principles. ANM's claims to the contrary are without foundation. Changing its approach, ANM further argues that GAAP compliance is not sufficient to "satisfy economic regulatory standards." ANM Brief at 6. This argument, however, is totally inconsistent with more than 25 years of postal ratemaking and Commission Recommended Decisions, which have always been based on accrued costs as defined by the accounting standards applied to the Postal Service by its public auditors. Furthermore, ANM's contentions are at odds with Section 2008 of the Act, which requires the Postal Service to annually "obtain a certification from an independent, certified public accounting firm of the accuracy of any financial statements of the Postal Service used in establishing postal rates."

Finally, ANM argues that the Postal Service has "offered no reason why the investment expenditures could not be financed by issuing debt ...." ANM Brief at 8. The Postal Service, however, does not have to justify its financial decisions in this forum. The Commission understands that it may not take actions that will force postal management to incur debt rather than finance its operations by means of moderate rate increase, contrary to the financial policy choice already made by the Board of Governors. *See* PRC Op., R74-1, Vol. 1, at 39; PRC Op., R77-1, Vol. 1, at 27.

C. If Any Adjustments Are to be Made, They Must Be the Ones Provided in Mr. Porras's Testimony Based on Known Changes and Not Those Urged on the Basis of Speculation

As witness Porras testified, no adjustments to the revenue requirement should be made. Tr. 35/18575-77, 18591-92. However, if any adjustments to the revenue requirement are to be made, they should be limited to known changes, quantified on the record, and should include both increases and decreases. These have been identified fully in Mr. Porras's testimony, Tr. 35/18578-86, which provides a comprehensive listing of all major changes known at the time that testimony was filed.

The OCA joins Direct Marketing Association to recommend that the Commission reduce estimated test year costs by $51 million to reflect supervisor savings which witness Buc says the Postal Service forgot to include in its cost reductions. The OCA argues that witness Buc showed that program managers overlooked supervisor savings related to cost reductions. OCA Brief, Second Section at 31. Witness Buc, however, offered no evidence other than his opinion that supervisor costs were not considered by program managers when they calculated cost reduction savings and that they simply determined that no savings should be included. Further, he admitted that "I do not know for a fact that Postal Service program managers did not consider adjustments in supervisor costs when they estimated the impact of cost reduction programs". Tr. 28/15428. Rather, he argued that a mechanical calculation should be used to maintain the ratio of supervisors to employees supervised. *See* Tr. 28/15428-30. The Postal Service relied on the first-hand knowledge and expertise of program managers, not a blind mechanical calculation such as witness Buc suggests, to determine which, if any, program increases and/or cost reductions should also include changes to supervisor costs. Witness Buc, conversely, bases his argument totally on his uninformed opinion and speculation. The only fact he has provided is that the supervisor ratio has changed. He has not, however, shown that this change is not valid.

D. If Adjustments Are Made to the Revenue Requirement, the Contingency Should Also be Adjusted

The OCA recommends rejection of Mr. Porras's suggestion that, if adjustments are indeed made, a more adequate contingency of 1.5 percent is justified now that expenses are estimated to be slightly less than originally estimated. OCA Brief, Second Section at 41-42. The OCA claims that this "indicates the Postal Service's view that an increased contingency is set at a level to assure a preconceived level of revenue requirement." *Id.*

The OCA's conclusion, however, is unfounded. The Postal Service originally requested an artificially low contingency of only 1 percent in order to keep the rate increases as low as possible. USPS-T-9, at 38. As Mr. Porras explained, however, the contingency would have been set higher had the current financial circumstances been known at the time the revenue requirement was developed. Tr. 35/18587-89. Mr. Porras suggested that the prospect of slightly lower test year expenses would justify raising the contingency to a more adequate level, without compromising the Postal Service's objective to keep rates as low as possible. *Id.*

In this regard, Mr. Porras cited several examples of conditions that would support his conclusions, including, the increased economic uncertainty due to the Asian crisis, and the increased likelihood that unplanned expenses will materialize in the test year. Witness Porras also discussed the uncertain economic environment and draft Congressional legislation which is likely to result in significant unplanned expenses during the test year. *Id.*

Contrary to the OCA's suggestion, this proposal is far from radical. Rather, it is simply the opposite side of an approach advocated by the Postal Service and taken and endorsed by the Commission in several prior cases. Admittedly, the situation in those cases involved the estimation of higher test year expenses during the course of the litigation. In several instances, rather than formally ask for a higher revenue requirement, the Postal Service expressed a willingness to accept recommendations based on its original revenue requirement, even though the practical result of that decision would be that no or less money would be available for contingencies, in light of the increased costs in the test year. *See* PRC Op., R71-1, vol. I, at I-273, n. 7; PRC Op., R74-1, vol. 1, at 65; PRC Op., R77-1, vol. 1, at 20. In the one case where the Postal Service did ask for an upward revision of its revenue requirement supported by evidence of increased costs, the Commission declined, on the ground that the Postal Service's request was not part of a formal amendment of the Postal Service's Request by the Board of Governors. PRC Op., R76-1, vol. 1, at 22-23, 25.

In that circumstance, however, the result was the same. In light of the increased revenue need, less money would be available for contingencies in the test year. Finally, in Docket No. R90-1, in the face of the extraordinary imposition of OBRA liability that developed during the course of the proceeding, the Postal Service again declined to revise its revenue requirement, recognizing that the practical effect would be to reduce the contingency amount as a percentage of total costs. *See* PRC Op., R90-1, vol. 1 at II-12-13.

Here, witness Porras simply testified that, in the opposite situation, where the record arguably supported a lower level of test year expenses, the Postal Service believed that its original revenue requirement remained justified and should be recommended. In that circumstance, furthermore, the availability of more money available for contingencies than originally requested would also be justified, in light of witness Porras' testimony supporting a greater level of uncertainty due to unforeseen events.

E. Recovery of Prior Years' Losses Should be Allowed to Continue at the Same Rate as Has Been Provided for in the Past

In an attempt to defend its indefensible position that the Postal Service's revenue needs should be disregarded, the OCA makes the following statement with respect to the recovery of prior years' losses (RPYL): "Finally, the Postal Service's preferences on the restoration of equity might be undermined but, unfortunately for the Postal Service, the policy on the restoration of equity has been established by the Commission as one-ninth of the remaining prior year losses." OCA Brief, First Section at 13. Unfortunately for the OCA, it is the Postal Service, and not the

Commission, that sets the Postal Service's financial policy. The Commission has recommended a mechanism to enable the recovery of prior years' losses, but that is not the same thing as a policy. Resolution No. 95-9 of the Board of Governors of the United States Postal Service is quite clear that the Board expects the Postal Service to plan for net incomes that equal or exceed the amount for RPYL used by the Commission in recommending rates. The OCA cannot seriously be suggesting that the Commission may cut the revenue requirement in such a way that would frustrate the accomplishment of the Board's policy, or that would undermine the ability of the Postal Service to recover prior years' losses and remove the burden from future mailers at an accelerated pace.

F. The "Smoking Gun" Is Neither Smoking Nor a Gun

The document inadvertently included with the electronic version of the exhibits accompanying USPS-RT-11 (hereinafter, "the document"), Tr. 35/18730, has been characterized by ANM, both in the press and in its brief, as a "smoking gun" memorandum.[12] To the contrary, the document contains no information not publicly stated in the filed rebuttal testimony. Rather, the document is a clear window on the testimony, which, apparently shockingly to some, takes positions that the Postal Service has taken consistently in this and past cases: the revenue requirement need not be updated; but if it is to be updated changes in both directions must be included. The document says nothing more and nothing less than the testimony itself, except

[12] ANM Brief at 7; *"Smoking Gun" Memo Stirs Up Debate on Stamp Rate Increase*, Washington *Post*, March 22, 1998, page A14.

for those who wish to read between the lines, or insert words that the document does not contain.

Paragraph 1 of the document proposes that the rebuttal testimony provide two types of updated information, both of which reflect decreases in estimated FY 1998 expenses: those publicly known or already on the record, and those "not currently on the record." If the Postal Service were truly attempting to manipulate the revenue requirement, it seems unlikely that the alleged "smoking gun memorandum" outlining this strategy would have suggested voluntarily providing information about decreases not currently on the record. Rather, the document represents the honest attempt made in the rebuttal testimony to provide comprehensive information about changes known to the Postal Service.

Paragraph 2 continues this attempt, by suggesting that the Postal Service "[p]rovide updated information on cost increases to offset the decreases ...." The document does *not* say "find enough increases to offset those decreases."[13] Even without the word "enough," moreover, a complete offset is not implied. The word "offset," no matter where one is from, does not necessarily mean an equilibrium of increases and decreases. If that were the case, one would not hear common expressions such as "completely offset" and "partially offset"; indeed, they would be redundant and oxymoronic, respectively.

[13] *See* Tr. 35/18723-24.

The testimony is consistent with this reading of the document, in that it provided $195 million less in cost increases than in decreases.[14] If the Postal Service were, as alleged, manufacturing cost increases to offset decreases, surely it could have manufactured an additional $195 million, or more. The document itself recognizes that the offset would indeed be only partial, since it suggests an increase in the contingency "[i]n order to balance back to the original revenue requirement."

This is not the least bit extraordinary or shocking. The Postal Service's position is that the revenue requirement used as the basis for its proposed rates and fees remains reasonable and that no adjustment is necessary. This is so because, if one examines the revenue requirement in light of everything known today, it is within approximately one half of one percent of the amount originally estimated, and this amount can be viewed, as Mr. Porras testified, as an small addition to the original, extremely low contingency provision. A similar position has been taken by the Postal Service in past cases, as noted above.

The document also does not propose, as ANM states, "a *selective* updating of its costs accounts ... to create the impression that cost increases had offset the cost decreases ...." ANM Brief at 7 (emphasis added). This accusation is repeated in Presiding Officer's Ruling No. R97-1/121: "The document at issue could be

[14] Similarly, ANM's claim, repeated by the Presiding Officer in Ruling No. R97-1/121, that the document "is likely to be the only [document] where a Postal Service representative admits to knowing that the requirement has been overstated" is contradicted by the rebuttal testimony itself. The testimony presents facts showing that the Postal Service's latest estimates result in a reduction of $195 million compared with the original revenue requirement.

interpreted to suggest that the Postal Service was *selectively* furnishing cost information to the Commission ...." *Id.* at 16 (emphasis added).[15] To the contrary, as stated above, the alleged selective nature of the information is belied by the fact that the rebuttal testimony presented information regarding both known *and therefore unknown* decreases. With regard to the breadth of the Postal Service's attempt to provide information about increases, Mr. Porras testified that, rather than conduct a comprehensive scouring for any and all increases, the Postal Service included in his rebuttal testimony, only major increases, resulting in only a partial offset of the decreases.[16] If the Postal Service were truly engaging in the calumny imagined, it would certainly not have gone looking for "unknown" cost increases and would not have limited information about increases to only major ones. Thus, there is absolutely no basis to conclude that the rebuttal testimony represents an attempt to mislead the Commission or in any way evinces "a lack of candor." *Id.* at 11.

Paragraph 3 suggests that FY 1996 be maintained as the base year, rather than changing it to FY 1997. The reasons given in the document are essentially the same as those given in Mr. Porras's testimony. First, the difficulty of the exercise and the resulting potential for denial of due process. The document states: "[A]ll cost factors would have to be updated and the rollforward model would have to be re-run. This

[15] *See also id* at page 11: "The Postal Service's apparent effort to mislead the Commission."

[16] "Again, we were looking at did we have any particular costs that were majorly going up. We weren't trying to go through every single line item. In fact, when you look at the bottom line, there's a difference of the $195 million." Tr. 35/18724.

would constitute a total update to the revenue requirement which would defeat the purpose of the current rate case process where the estimates supporting the rate request are reviewed on the record." The testimony similarly states: "The practice of substituting updated information for original estimates complicates the ratemaking process. ... Updated information does not receive the thorough analysis and review by interested parties that the ratemaking process provides for original estimates." Tr. 35/18576.

Second, both discuss the likelihood of erroneous results, including the potential for unjustified reductions. The document states: "Changing the base without changing the cost change factors would result in erroneous and understated test year costs." In this regard, it cites the zero-based programs and servicewide personnel cost change factors which "do not relate logically to FY 97 actual costs" and the UPS strike effect for which it would be difficult to estimate what amounts, if any, should not properly roll forward. Therefore, it concludes that a "complete revenue requirement update would be time consuming," and speculates that such an update "would probably result in a further reduction in test year costs."

Similarly, the testimony states: "Without a complete update of all affected testimonies, workpapers, and a re-running of the rollforward model (i.e., starting over again from scratch), updating also increases the odds of errors and a flawed revenue requirement." Tr. 35/18577. The testimony cites difficulties relating to the UPS strike, and the fact that "most of the other program change factors used to develop test year cost component estimates reflected in the roll forward were zero based."

Tr. 35/18578. It also discusses the likelihood that "the addition of the original workers' compensation other program change factor for the test year to the actual expenses for FY 1997 would result in a total test year expense that is too low." Tr. 35/18580. For these reasons, the testimony concludes that recalculation of all change factors "would be time consuming and would not be superior to relying on the original estimates ...." Tr. 35/18580. The testimony, like the document, concludes that mechanically updating the rollforward would lead to unjustified reductions in test year costs.

The Postal Service is most deeply troubled, not by the fact that this document was made public, but by the manner in which it was made public, which represents a disturbing development in ambush litigation before the Commission. The fact that the law and ethical rulings on matters relating to the permissibility of its disclosure are mixed, as presented fairly in Presiding Officer's Ruling No. R97-1/121, should have been taken as a caution, and not as a green light. Moreover, the Commission's special rule regarding cross-examination exhibits, particularly as applied in this phase of the hearings,[17] not to mention common notions of professional courtesy, should have at the very least suggested that counsel for the Postal Service be informed of the disclosure of the document and the intention of the Commission to question Mr. Porras about it. Such an approach would seem to be applicable regardless of whether return of the document and prevention of further disclosure was required or possible. But the fact that it was not taken undercuts the conclusion that the intention

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[17] *See* Presiding Officer's Ruling No. R97-1/107, at 1.

was to have Mr. Porras investigate the provenance and intention of the document and be prepared to respond to questions about its contents, as asserted in the Ruling at 16-17. Rather, the manner of the document's disclosure, coupled with the attempts to read words into it, points to a possible conclusion that the intent was to embarrass the Postal Service.

G. The Commission Should Take Into Account the Mailers' Perspective Expressed in the Joint Brief.

The issues raised concerning the revenue requirement need to be considered in a proper context. The mailers filing the Joint Brief have done so. Surely, if there were a valid opportunity for them to argue that they should have a lower rate increase, or no rate increase, these parties would not be shy about making that argument. Many of them certainly have in the past. But they are able to put the request in this docket in the proper context and have concluded, based on an understanding of management's goals and the moderate size of the increase, that even if it meant lower rates in the short term, attacking the revenue requirement is not in their interests. It is certainly not in the Postal Service's in light of the decisions it has made and the obligations in has undertaken for the foreseeable future.

The answer to the Chairman's question to Mr. Porras, "whether you thought some mailer somewhere might be happy or unhappy at the prospect of paying higher rates than might otherwise be warranted if you took into account" updates that might be made to the revenue requirement, was provided by the mailers who filed the Joint Brief.

H. Conclusion

A significant reduction to the revenue requested by the Postal Service could have some or all of the following adverse affects: program cancellations, program deferrals, incurrence of contractual penalties, altered timing and size of rate increases, lost cost savings, lost revenue generation opportunities, service degradation or failure to achieve service improvements, unplanned borrowings and related additional interest cost, unplanned losses and resulting equity decline, and lost opportunity to continue equity restoration. The Postal Service urges the Commission to avoid basing its recommended decision on a false assumption that recent financial history will repeat itself, contrary to the expert testimony of witnesses Tayman and Porras. The Commission should also avoid making reductions to the revenue requirement based on a mechanical projection of lower test year costs based on interim results. Doing so would seriously compromise management's goals and objectives, would risk not achieving break-even, and would threaten continued equity restoration.

II. EVEN PARTIES THAT RAISE VOLUME AND FORECASTING ISSUES DO NOT ATTEMPT TO MOUNT SERIOUS SUBSTANTIVE ALTERNATIVE PROPOSALS

In this section, we discuss the matters raised by intervenors which touch on volume-related issues. It should be stressed, however, that no party presented the Commission with any alternative test year forecasts (or volume distributions) which are capable of being implemented on this record.

A. OCA Witness O'Bannon Did Not Provide On The Record Any Usable Alternative Volume Distribution Methodology

The rather ambitious heading of the section of the OCA brief regarding its witness O'Bannon claims that "OCA witness O'Bannon establishes that the Postal Service's method of distributing volume to individual rate cells of parcel post violates basic tenets of economic theory and generates unrealistic revenue estimates." OCA Brief at 170. At the very least, this heading must be considered ambitious because, with respect to the second claim, if there are any instances of mention of "revenue estimates" ("unrealistic" or otherwise) in witness O'Bannon's testimony (and there do not appear to be), they certainly are not cited in the following pages of the OCA's brief.

The first claim in the heading is unwarranted as well. As discussed in the Postal Service's initial brief at II-3, Mr. O'Bannon had some problems with his analysis. If he had been able to do what he intended to do, Mr. O'Bannon apparently would have calculated positive implicit own-price elasticities for two of the 272 cells of

DBMC Parcel Post (the two cells in which rates are proposed to decrease).[1] The OCA Brief at 170 suggests that a volume distribution method that implies positive own-price elasticities is "economically untenable." Yet Mr. O'Bannon's direct testimony at page 6, lines 5-8 (Tr. 25/13479) appears to state that having positive implicit own price elasticities only in some rate cells is implausible only under certain conditions.[2] In fact, as Mr. O'Bannon agreed during cross-examination, the two cells that actually exhibit positive implicit own price elasticities would not have caused failure of the test of economic implausibility that he identified in his testimony. Tr. 25/13534-35. Therefore, there is no sound record basis to suggest that witness O'Bannon's testimony "established" either of the two propositions which the OCA's section heading now claims it did.

Of much more practical relevance, the OCA also claimed that "during oral

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[1] The OCA's claim that "witness O'Bannon computes a theoretically implausible positive own-price elasticity for [the DBMC rate category]" is just flat wrong. First of all, Mr. O'Bannon did his analysis at the rate cell level, not the rate category level. He never even attempted to calculate any implicit own-price for the DBMC category. Second, even if he had, any such calculation made without taking cognizance of the cross-price effect from Priority Mail on aggregate DBMC volume would not have been a true "own-price" elasticity and would have been meaningless. In fact, however, we know that actual value of the own-price elasticity of the DBMC category used by Dr. Tolley, and that value is negative, not positive.

[2] This makes sense, because by the top of page 4 of his testimony, witness O'Bannon had already established that, by his calculation, there were numerous positive implicit own price elasticities in DBMC. If the existence of any positive implicit own price elasticities were sufficient to establish economic implausibility, Mr. O'Bannon's testimony would presumably have ended with his conclusion appearing on page 4, rather than on page 14. Instead, he has 10 additional pages of testimony, including both theoretical exposition and further empirical testing, to attempt to prove the point that he was trying to make about implausibility.

cross-examination, witness O'Bannon outlined a procedure which, while not perfect, is far more reasonable," and urged the Commission to give "serious consideration to allocating after rates volumes to rate elements in a way that takes account of relative changes in price among rate elements." OCA Brief at 172, 173. Witness O'Bannon, however, only made very broad suggestions as to how the procedure might be improved on a conceptual level.[3] He never specified, much less attempted to apply, any of the types of alternatives that the OCA now suggests are "more realistic than the Service's current approach." *Id.*[4] If the OCA intended for the Commission to be able to apply any such alternatives in this docket, it was incumbent on the OCA to have its witness sponsor a specific alternative and allow that specific proposal to be subjected to adversarial testing. Having failed to do so, the OCA has failed to provide the Commission with the necessary record basis to make in this case any of the kinds of adjustments that it now apparently believes would be beneficial.

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[3] The OCA translates his comments as a suggestion to use "a little bit of judgment and a larger measure of common sense." Whatever the merits of this advice, it does not constitute a substantive proposal upon which the Commission may rely to adopt any particular new procedure of its own choosing.

[4] It is somewhat ironic that, when the Postal Service and the Commission have been jointly using a methodology over many cases, in instances in which the Postal Service proposes a change with which the OCA disagrees (e.g., mail processing), the previous methodology is called the "Commission" methodology, and heaven and earth must move before any change can be adopted. But in instances in which the OCA is proposing change, as in the instant example, the previous methodology is referred to only as the "Postal Service" methodology, and the standard is apparently much lower, even to the point of being able to accommodate changes which are not "theoretically pure or perfect."

B. NNA's Attack on the RPW System is Uninformed and Unwarranted.

In its initial Brief, the Postal Service presented its position on the survey performed by witness Max Heath, NNA-T-1, which attempted to measure the extent to which he felt that the Postal Service's RPW system was underreporting the volumes of within-county Periodicals. Postal Service Brief at II-7-11. NNA's initial brief more generally attacks the Postal Service's reported volumes for within-county mail, continuing its witness's claim that these volumes are being significantly underreported. NNA Brief at 11. However, these allegations only indicate that NNA has failed to comprehend or chooses to ignore the facts on the record.

1. Within-county mail volumes have been steadily declining.

Within-county mail volumes have steadily declined for several decades. In Docket No. R94-1, Postal Service witness Steele prepared a chart that showed average daily volume for second class within-county mail between the years 1967 and 1993. Docket No. R94-1, Tr. 1/326. Using a trend line plotted on the chart, he noted that within county volumes follow a steady downward linear trend. *Id.* at 302.

NNA witness Heath notes that the reported volume of within-county Periodicals has continued to decline since then. Tr. 27/14750. Using the Postal Service's annual within-county volume estimates, he shows 1,006,000 million pieces in FY1994, 907 million pieces in FY1995, and 877 million pieces in FY1996. Tr. 27/14749. These declines have continued even in the presence of considerable improvements to the Postal Service's systems, including statistical design changes.

2. The Postal Service continues to strive to improve its Noncountable subsystem.

The record is clear that the Postal Service's Non-countable Subsystem has changed in response to new technology and the need to update the panels of sampled post offices. Tr. 15/7609; Docket No. R94-1, Tr. 1/47. Throughout the 1980's and early 1990's the panel of post offices sampled by the subsystem was updated as a result of surveys of post offices' in-county mail revenue, and the development of the automated system for the collection of mailing statement data (PERMIT system, and the former BRAVIS system). *Id.* The claim that NNA's makes in its initial brief that "there has been no change by the Postal Service in its sample design or designation of offices comprising the sample" (NNA Brief at 5) is simply not true.

Witness Pafford clearly states on the record that the panel of sampled post offices was updated and the sample design improved after FY 1994. Tr. 9/4363. Specifically, during PQ 4 FY1996, and after the completion of Docket No. R94-1, the Postal Service updated the Non-countable Subsystem, including the panel of non-automated offices. *Id.* The Postal Service recognized that the within-county subclass of Periodicals does not share the same high level of coverage that applies to other Periodicals. Based on a census of within county revenue (in which all post offices were surveyed), the probability- based panel of non-automated offices was updated to supplement the PERMIT system's on-going census data. Tr. 15/7607, 7609.

3. The noncountable subsystem is on solid statistical footing.

NNA seems to be unable to comprehend the notion that a small sample of offices can be and is used to represent those offices not in the PERMIT system. NNA Brief at 11. It ignores the fact that the Postal Service estimates other subclass revenues and volumes using the Domestic Probability Subsystem, and achieves similar levels of precision. USPS-T-1 at 6, 11. When the Postal Service was asked to estimate the precision level for within county mail volume for the base year, a coefficient of variation of 3.18 percent was derived. Tr. 15/7613. Witness Pafford estimates similar or larger precision levels for fourth class mail special fourth-class rate, library rate, first-class postal cards, third class single piece, and all types of mailing fees, which are derived from small samples of the mail through the Domestic Probability Subsystem. USPS-T-1 at 6 and 11.

The fact that the non-automated office panel sample size is small relative to the population for which it provides estimates does not have a significant bearing on the outcome of the precision levels of the estimates, because the stratification variable(s) (here, reported within-county revenue) is correlated with the characteristic that the sample is trying to estimate.[5]

It is evident that NNA does not understand the Postal Service's probability based measurement systems, or statistical systems in general. NNA and witness Heath have continually failed, despite extensive explanation by witness Pafford, to grasp the Postal Service's system for measuring within county mail. In written discovery requests and oral cross-examination of witness Pafford, counsel for NNA

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[5] Cochran, William G. 1977, *Sampling Techniques*, John Wiley & Sons, Third Edition.

repeatedly indicated her confusion regarding whether automated offices can be included in the non-automated panel office strata. Tr. 9/4388. NNA evidently had a great deal of difficulty distinguishing between volumes derived from non-automated offices, instead of from the non-automated panel office strata. Tr. 9/4354, Tr. 9/4360, and Tr. 15/7599.

In the non-automated panel office strata, whether or not an office subsequently becomes automated has no impact on that office's probability of selection. In its initial brief, NNA makes clear that it still has not grasped this critical point, arguing that the conversion of an office to the PERMIT system should justify a change the sample design. NNA Brief at 10. Similarly, counsel for NNA could not seem to comprehend the idea of there being a complete census of mailing statement data for the base year for offices reporting within county volume. Tr. 9/4383, 4388.

The fact that the Postal Service employs sound measurement practices regarding within-county mail and generally with the Non-countable Subsystem, should not be obscured by NNA's failure to ask meaningful questions about the data systems. The base year estimated within county volumes are sound and precise. NNA can neither claim otherwise, nor that the sample designs have remained fixed and unresponsive to forces for change.

C. NNA's Criticisms of the Work of Witness Tolley are Similarly Unfounded

The brief of NNA is less than accurate regarding the testimony on this record of Professor Tolley on the subject of within-county mail volumes. NNA Brief at 16. Overall, NNA appears to be unaware that Dr. Tolley's testimony is directly supported by the econometric analysis of within-county mail volume presented by his associate, witness Thress. It is the testimony of witness Thress which explains the conclusions that a sampling system change did affect estimated volumes (USPS-T-7 AT 49, 53), which provides the own-price elasticity of -0.530 (*Id.*), and explains the full details of the estimated relationship between cable television expenditures and within-county volume (*Id.* at 48-49). NNA's claims on page 16 that these conclusions were reached on the basis of "no data in this docket" are simply in error.

To support its claims that Dr. Tolley failed to offer "any explanation of the role he believes daily newspapers play in within county volumes, or not[e] the historical fact that weeklies constitute the primary users of the subclass," NNA cites only to a portion of the transcript of Dr. Tolley's cross-examination. NNA Brief at 16. Examination of Dr. Tolley's direct testimony, however, would have revealed discussion of both of the matters alleged to be missing from the analysis. USPS-T-6 at 85-86. Also included in Dr. Tolley's direct testimony is an analysis of Household Diary Study data which, although not subclass specific, does provide independent corroboration of a substantial decline in newspaper circulation through the mails over the last decade. *Id.* at 84.

III. THE ARGUMENTS ADVANCED BY THE PARTIES IN THEIR BRIEFS FAIL TO SUPPORT THEIR CLAIMS THAT ANY ADJUSTMENTS IN THE POSTAL SERVICE'S PROPOSED COSTS ARE WARRANTED

In their initial briefs, many of the parties claim that, for one reason or another, the costs upon which the Postal Service has predicated its rate proposals are incorrect. As discussed in this part of the brief, such claims lack merit. In the first section, we address MMA's somewhat nebulous assertions that the Commission should reject (apparently) all of the proposed costing changes, not on their own merits, but because of allegedly overriding pricing concerns that compel eternal preservation of the status quo. Next, we address those specific costing proposals which have been addressed in the initial briefs of other parties in such fashion as to warrant a reply. (In some instances, either because no party commented on a proposal, or because all of the matters they raised were amply addressed in the Postal Service's initial brief, no further discussion is included in this brief. With regard to costing, as with all other aspects of this case, the mere fact that the Postal Service has not specifically responded in this reply brief to arguments made by other parties in their initial briefs in no way indicates that the Postal Service necessarily agrees with the positions they have espoused.) This costing part of the brief concludes with a further discussion of the cost model sponsored by OCA witness Thompson. It may also be noted that, because of the contexts in which they were raised in the briefs of other parties and the general overlap between costing and pricing theory, certain matters relating to broader costing theory issues are discussed in the next section of this brief, regarding pricing theory and rate policy.

A. Despite MMA's Illogical Rhetoric To The Contrary, The Postal Service And The Commission Must Jointly Strive To Improve The Accuracy And Reliability Of The Measurement Of Cost Causality

In its brief at 6-10, MMA makes the same illogical arguments that its witness Bentley made in his testimony in order to dissuade the Commission from accepting proposed changes in costing. The particular issues raised in this portion of the MMA brief have nothing to do with the technical merits of any of the proposed changes.[1] Instead, the arguments can be distilled into three separate, but equally erroneous, parts.

First, MMA alleges that the costing changes should be rejected because to accept them "would decrease objective cost-based ratemaking in favor of subjective demand-oriented judgments." MMA Brief at 5.[2] The impropriety of this result, according to MMA, is that increasing the pot of institutional costs necessarily increases reliance on the "discretion" inherent in the pricing process.[3] *Id.* at 5-6.

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[1] Exactly as with Mr. Bentley's testimony (see Tr. 21/11208, 11287-88), the MMA brief is confusing because it refers to the Postal Service's proposed costing "methodology," when, in fact, what the Postal Service has done is propose a series of improved procedures regarding a wide variety of cost segments, with a wide variety of results, each of which must be reviewed on its own merits. Tr. 21/11289-93.

[2] In advancing this assertion, MMA once again parrots the testimony of witness Bentley. Tr. 21/11161. When making this claim, however, Mr. Bentley never could quite get over the hurdle of explaining how the costing exercise could be "objective" if, on the one hand, he states that the goal of the cost analyst "is to attribute as much as possible and within reason" (Tr. 21/11303), yet on the other hand, he defines objectivity as "with no pre-determination in mind" (Tr. 21/11289). See generally Tr. 21/11294-303.

[3] The MMA brief speaks as if this discretion rests entirely with the Postal Service, as if the Commission did not even exist. In fact, however, as witness Bentley conceded, any discretion the Postal Service has in this regard is very tightly constrained by the reviewing powers vested in the Commission by the statute. Tr.

MMA's arguments appear to be totally oblivious to the fact that the Supreme Court in its *NAGCP IV* opinion firmly rejected previous misguided attempts specifically directed by the same faulty reasoning towards reducing the pot of institutional costs. In rejecting the D.C. Circuit's discernment in the Act of "an overriding purpose to minimize the Rate Commission's discretion by maximizing the use of cost-of-service principles," the Court held:

> There is no suggestion in the legislative history that Congress viewed the exercise of discretion as an evil in itself. Congress simply wished to substitute the educated and politically insulated discretion of experts for its own.

NAGCP IV, 462 US at 821-22. Thus, MMA's flawed arguments to the contrary, an illegitimate desire to limit ratemaking "discretion" cannot override whatever consequences to the pot of institutional costs may result from "objective" costing in furtherance of the Court's admonitions to establish reliable causal relationships between postal costs and subclasses of mail.

Second, MMA persists in witness Bentley's baseless claim that the proposed new costing methodologies are "designed to mask the Service's failure to relieve First-Class Mail of an excessive share of the Service's institutional costs." MMA Brief at 7. Of course, witness Bentley could provide no direct evidence that any of the costing methodologies were provided for any reason other than to improve costing accuracy, and even he admitted that improved accuracy was "one" possible motivation. Tr. 21/11209.

21/11219.

Even if he had any coherent basis for his allegation, however, which he does not, it lacks inherent credibility. It was the proposition of witness Bentley (and remains that of MMA) that, using the Docket No. R94-1 costing methodologies, the failure of the Postal Service's proposed rates to "relieve First-Class Mail of an excessive share of the Service's institutional costs" is revealed. MMA Brief at 10. This revelation comes in the form of markup indices which are not "roughly equivalent." *Id.* Yet if the Postal Service's new methodologies were designed to "mask" what the old methodologies reveal, and what the old methodologies reveal is markup indices which lack rough equivalence, logic dictates that the allegedly "masking" methodologies must make those markup indices appear to achieve rough equivalence. In fact, as even Mr. Bentley's own testimony shows, that is not the case. Mr. Bentley could deny neither this logic nor these facts. Tr. 21/11304-10. Instead, his attempt to extricate himself from this conundrum of his own making leads to the third fallacious argument included in this portion of the MMA brief.

As the MMA brief recounts at page 9, Mr. Bentley suddenly decided that the real issue was not whether the markup indices were or were not roughly equivalent, an assessment which requires no more information than a direct comparison of the two index numbers themselves, but instead involves a totally different comparison, involving markup indices from prior cases. See Tr. 21/21306-10.[4] In conjunction

[4] That a comparison involving markup indices across cases is a different comparison than the one which Mr. Bentley originally indicated to be the relevant one is evident from his earlier cross-examination, in which he confirmed that the numbers he was citing to support his assertion were simply the two markup indices numbers from this case, based on the old methodology. Tr. 21/11304-06.

with this approach, MMA argues that accepting proposed costing changes would obscure the Commission's pricing "yardsticks," making it more difficult to make pricing comparisons from case to case. MMA Brief at 9. The practical consequences of this argument are rather startling. Implicitly, MMA is arguing that the Commission should ignore any potential improvements in costing in order to preserve the utility of the previously-established pricing benchmarks.[5] Yet even Mr. Bentley could not deny that having the best possible costs superseded the need to have comparable pricing benchmarks. Tr. 21/11311.[6] In reality, postal ratemaking has benefited greatly from the major and minor improvements in costing methodologies litigated in every general rate case (with the possible exception of Docket No. R94-1), and it is nothing short of ludicrous for MMA to suggest that this practice should be halted so that MMA can pretend to live in a world that never changes.

Therefore, the Commission should reject MMA's attempts to argue that more abstract pricing concerns could provide any justification whatsoever for the Commission to reject the improved costing methodologies presented and defended

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[5] A term which has gained a fair amount of currency in this case -- "struthious" -- certainly lends itself well to the description of such an attitude.

[6] Mr. Bentley's further suggestion to resolve what he perceives to be this problem is to exclude costing issues from rate cases. Tr. 21/11311. Not only would such a suggestion in all likelihood be contrary to the statutory ratemaking scheme, but it would, in fact, do nothing to guarantee the comparability of pricing benchmarks between rate cases. Specifically, Mr. Bentley was never able to articulate any reason why costing changes emanating from a rulemaking proceeding between rate cases would be any less detrimental to the utility for comparison purposes of the markup indices from the first rate case than costing changes proposed directly within the second case itself. Tr. 21/11311-14.

on this record by the Postal Service's costing witnesses. The merits of those costing proposals will be discussed next, in the context of the arguments made in the initial briefs of other parties.

B. The Commission Should Adopt Both The Methodologies And The Results Of The Postal Service's Mail Processing Cost Witnesses

In this brief, as in our initial brief, the discussion of mail processing cost issues is separated into three parts. The first part addresses the variability analyses presented by Dr. Bradley. The second part addresses the distribution methodology presented by witness Degen, which includes discussion of the close linkage between his analyses and those presented by Prof. Bradley, as well as discussion of complaints by Periodicals mailers regarding the trends in the mail processing costs of their mail. The third part addresses the concerns raised by ANM in its brief regarding the matter of the reported costs for Standard Nonprofit Mail.

1. The Postal Service Has Accurately Measured the Volume Variable Portion of Mail Processing Labor Costs.

The initial briefs of those opposed to the Postal Service's new analysis of mail processing labor costs have raised no arguments which warrant anything other than adoption of that analysis. By and large, participants' briefs either virtually ignore the rebuttal testimonies of Postal Service witnesses Bradley and Ying and MPA witness Higgins, or they erect new arguments -- in effect, surrebuttal -- which is not allowed and cannot even be considered by the Commission. Even if some of these new arguments were to be considered, however, they can quickly be dismissed as forlorn attempts to maintain the status quo of 100 percent variability in the face of overwhelming evidence that the status quo does not represent reality.

a. The Postal Service decisively has carried its burden in establishing that the variability of mail processing labor costs is less than 100 percent, and in demonstrating that Dr. Bradley's analysis is the superior approach for accurately estimating variabilities for the operationally-based cost pools.

The OCA makes the point that the Postal Service, as the proponent of the new mail processing methodology, bears the burden of demonstrating that it should be adopted.[7] UPS seems to make a similar argument, although not couched in the same terms, with references to the Postal Service's "effort to persuade the Commission to depart from its well-established and consistent precedent. . . ." UPS Brief at 16.[8] The Postal Service fully agrees that it has both the burden of producing evidence and of demonstrating that this evidence proves its point.[9] The

[7] The OCA's discussion somewhat intermixes the terms "burden of proof," "burden of going forward," and "burden of persuasion." *See* OCA Brief at 182-83.

[8] Actually, neither the Postal Service nor the Commission have been entirely consistent in their past treatment of mail processing variabilities. The assumption of 100 percent never applied to all mail processing labor hours -- for example, platform was not assumed to be 100 percent variable. Also, mail processing *space* has never been assumed to be 100 percent variable. The vast majority of mail processing space categories have been treated as either 70 or 80 percent variable; only Express Mail, Priority Mail and Registry facility space have been assumed to be 100 percent variable. USPS LR-H-1, at 15-3-4 and App. F, Table F-2, at 1.

[9] The Postal Service does disagree with the OCA statement that "the proponent bears the burden of persuasion that the present policy is not as *favorable* as the one offered." OCA Brief at 183 (emphasis added). One might ask, "Favorable to whom?" This is not the point. The point is whether the Postal Service has shown that its sophisticated and robust econometric models more accurately measure variability than the prior, untested assumption.

Postal Service unarguably has carried its burden in both instances.

The Postal Service (and other parties in this case) have presented a great deal of evidence concerning the variability of mail processing labor costs. Dr. Bradley filed direct and rebuttal testimonies, responded to numerous interrogatories and POIR's, and filed supplemental testimony in response to NOI No. 4. Dr. Ying also filed rebuttal testimony affirming the validity of Dr. Bradley's approach. Dow Jones witness Shew and MPA witness Higgins, among others, also filed testimony supporting Dr. Bradley's analysis. Witness Higgins also responded to NOI No. 4. In these various pieces of evidence, a number of alternative specifications were put forward and were tested. This substantial body of evidence shows clearly and convincingly that the old, untested assumption of 100 percent variability is just flat out wrong. This substantial body of evidence also shows that the only valid models for the Commission's consideration are either Dr. Bradley's initial fixed-effects model or the site-specific variation tested in response to NOI No. 4. For reasons fully articulated in his response to NOI No. 4, Dr. Bradley's fixed effects model is the best choice for the Commission. Tr. 28/16082-84.

The only evidence produced by proponents of the 100 percent assumption consists of Dr. Neels' modified "between" model[10], which was proven to be demonstrably biased, and Dr. Smith's hocus-pocus visual examinations of data

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10 This is the standard econometric term that describes what Dr. Neels and the OCA on brief call the "cross-sectional" model on average data.

plots.[11] Once the Postal Service came forward with compelling evidence that the 100 percent assumption had to be abandoned and that Dr. Bradley's model presented the best methodology, it was incumbent upon those opposed to produce credible evidence to the contrary. They simply have not been able to do this, and thus the Postal Service has successfully carried the burden of demonstrating that its proposal must be accepted.

One final point deserves mention. The OCA basically argues that Dr. Bradley's study does not demonstrate a causal connection between mail processing labor costs and the appropriate classes of mail. OCA Brief at 184. First, Dr. Bradley's analysis does not distribute volume variable costs to particular classes and subclasses of mail, but rather is concerned with the initial step of determining the appropriate variability. Distributing the volume variable costs to particular classes and subclasses of mail was witness Degen's task, and the OCA asserts that this was done properly. *See id.* at 217-18. In fact, the OCA's erroneous argument only serves to demonstrate Dr. Christensen's conclusion that one cannot separate the variability and distribution steps in this analysis and still "produce economically meaningful costs by subclass." Tr. 34/18219.

[11] It is interesting to note that none of the opponents of Dr. Bradley's study have really come up with their own alternative models. They essentially pick at the edges of Dr. Bradley's analysis, and use his data and models to argue their points. Other data were made available to parties from which they might have constructed independent analyses, but they chose not to do so. *See* USPS LR-H-285, Weekly MODS Data Provided in Response to DMA/USPS-T14-43, and USPS LR-H-307, CD-ROM of FHP Data Provided by the Postal Service in Response to Oral Request of Commissioner LeBlanc (Tr. 11/5595-96).

b. Dr. Bradley's analysis properly measures actual marginal costs.

The economic definitions of long run versus short run, as well as the appropriateness of a short run approach to determining volume variable costs, is very simple and very clear. The treatment of these straightforward issues in participant briefs, however, is akin to a maze.

First, the parties cannot seem to grasp the basic economic definitions of short run and long run. UPS faults Dr. Bradley's study for supposedly failing to measure "the long run variability of costs with volume." UPS Brief at 17. The OCA also concludes that Dr. Bradley's analysis is short run and "not relevant to the time period during which the rates will be in effect." OCA Brief at 199. Elsewhere, UPS refers to "the copious and confusing testimony of how to define the 'short run' and the 'long run.'" UPS Brief at 9. The OCA apparently does not find the same testimony confusing, as it states, "The economists in this case seem to be in universal agreement that the long run is theoretically defined by the variability of input factors, " although the OCA evidently is of the opinion that economics should be ignored in favor of the purported "practicality" of defining "the long run in terms of a time period." OCA Brief at 196-97.[12]

No one in this case has made an argument that all input factors of the Postal

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[12] MMA argues that Dr. Bradley's analysis is short run because his models "are premised upon only a single accounting period." MMA Brief, Attachment A at 2. The MMA Brief merely restates in summary fashion the arguments advanced by OCA witness Smith and UPS witness Neels. Thus, the arguments raised in the MMA Brief will not be separately addressed and should be considered included in the discussions of the OCA and UPS briefs.

Service are fully variable, or that the Postal Service is or has been in a state of long run equilibrium. Therefore, it *must* logically follow that economic long run costs cannot be estimated. Thus, it then *must* logically follow that the appropriate measures of actual marginal costs are short run costs. This is what Dr. Bradley appropriately estimated. It does *not* logically follow that properly estimated, economic short run costs are costs relevant to one day, one week, one AP, or even one year. It does *not* logically follow that short run costs are inapplicable or somehow do not "cover" the period of time over which rates will be in effect. As Dr. Baumol lucidly explained in Docket No. R87-1, "The actual marginal costs are normally closest to what economists call short run marginal costs (SRMC). But it must be emphasized that these *actual marginal costs do include cost consequences of a current volume change that may occur in future periods*." Tr. 11/5417, *quoting*, Direct Testimony of William J. Baumol on Behalf of United States Postal Service, Docket No. R87-1, at 12 (emphasis added).[13]

Second, the parties cannot seem to associate the basic economic definitions of

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[13] In that Docket, the Commission also made clear that it endorsed the economists' definitions of the terms. In discussing purchased transportation costs, the Commission stated, "'Long run' is an economic term used to describe the changes that could be made under ideal conditions of perfect flexibility to tailor the costs that must be incurred to accommodate volume. 'Long run' does not connote any particular time span." PRC Op., R87-1, Vol. 1, at 291.

It should also be noted that long-run costs are usually less than short-run costs. As Dr. Christensen stated, "In fact, it is often the case that it is more costly to expand output when a relatively greater number of inputs are fixed than when more inputs can be chosen optimally. Therefore, it is often true that short-run costs will be greater than long-run costs." Tr. 34/18245.

short run and long run with what Dr. Bradley did. UPS still seems to think that because Dr. Bradley used AP data to estimate his equations, by definition his results do not account for "cost consequences . . . in future periods." *See* UPS Brief at 17.[14] Virtually any economist would affirm that use of AP data is irrelevant to the issue raised by UPS. *See* Tr. 33/18151 (Dr. Ying). Also, UPS still manages to overlook the fact that Dr. Bradley did re-estimate his equations with annual data and generally confirmed his initial results, demonstrating that data frequency is simply not a concern. USPS-T-14, at 76.

Amazingly, the OCA claims that Dr. Bradley's analysis is inappropriately short run "because it fails to consider capital." OCA Brief at 199. Is the OCA saying that addition of a capital variable to the cost equations means that the Postal Service is operating in an optimal environment with all inputs fully variable? Of course, it does not and cannot. The OCA argues that Dr. Bradley fails to consider capital, yet on the immediately preceding page acknowledges that "witness Bradley presented an elasticity study involving capital in his rebuttal." *Id.* at 198. The way the OCA gets around this apparent contradiction is to suggest that Dr. Bradley's analysis including capital has "limitations." *Id.* at 199. Of course, these alleged "limitations" are not plainly spelled out; rather, the OCA hints that "capital data on machines" are needed.

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[14] UPS does suggest that Dr. Neels' conclusions are not really based on the frequency of Dr. Bradley's data, but instead on the specification of variables contained in Dr. Bradley's cost equation. *Id.* at n.11. But UPS does not specify what variables should be added to magically convert Dr. Bradley's variability estimates to "long run" estimates. Some sleight of hand would certainly have to be involved to transform the Postal Service into an organization where all inputs were fully variable.

Id.[15] Realizing the very weak grounds on which this argument rests, the OCA does not highlight Dr. Bradley's results when adding the capital variable -- variabilities not significantly different from his initial analysis and "significantly less than one." Tr. 33/17912.

In lieu of specifically addressing the real meaning of long run versus short run and the import of Dr. Bradley's results when capital is added, the OCA reserves its energy for a final stab at trying to convince *someone* that Dr. Smith's data plots "are visually compelling in suggesting longer run variabilities approaching 100 percent." OCA Brief at 198. Dr. Smith's "analysis" in this regard, and the OCA's reliance on it, are of no assistance to the Commission and the parties in this or any other case who desire to use data to reach solid conclusions. As the Commission has made clear in past cases, detailed econometric study of an issue should always be the preferred approach. As the Commission stated in its discussion of transportation costing issues in Docket No. R87-1:

> This case has seen substantial improvement in the costing for purchased transportation. We have decided to accept the translog cost model presented by the Postal Service (USPS-RT-5) for determining variability and so replace the attribution method first adopted in Docket No. R74-1. There are two primary reasons enabling us to make improvements. The first is the extensive data bases -- particularly for highway service -- which the Postal Service has gathered. The second factor is the consistency between the description of the functioning of the Postal Service's highway transportation network -- as presented by the Postal Service's operational witnesses in the previous cases and accepted by the Commission -- and the Postal Service's description used by its economic witnesses in formulating the theories that go along

[15] The OCA argument that Dr. Bradley measured the "wrong" capital variables is addressed in a later section of this brief.

> with the econometric cost models used with the data to estimate variability. The consistency and agreement about how the transportation system is operated can help provide a good starting place for the consideration of the detailed issue of how transportation costs behave as volume varies and the proper method to be used in determining attribution levels.

PRC Op., R87-1, Vol. 1, at 290. Dr. Smith's predilection for "eyeballing" data, rather than subjecting it to rigorous econometric examination, must be rejected.

c. The NAA brief puts forth a new and unsupported argument about economies of scale. That argument is clearly wrong and has no basis in the record.

NAA presented no testimony on the volume variability of mail processing. Nevertheless, it takes advantage of its brief to offer a brand new and novel argument about why the Commission should reject the Postal Service's mail processing analysis. Curiously, NAA has no quarrel with the econometric methods used by Professor Bradley or the econometric results that he produces. *See* NAA Brief at 45. It instead chooses to examine "the proposed reduction in attribution from a practical point of view." *Id.*

NAA produces no operational or economic expert to justify its "practical point of view," and it has provided the parties no opportunity to review its hypotheses for their merits. It provides no justification for the assertions that it makes nor the conclusions that it reaches. Nevertheless, it is easy to show that the NAA argument is erroneous. Because it is not based upon a solid analytical footing, the NAA argument contains errors and is controverted by the evidence on the record.

The NAA argument can be stated succinctly. It believes that economies of scale in mail processing exist only in the short run, not in the long run, and, as a result, the Commission should reject the Postal Service's new mail processing analysis. NAA goes on to argue that although the Postal Service benefits from economies of scale in machine-based and manual operations, and thus has variabilities less than one, these scale economies exist only in the short run. This argument is impossible. NAA is confusing the time it takes to achieve a scale economy with its duration. Even if, *arguendo,* the Postal Service did achieve its economies of scale over a relatively short period of time, such economies of scale do not disappear as time passes.

Sustained increases in volume do not disappear as time passes and neither do the economies associated with them. Thus, a scale economy achieved in the short run is sustained into the long run. NAA is nibbling on an argument, but it has the argument backwards. The long run variabilities will be below the short run variabilities. As time passes, a firm has additional opportunities to respond to a sustained increase in volume, so it will be better able to respond to a given volume increase and would thus face a smaller increase in cost. Tr. 34/18245 (Dr. Christensen). Consequently, one would expect the long run volume variability to be *less than* the short run variability.[16]

Economies of scale are measured with respect to sustained increases in

[16] The NAA cite to Professor Bradley at Tr. 11/5512 suffers from this same error. There Dr. Bradley was talking about the productivity response to a temporary "surge" in volume which he said could possibly be handled temporarily with an increase in productivity. He was not discussing the short and long run responses to a sustained increase in volume. In fact, he qualifies his answer by suggesting that this phenomenon could occur only over "a week or ten day period." *Id.* This is a far shorter period than used to estimate the econometric variabilities.

volume, not temporary ones. If volume never increases to a point where economies of scale are exhausted, then economies of scale are, for all intents and purposes, a long run phenomenon.

NAA also attempts to justify its argument by discussing Professor Bradley's *explanations* of the variability results. Rather than simply admitting the obvious fact, that Professor Bradley's econometric equations provide substantial evidence demonstrating the existence of sustained economies of scale in mail processing activities, the NAA would prefer to shift attention to the explanations of the results. Even in this limited forum, however, NAA's feeble attempt fails to provide the whole story.

In discussing the variabilities for manual operations, the NAA claims, without a shred of evidence, that economies of scale in manual mail processing activities exist only in the short run. Not only is this fallacious argument subject to the general theoretical criticism discussed above, it has been directly refuted *on the record.*[17]

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[17] It is not clear how closely NAA followed the record on the issue of mail processing labor costs. For example, the NAA brief claims that Professor Bradley did not "analyze the relationship between mail processing costs and volumes across all processing options." NAA Brief at 47. This assertion was based upon an interrogatory response relating to Professor Bradley's *direct* testimony. Apparently NAA is unaware that Professor Bradley did that very analysis in his *rebuttal* testimony when he estimated the joint variability for all activities in a facility. (Tr. 33/17910). Ironically, the NAA makes a concrete prediction what such an analysis would show:

> Had he analyzed the cost of mail processing across all operations, his results could have shown diseconomies of scale in the short run.

In fact, Professor Bradley's results showed just the opposite result - *economies* of scale across all operations. This conclusively demonstrates that NAA prediction, like

Under cross examination, Professor Bradley first explained what economies of scale in mail processing activities imply:

> By economies of scale, I was referring to the idea that as an activity grows in size, it's possible that the unit cost, in this case, of sorting a piece of mail would fall.

Tr. 11/5521. He then made very clear that these economies of scale are not just a short run phenomenon:

> That economist's preamble notwithstanding, I would suggest to you that I'm thinking about these responses in hours to sustained changes in volume. I'm not really thinking of them on the day-to-day basis, or, you know, an hour-to-hour basis, but more on a sustained basis, where the volume increases or decreases and stays up or down. *And so, in that sense, I would think of them in a longer run.*

Id. at 5524 (emphasis added). Professor Bradley went on to make this point unambiguously:

> In terms of a manual component what my analysis looks at is what would happen to productivity or the unit cost in manual operations if volume went up and stayed up over a longer period of time, and yes, my testimony is that that would lead to a reduction in marginal cost or the unit cost of sorting mail.

Id. at 5527.

In similar fashion, NAA ignores the record on explanations for scale economies in manual operations. It attempts to say that "the only possible remaining explanation for economies of scale in manual operations is that people simply work faster when there is more mail to process." NAA Brief at 49. However, this last ditch

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the rest of its speculative assertions, is unquestionably wrong.

attempt to discredit the mail processing variability analysis omits the evidence on the record showing that there are many sustained.reasons for economies of scale in manual mail processing activities.

First of all, Professor Bradley made clear that based upon the experience in other industries, one would expect economies of scale in manual activities:

> I think there's a couple of characteristics, as I suggested before, of manual operations which — which lend themselves to economies of scale. First of all, let me suggest to you, as a general matter, manual activities, whether their in a factory or in the Postal Service, are known to lend themselves to economies of scale.

Tr. 11/5527. Professor Bradley also gave many specific explanations as to why scale economies exist in manual mail processing activities. In addition to the reasons in his provided in his direct testimony that were cited by NAA, Professor Bradley provided extensive explanations during oral cross examination:

> With specific reference to manual sorting activities I think the idea here has several possibilities for why there would be economies of scale.
>
> One would relate to the — the nature of the work. It's a — its's a human manual effort and to the extent that a manual operation gets larger, individuals would be, in my belief, more familiar with the sorting scheme they are undertaking, they'd be able to specialize, they'd know what they were doing, and that could lead to increase efficiency in their work and lower unit cost.
>
> Secondly, another characteristic is, when we're talking about a manual activity, we're really talking about the whole activity, bring the mail to the activity, taking the mail out of the cases, preparing it on its containers to be wheeled to the — next activity, and certain activities, such as bringing the mail or organizing the mail or preparing it to move on to its next stage are the natural types of things

> that we tend to think of in terms of economies of scale.
>
> That is, some — one person can bring a whole wheeled container of mail for several clerks who are sorting in an operation, and its lower on a unit [cost] basis to bring that mail for — for more clerks than less. . . .

Id. at 5522.[18] Finally, Professor Bradley explained that economies of scale can come from better organization of the entire activity, not from people simply "working harder" as NAA asserts:

> [I]n this instance I believe that it has to do with the ability to organize the operation, to take advantage of the ancillary services. It — it has to do with things like the fact that, when the clerk is done sorting for the time period, they have to pull the mail out and put it on its container to send it on to the next operation.
>
> Well, pulling mail out of slots has to be done for each one of the slots in the case, but of course, if I've go another piece in five or six of those slots, a small increase in the volume, it may not take me much more time to pull it out, because pulling one out is very similar to pulling two out.

Tr. 11/5528.

In sum, NAA has not taken the time to understand the basic economics of mail processing activities and, by its own admission, has not evaluated Professor Bradley's econometric results. Thus, its half-hearted attempt to discredit the results of the study on "practical" grounds fall far short of the mark and NAA's unsupported

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[18] Witness Moden also stated that a sustained increase in volume can result in productivity increases because "[m]ost activities have some associated work such as obtaining mail, positioning rolling stock, or changing schemes that does not change proportionately with changes in volume, but is driven more by the operating schedule for the activity." USPS-T-4 at 19. This would apply to manual and machine-based operations.

claims must be rejected by the Commission.

d. Total Piece Handlings (TPH) is the obvious cost driver for mail processing operations, and is the appropriate choice for the variability equations.

Both the OCA and UPS attempt to overturn long standing Commission and Postal Service costing practice by arguing that a mail processing variability equation must include a measure of originating or "raw" volume as the primary driver of costs. OCA Brief at 186; UPS Brief at 21. For many years, Commission, Postal Service, and even UPS cost analysts have stressed the utility of using cost drivers to investigate the variability of cost. Cost drivers have been used by these analysts in large, important cost segments like transportation and city carrier street time.[19] When this well established costing method is applied to mail processing labor costs, however, these two parties raise a howl of false indignation. This transparent attempt to derail the Commission from accurately determining the variable mail processing cost of the subclasses of mail and special services has been effectively dispatched in rebuttal testimony as explained in the Postal Service initial brief (Postal Service Brief at III-35-40), but some points bear repetition.

The use of a cost driver in the process of causally relating costs to products is not solely a postal costing procedure. The widespread acceptance of activity-based costing has established the essential principle that, in many activities, costs are

[19] It is revealing that in the instant case, the OCA and UPS have not objected to the use of a cost driver in purchased highway transportation or carrier load time. Apparently, it only offends them in the case of mail processing.

caused not by raw volume but by a cost "driver."[20] In this two-step process,[21] costs are attributed to products by first identifying the driver and specifying the relationship between costs and the driver. In the second step, the amount of the driver is associated with the individual products that caused the driver to be needed.

This approach is directly applicable to mail processing labor costs, where it is obvious that it is the sorting of mail that causes cost to arise, not the origination or delivery of that mail. In fact, UPS' repeated claim that mail of different subclasses may require different numbers of handlings makes it all the more important to use the appropriate cost driver, piece handlings. Mail processing labor cost is not caused solely by the number of originating pieces of a subclass but the amount of sorting that those pieces require. Using the piece handlings as the cost driver explicitly allows for this important difference, and provides a more accurate cost tracing to the activities where they are incurred. In fact, UPS' unsupported claim that "if, as is likely, the number of times a piece of mail is handled tends to increase with volume, Dr. Bradley's analysis would understate the volume variability of costs" (UPS Brief at 21) is patently false. Apart from not providing a shred of evidence to support the speculative claim that an increase in handlings per piece is "likely" to occur when

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[20] The link between activity-based costing and the Postal Service and Postal Rate Commission method of costing has been explained in Bradley, Michael D., Colvin, Jeff, and Smith, Marc, "Measuring Product Costs in Ratemaking: 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).

[21] This process is described in the Summary Description, USPS LR-H-1, at App. H.

volume increases, the UPS argument fails to acknowledge that such an occurrence would explicitly be accounted for in the Postal Service costing framework.

If, however, the number of handlings per originating piece were, for some reason, to rise with volume[22], then per piece as well as total mail processing costs would rise accordingly. This increase in cost would be captured in Mr. Degen's cost pools, which reflect the actual costs being incurred to handle the actual mail being processed. Dr. Bradley's analysis informs us as to how quickly those cost pools rise with the increase in TPH, the correct measure of handlings in each activity. Finally, Mr. Degen's distribution analysis informs us as to the amount of the various subclasses of mail handled in each activity, forming the final link between piece handlings and volume. Since the distribution analysis is updated annually, the Postal Service costing procedure thus directly accounts for any changes over time in the relationship between piece handlings and volume. It assigns the cost implications of such a change to the postal products that exhibit the change. In sum, the linkages are complete, and the Postal Service costing method accurately assigns variable mail processing labor costs to the subclasses that caused them.

To be sure, if Professor Bradley had performed an econometric analysis relating mail processing labor costs and originating volume, and that analysis showed variabilities less than one hundred percent, then both the OCA and UPS would still be

[22] The number of handlings per originating piece would only rise with volume if the volume increase were to occur disproportionately in subclasses with higher-than-average handlings per piece. As stated above, there is no reason to believe (and certainly no evidence of record to suggest) that it is "likely" that a volume increase would be concentrated in such subclasses.

criticizing him for not accounting for the "shifting" relationship between volume and the number of times a piece of mail is sorted. It is patently obvious that the current and spurious criticism of the Postal Service methodology is not based upon adherence to any costing principles, but rather is generated solely by the parties' distaste for results of the analysis.

e. Criticism of use of labor hours as the dependent variable is much ado about nothing.

Both UPS and the OCA challenge the use of labor hours as the dependent variable. UPS Brief at 18-20; OCA Brief at 185-86. This issue has been discussed in full in the Postal Service's brief, and that discussion will not be repeated here, other than to emphasize several points. Postal Service Brief at III-28-34.

First, the fact that higher paid overtime hours may be incurred to handle either seasonal or non-seasonal peaks in volume does not, in any way, discredit Professor Bradley's analysis, UPS' contentions notwithstanding. As Dr. Bradley clearly indicated, if the goal is to measure variability, it is inappropriate to include the influence of seasonal volume peaks on hours. *See* Tr. 33/17784. The proper approach for dealing with the cost effects of seasonal volume peaks is to control for them by use of seasonal dummy variables, as Dr. Bradley has done. *Id.* As for possible non-seasonal spikes in volume, UPS' assertion that "Dr. Bradley's model would not capture this impact" is false. UPS Brief at 20, n. 14. It is symptomatic of the underlying emptiness of the UPS position that, despite insisting that "long(er) run" costs are the appropriate concept, UPS insists that every transient change in costs be reflected in variability estimates. Common sense dictates that the Postal Service's "long(er) run" response to a random fluctuation in volume today would be nil. Dr. Bradley is correct to control for the effects of temporary volume fluctuations as a result.[23] By raising this issue, UPS seems to lose sight of a very important fact for the estimation of long(er) run costs -- that over time, an optimization process is used to manage overtime, as Area Vice President Steele has indicated. He said that "sustained, steady use of overtime" simply is not a sound way to manage. *Id.* at 17870. UPS' own witness Neels even conceded this point, indicating that in response to a sustained increase in mail volume in an activity, "As a general proposition, I would expect an employer would be more likely to use overtime labor in the short run rather than in the long run." Tr. 28/15698.

Both UPS and OCA complain that Dr. Bradley's analysis does not account for possible changes in the mix of casual, part-time and full-time labor. UPS Brief at 19; OCA Brief at 185-86. Again, this does not undermine Dr. Bradley's study. First, it is important to note that the UPS and OCA arguments are nothing more than speculation. They do not know that the mix within a given operation would change at any significant level.

In addition, as already pointed out by the Postal Service, both casual and part-time employees work essentially a full work week. Postal Service Brief at III-33. Pay rates for full-time and part-time workers are not greatly different. *See* United States

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[23] Dr. Bradley clearly indicated that random, non-seasonal cost peaks would be picked up in the residual term of his equations. Tr. 33/17953. It also should be noted that Dr. Bradley's analysis uses data at the AP level -- not the daily or nightly level -- where the largest incidence of non-seasonal volume peaks would be expected to occur.

Postal Service National Payroll Hours Summary Report. To the extent that casuals receive notably less pay, and to the extent that an influx of volume might result in markedly greater and sustained use of casual labor, then this would mean that Dr. Bradley's variabilities could well be *overstated.*

There could not be markedly greater use of casuals, however, as limitations on their use are specified in union contracts. For example, the current contract with the American Postal Workers Union, which covers clerks, states that casuals cannot exceed 6.6 percent of the total career employees in any accounting period, except for APs 3 and 4 (the holiday season), and may not exceed on average 5.6 percent during a fiscal year, again exclusive of APs 3 and 4. USPS LR-H-88, Agreement Between the United States Postal Service and American Postal Workers Union, AFL-CIO, 1994-1998, Article 7.1(B)(3). Similarly, under the current contract with the National Mail Handlers Union, casuals cannot exceed 10 percent on a Division basis of the total number of employees covered by the contract, with the exception of APs 3 and 4. USPS LR-H-253, National Agreement with National Postal Mail Handlers Union 1994–1998, Article 7(1)(B). Thus, the only time that there might be a significant change in mix would be during the holiday season, and this is controlled for in Dr. Bradley's equations by means of his seasonal dummy variables. While employee mix may vary from day-to-day to accommodate volume fluctuations, over longer periods of time, the Postal Service's employee mix reverts to a "target" mix circumscribed by labor contracts and postal management practices. As is often the case with their objections, the OCA and UPS again fail to acknowledge that their concerns, even if correct, do not hold any actual implications for the variability analysis. Dr. Bradley estimated his equations using both annual and SPLY data, both of which are free of these transitory issues. Those alternative studies strongly confirm that mail processing labor variabilities are less than one.

UPS and the OCA go even farther afield in totally unsupported speculation. They first hypothesize, in the absence of any proof, that there could be a large increase in the use of casual labor. They then compound that speculation by imagining that these swarms of casual workers will be conspicuously inefficient. *See* UPS Brief at 19, n. 13; OCA Brief at 186. It is just as easy to speculate that casuals may be assigned to the same or similar operations over time and thus become more productive over time. It is also just as easy to postulate that casuals would be assigned to work that does not require scheme knowledge or other specialized training, thus mitigating the effect of the casual workers' "quality" on the facility's operations, meaning that any "inefficiency" would have negligible impact on the productivity of the operation.

Finally, as pointed out previously, actual labor time is used as the dependent variable for variability estimations of other kinds of costs. Postal Service Brief at III-28-29. In fact, in this docket, Postal Service witness Wade used workhours as the dependent variable in estimating the variability of vehicle service driver costs. *See* USPS-T-20. Not a word of criticism of Dr. Wade's choice of variables was heard from either UPS or the OCA. Of course, Dr. Wade's analysis showed that the variability of vehicle service driver costs is higher than what had traditionally been used. Accordingly, the UPS and OCA standard for use of hours as a dependent variable can be summarized as follows: use of hours as a dependent variable is appropriate if it raises variabilities, but is apparently totally unsuitable if it lowers variabilities.

f. The OCA discussion of econometric methods is as flawed as the testimony of witness Smith.

In one part of its brief, the OCA presents its discussion of the choice of econometric models. OCA Brief at 199-204. Unfortunately, the entire discussion is rife with basic errors and exhibits a deep misunderstanding of the fundamental econometric points at issue. Just as OCA's witness, Dr. Smith, was unable to estimate econometric regressions, the OCA brief is unable to explain the econometric issues before the Commission. Moreover, little if any of what the OCA states is supported by the record. Most of the section is devoid of transcript cites and when cites are used, they are only most tangentially related to the matter at hand. In the balance of this section, the OCA "arguments" will be discussed and their fundamentally flawed nature will be illustrated.

The OCA starts this section of its brief with a discussion of Dr. Smith's erroneous interpretation of a standard graph from a textbook on panel data econometrics. Either due to incompetence or a deliberate attempt to mislead the Commission, Dr. Smith presents an interpretation of the classic diagram that is completely backwards. As Professor Ying, a noted econometrician, states:

> The cited figure from Hsiao warns against precisely the mistake Dr. Smith is making: although the pooled model (incorrectly) suggests a slope of about one, the true

> common slope is much less. *His attempt to use the figure to support his contention is so ironic that one might question whether he understands the point being made with the figure.*

Tr. 28/18145-6 (emphasis added). Moreover, Professor Ying makes clear that Dr. Smith's faulty interpretation of the graph is without merit:

> Dr. Smith's description of the pooled model line as "longer-run expansion path" is *nonsense.*

Id. (emphasis added).

This type of nonsensical description of the econometric issues continues in the OCA brief. At one point, the brief attempts to summarize what is allegedly Dr. Smith's belief.[24]

> In specifying the equation, the graph of which is presented on Diagram 1, Dr. Smith advocates a pooled regression on data averages.

OCA Brief at 200. Unfortunately for the OCA, no such "animal" exists and the statement stands in direct contradiction to itself. A pooled regression is just that, a regression in which *all* the data are put together in a single pool, with *many data points* for each site. A regression on data averages is something quite distinct, with only *one data point* for each site. To suggest that one should estimate a "pooled regression on data averages" is akin to suggesting that one should grill a hamburger

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[24] It is difficult to ascertain if Dr. Smith would agree with this statement because the only transcript cite provided by the OCA is to Tr.28/15845. That page is, of course, only a graph and contains no text. Thus, one can only conclude that the OCA is taking a novel, "introspective," approach to providing a record basis for its new assertion.

by boiling it in water.

The OCA description of the specification tests presented in witness Bradley's direct testimony based upon Gauss Newton Regressions is equally tortuous and reveals that the OCA neither understands the tests nor their implications. The OCA claims that:

> [Professor Bradley] concluded that the Gauss Newton test showed that important site specific variables were omitted from the equation.

OCA Brief at 200. Of course, no transcript citation was provide to support this contention because no such statement was made on the record by Professor Bradley. What he did state was :

> In every case, the GNR tests reject the null hypothesis, indicating that the facility-specific *effects* are important and that both the pooled model and the simple cross-sectional models are not appropriate.

USPS-T-14 at 42 (emphasis added).

Note that, contrary to the OCA claim, Professor Bradley does not mention specific variables. This distinction is important because the OCA goes on to transmute, without any citation to the record or any other authority, the test for site-specific effects into a test for specific omitted variables. They are not the same thing. The OCA argument is as flawed as it is bold. Its brief startlingly states, without a scintilla of evidence, that:

> In specifying the equation witness Bradley did in fact eliminate an important explanatory variable — capital, and of course the Gauss Newton test showed that, in fact, the

variable was missing.[25]

This is an outrageous statement even for the OCA. There is simply no possible way that the OCA could know that the so called “Gauss-Newton test” showed that a specific variable was missing because the test can do no such thing. In addition, Professor Bradley never *eliminated* the capital variable from the regression; it was never there. Furthermore, the OCA never explains what “capital” variable it would include in the equations for manual letter or flat activities, for which labor is essentially the only input and the capital "services" provided by mail processing equipment are trivial. Tr. 33/17908. The OCA’s statement is revealing both in its ignorance and in the desperate attempt by the OCA to manufacture new analyses at this late date. The only reason for such extreme tactics is the fact that it has yet to present a shred of credible evidence criticizing Dr. Bradley’s econometric methods.

In many places in its brief, the OCA recounts Dr. Smith’s apparent preference for including “capital” in the cost equation.[26] The brief also suggests that a non-volume related variable such as a facility’s age could serve as the “capital variable.”

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[25] OCA Brief at 201. True to course, the OCA provides no citation to the record in which any witness has made any such statement. No such statement exists, as OCA witness Smith was apparently too embarrassed to make such an erroneous statement, and the OCA was thus forced to make it in its brief.

[26] Neither the OCA not Dr. Smith is specific as to what this variable should be. Sometimes it is the physical characteristics of the building, sometimes it is apparently the number of machines, and sometimes it is apparently the “value of the capital.” This lack of specificity is intellectually bankrupt but quite convenient for the OCA. It allows the OCA to claim that no matter what variable Professor Bradley used as the “capital” variable it would not be the “right” one.

Finally, the brief reiterates Professor Bradley's explanation that non-volume facility specific effects could be captured either through the fixed effects approach or through the inclusion of the relevant non-volume variable. OCA Brief at 201. The two methods accomplish the same goal -- controlling the bias caused by omitting site-specific effects. Thus it is astounding that the OCA would state:

> Having rejected the Gauss Newton approach, witness Bradley went to a fixed effects model, which assumed away capital in an alpha intercept, thereby making the equation a short run equation, as previously discussed.

OCA Brief at 201.

This statement is astounding, in part, because it contains so many fundamental mistakes despite is abbreviated length.[27] First of all, there is no such thing as a "Gauss Newton approach" to estimating equations on panel data. Gauss-Newton Regressions are part of a *test* for the presence of site-specific effects, not an estimation technique. *See* USPS-T-14 at 40-43. Second, there is nowhere on the record the Professor Bradley stated that he rejected such an approach, as no such approach exists. Third, as its own brief points out, the "alpha intercept" does not "assume away" capital, rather it embodies any site specific effects that capital could have on productivity and hours. OCA Brief at 201. Lastly, "assuming" away capital does *not* make an equation short run, Note that the OCA erroneously argues that controlling for capital in the cost equation makes the equation *long run* (when capital is controlled for via explicit capital variables -- OCA Brief at 199) and that controlling

[27] As always, the OCA provide no citations to any witnesses to support this wild claim. No witness on this record has said anything along these lines.

for capital in the cost equation makes the equation *short run* (when capital is controlled for via the site effects and/or time trend variables -- OCA Brief at 201). Witness Smith's argument that capital should be included in the cost equations may or may not contradict his argument that the equation should be "long run" -- depending on how the OCA's own contradictory arguments are resolved.

The OCA also attempts to rehabilitate Dr. Smith's discredited analysis of data plots. Although its position contradicts one of the most basic tenets of applied statistics, the OCA seems comfortable advancing the untenable position that simple two dimensional plots are more revealing than regression analysis. The OCA audaciously advances its conclusions by claiming that the plots in Dr. Smith's exhibits were unchallenged. OCA Brief at 202.[28] The plots themselves are not at issue -- they are what they are -- but the interpretation of them is. To contend that Dr. Smith's interpretation of the plots went unchallenged is patently false. The OCA brief simply ignores the fact that this untenable position was strongly and effectively rebutted by both Mr. Higgins and Dr. Ying, and the brief does not attempt to refute their rebuttal. Mr. Higgins points out that Dr. Smith's visual inspection of the data is both inadequate and misleading, and indicates that witness Smith's conclusions

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[28] Postal Service interrogatories, however, revealed that the axis scaling in many of the plots was wrong. *See* Tr. 28/15923. Insofar as Dr. Smith was able to draw his conclusions regarding variability without reference to the correct data scaling, it is all the more amazing that Dr. Smith cited the absence of the origin in Postal Service exhibits as the reasons why he could not reprise his feat while on the stand. *See* Tr. 28/15939-40. Of course, any algebra student (hopefully) knows that, with *correct* scales on the axes, the slope of a line can be calculated as the rise over the run, without recourse to the location of the origin.

based upon the plots are "simply indefensible." Tr. 33/17991 and 17992.

Moreover, Mr. Higgins persuasively demonstrates that even if Dr. Smith's approach was correct theoretically (which it is not), it is still flawed:

> Finally, even if witness Smith's analysis of his graphs were not fatally flawed for the reasons already stated, his analysis would fail because it is based on plots in which *most of the data he claims to have examined does not actually appear.*

Tr. 33/17994 (emphasis added). This utter rejection of Dr. Smith's plotting approach is shared by Professor Ying:

> If Dr. Smith is basing his argument on a visual inspection of plots, I think he is on shaky ground. Such plots show little or nothing, and are subject to selective interpretation. Under cross-examination and in USPS/OCA-T600-11 (Tr. 28/15916), he seems to admit this problem.

Tr. 33/18145. The OCA brief continues to incorrectly describe what the plots reveal by suggesting (again without citation) that the plots:

> measure the variability in the longer run the time frame which during which rates will be in effect.

OCA Brief at 202.

The plots *present* the data on a two-dimensional basis, but they do not

measure

anything. This statement is symptomatic of the entire OCA effort to fabricate analysis by assertion. This approach, quite naturally, is rife with errors and these errors are revealed in the OCA statements. For example, the OCA claims that the plots reveal something about the size and nature of the facilities in which the data were taken. It asserts that:

> The plots show cost variability across facilities for different sizes of facilities . . . As one moves from one facility to another, bigger ones having more TPH, one encounters facilities with a larger scale of operation, i.e., more capital.

OCA Brief at 202-03.

The OCA's description of the plots is not even close to being correct, as the plots show hours and TPH for various facilities, not the variability across the facilities. Such a variability must be calculated with a regression equation, which the OCA has failed to do. No amount of mysticism will allow the OCA to extract a variability measurement from the plots.

The OCA has also missed the basic point that the data plots are hours and TPH for an individual *activity*, not for a facility. There is no way to determine from the plots whether the data for the particular activity is from a large or small facility or from a heavily or lightly capitalized facility. This is pure speculation on the part of the OCA. For example, it is quite possible that a large manual letter activity could be located in a relatively small facility that does not have a lot of automated equipment. Thus the OCA's unsupported assertion holds no water.

g. The OCA's ever-shifting argument on inclusion of a capital variable is without merit.

The OCA argument on inclusion of a capital variable in Dr. Bradley's econometric analysis can be condensed into an old cliche: Be careful what you ask for because you just might get it. At Dr. Smith's urging, Dr. Bradley estimated a new "between" model that explicitly factored in capital.[29] Dr. Bradley estimated this model using FY 1994 data and including control variables for facility age, facility square feet devoted to mail processing, and facility floors devoted to mail processing. *Id.* at 17911. A variability well below 100 percent resulted. *Id.* at 17912.

Likely for this reason, the OCA is now claiming that Dr. Bradley included the *wrong* capital variable. The OCA states, "[T]he key capital variable -- the value of plant and equipment -- was missing from the analysis." OCA Brief at 193.[30] First, Dr. Smith did not specifically designate one and only one "key" capital variable. In fact, in the portion of Dr. Smith's testimony quoted by the OCA, *value* of plant and equipment is not explicitly listed, rather Dr. Smith lists *age* and *types* of equipment. *Id.* at 192, *quoting,* Tr. 28/15825. In another portion of his testimony, Dr. Smith listed:

> the *age of the facility*, the magnitude of the facility support costs, the size of the facility (*square feet of space* and/or number of people employed), the *space utilization*, the number of processing activities, the types of mail processing equipment, the value of the equipment located within a facility, and the quality of the work force.

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[29] Direct measures of capital in Dr. Bradley's equations are not necessary in a panel data analysis, however, as the effects of technological change, among other things, are captured in the time trends. *See* Tr. 33/18002. In addition, MPA witness Higgins explained that Dr. Bradley had used a more sophisticated approach than simple time trends by including the manual ratio in his letter and flat sorting models to take direct account of automation, and by allowing for site-specific intercepts to accommodate "the uneven spatial distribution of technical advances." *Id.*

[30] The OCA's argument is somewhat confusing. Although seemingly alleging that value of plant and equipment is "key, " the OCA also states on the very same page that "[c]onsiderations of capital *deployment* are *essential*. . . ." *Id.* at 193. Does this mean the *schedule* for capital deployment or the *value* of the capital?

Tr. 28/15851 (emphasis added). Some of the variables in this latter list are either identical or very close to the capital variables that Dr. Bradley included in his alternative analysis.[31] Others are non-time-varying quantities that would be captured by the fixed effects.

In any event, even if Dr. Smith had specified value of plant and equipment as the "key" variable to include, what does this mean? For example, is the OCA referring to the purchase price of an OCR or the depreciated value of the OCR or an imputation of value to the services provided by the OCR? Is an OCR purchased three years ago less productive than a brand new one, even if purchased from the same manufacturer? What about fair market value? One might argue that the fair market value of at least some types of mechanized or automated equipment might be nothing more than the scrap value. Also, Dr. Bradley's original analysis is not at the site level, but rather at the level of the activity. What is the value of capital stock at the activity level? For example, what is the value of a manual letter case?

The remainder of the OCA argument concerning inclusion of capital variables is muddled, at best. The OCA first discusses "the implications for Dr. Bradley's model if it were based on a cost function," yet then seems to agree that Dr. Bradley is estimating a *cost equation*, thus making the cost function critique irrelevant. *See id.* at 193-94. The OCA then plunges ahead, totally mischaracterizing Dr. Ying's

[31] Further, despite the OCA's assertion that Dr. Bradley's capital variables "are not necessarily related to the value of the capital equipment actually at a facility" (*id.* at 193), one could just as easily argue that there is a relationship, for example, between the number of square feet or number of floors in a facility devoted to mail processing and the value of the equipment taking up that space.

comments on the matter. Dr. Ying had made reference to Dr. Panzar's discussion of a "reasonably well-defined set of operating procedures" and had said that "[t]he operating plan need not be optimal nor cost-minimizing, but must be reproducible and relatively stable." Tr. 33/18142. From this statement, the OCA reaches the astonishing conclusion that "it would appear that witness Ying believes that witness Bradley's cost equations for the Postal Service are non-optimal, do not deal with cost minimization (efficiency), but are reproducible." OCA Brief at 194. As should be obvious, Dr. Ying is not talking about *Dr. Bradley's cost equation*, he is talking about *the Postal Service's operating plan.*[32]

The OCA then concludes that if Dr. Bradley is estimating a cost equation (which he clearly is), then capital and other variables need to be included (which they were in his rebuttal analysis). The OCA states, however, that if Dr. Bradley is estimating a cost function (which he is not), then he has too many variables and the wrong ones (which is irrelevant since it is not what he is doing). *See* OCA Brief at 195. Finally, the OCA cryptically states that the need for additional variables in Dr. Bradley's cost equation "are also substantiated to a significant degree by witness Bradley's own article 'Measuring Performance in a Multiproduct Firm: An Application to the U.S. Postal Service.'" *Id.* at 196.[33] What does this mean? Additional

[32] Another question raised by this passage is, does the OCA believe that the Postal Service actually is a strict cost-minimizer?

[33] The OCA apparently is unaware of the irony in citing Dr. Bradley's own published article as the standard for proper model specification. As Dr. Bradley already has explained, one can estimate a *pooled* model with the cited variables included or a fixed effects model without them. Tr. 19E/9749-50. Moreover, only

variables -- some of the very ones suggested by Dr. Smith -- were added in Dr. Bradley's rebuttal analysis. Are there other variables in addition to those that the OCA *now* wants included? If so, what are they? How is the need for additional variables substantiated by the cited article? What specific variables, if any, does the article suggest? Are these variables different from those suggested by Dr. Smith and used by Dr. Bradley? It is impossible to even decipher what point the OCA is attempting to make.

To summarize, the OCA wanted a capital variable included and it got what it asked for. Unhappy with the less than 100 percent variability result, the OCA now wishes it had never raised the issue in the first place.

h. Dr. Bradley's application of proxy variabilities is appropriate.

Dr. Bradley applied the system variability from MODS office activities to the overall mail processing costs for activities at non-MODS offices because neither workhour nor piece handling data for non-MODS activities were available. USPS-T-14, at 90. The OCA argues that this has not been sufficiently substantiated, citing to Dr. Smith's testimony in this regard. OCA Brief at 210. It is clear that the data needed to estimate specific non-MODS variabilities do not exist, so a proxy or assumption of some sort *must* be used.[34] Moreover, the OCA has not demonstrated

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Professor Bradley has done them both. Indeed, had the OCA read the article upon which it relies, it would have noticed that even when the various capital variables are included in the equation, the implied variability is less than one.

[34] The OCA's preference, of course, would be to throw out the entire study -- including the MODS variabilities where data do exist -- because a proxy variability

that MODS and non-MODS operations are so different that use of the MODS variability is inappropriate. On the contrary, evidence in the record suggests that individual activities are generally the same, even if the operational mix is different.

Dr. Smith, and by extension the OCA, seem to confuse possible differences in offices with differences in operational activities. Dr. Bradley's analysis was at the activity level, not the facility level. Thus, facility-type distinctions such as simplicity of sorting schemes and size of the workroom floor are not a concern at the activity level. Postal Service operations expert Moden concluded that despite these sorts of differences, "the equipment and mailflows are similar to those at facilities reporting to MODS, and the factors accounting for volume variability would thus be much the same regardless of facility size." USPS-T-4, at 22. Dr. Bradley also highlighted the distinction between facility differences and activity differences, stating that "[t]he operational mix varies between MODS and non-MODS offices (*and even within MODS offices*), but I believe that there is not a substantial difference between MODS and non-MODS offices in the nature of the activities themselves." Tr. 11/5439. Thus, the OCA's concern that responses to like changes in volume would be significantly different between MODS offices and non-MODS offices, because the operational mix varies between MODS offices as a group and non-MODs offices as a group, is baseless speculation. OCA Brief at 212.

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has to be used for a portion of the study and return to the prior 100 percent variability assumption. The OCA position suffers from an internal inconsistency. It cannot logically be opposed to use of a proxy variability for a portion of the data and, at the same time, support use of a variability covering all offices and all operations that is based on no data at all.

Further, as Dr. Bradley pointed out, the real concern is not with using a MODS-based proxy for non-MODS activities, but rather whether "the application of the MODS *system* variability may raise the question of the distribution of costs across activities in MODS and non-MODS offices." Tr. 11/5358 (emphasis added). As Dr. Bradley states, "[T]o the extent that non-MODS offices have less automated and mechanized equipment, the MODS system variability could *overstate* the variability at non-MODS offices." *Id.* (emphasis added). In light of this concern, Dr. Bradley applied the MODS variabilities on a disaggregated basis to non-MODS activity cost pools using IOCS tallies and found that the disaggregated variability and the system variability were quite close. Tr. 33/5358-59.[35]

The OCA's remedy for the purported problem it has raised is to suggest that the Commission apply the 100 percent variability to the non-MODS activities. OCA Brief at 212. The OCA further states that Dr. Bradley testified that this "is an approach available to the Commission." *Id.* This is not exactly what Dr. Bradley said. In fact, Dr. Bradley was specifically asked during oral cross-examination whether he considered using the prior 100 percent variability for the non-MODS activities. Dr. Bradley indicated that he had considered this approach, but concluded

[35] The OCA footnote on this matter is quite misleading. OCA Brief at 210, n. 771. First, the OCA implies that Dr. Bradley supports application of the system variability, without addressing the possibility that non-MODS offices have less mechanized and automated equipment than MODS offices. In fact, Dr. Bradley addressed that possibility with his alternative approach of applying MODS-based variabilities on a disaggregated basis. Tr. 11/5358-59. The OCA also never bothers to mention that the concern over the possibility of less mechanized and automated equipment at non-MODS offices was that the MODS system variability would *overstate* the non-MODS variabilities. *Id.* at 5358.

that there was no support for it. He stated, "[G]iven my -- what I believe to be very strong results across many different offices, many time periods, for MODS offices, of variability substantially less than one, I didn't feel I had a basis for putting that forward. . . ." Tr. 11/5558. Dr. Ying also concluded that "the MODS results are more likely to be representative than the previously assumed 100 percent variability." Tr. 33/18147. It also must be realized that there is a glaring inconsistency here. If, as Dr. Smith believes (Tr. 28/15917) and the OCA asserts, there is no reason to believe that the variabilities are the same at MODS offices and non-MODS offices, then there is absolutely no basis for applying the 100 percent variability to both.

Finally, the OCA raises a new concern with Dr. Bradley's study. In addition to the proxy for non-MODS activities, the OCA now questions other proxy variabilities, despite the fact that this issue was not raised by Dr. Smith or addressed in any detail elsewhere on the record.[36] At the eleventh hour, the OCA surmises that six of the eight proxy variabilities used by Dr. Bradley for mail processing activities without recorded piece-handlings, and three of the nine proxy variabilities used for customer service activities, are questionable as there may not be an "equivalence between activities." OCA Brief at 213. The OCA's assertions are sheer speculation, which totally ignores the evidentiary record. In fact, Dr. Bradley responded to an OCA interrogatory on this very subject, stating that he had discussions with operational experts and had drawn "upon their knowledge of operations" in choosing these proxies. Tr. 11/5394. Moreover, witness Degen, also responding to an OCA request

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[36] This may explain the lack of citations in this section of the OCA Brief.

had provided a detailed table listing similarities between the activities for which a proxy variability was used and those from which the proxy was taken, as well as directed the OCA to several library references for further information. Tr. 12/6384-86. The OCA's last minute "arguments" are thus contradicted by evidence in the record. As such, they are entitled to absolutely no weight, and Dr. Bradley's proxies must be accepted as unchallenged.

i. The MODS data are voluminous and reliable. They are an outstanding basis for analyzing mail processing labor costs.

In their briefs, the OCA and UPS simply reiterate witness Neels' original claim that a Postal Inspection Service Audit somehow questions the reliability of MODS data for estimating mail processing variability equations. OCA Brief at 186-87; UPS Brief at 22. The inapplicability of this audit for a determination of overall reliability of MODS data has already been demonstrated by Mr. Degen (Tr. 18/8249-50), who also makes clear the fact that audit does not apply to Dr. Bradley's analysis. These issues have already been extensively discussed in the Postal Service initial brief (Postal Service Brief at III-50-59) where, *inter alia*, it is explained that the audit's criticisms of MODS are not relevant for Dr. Bradley's analysis:

> The audit contained statements indicating that, at the audited sites, actual piece counts differed from recorded FHP in MODS, for a number of reasons, 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 whenever possible. This is precisely the method MODS uses for TPH.

Postal Service Brief at III-55.

In addition, the UPS brief insists on preserving Dr. Neels' error that the TPH for machine-based operations is somehow based upon FHP measurements and/or weighing of mail. UPS Brief at 22. This was not true the first time Dr. Neels stated it, and it is still not true. Its falsity has been revealed by both Mr. Degen and Dr. Bradley. Tr. 18/8276 and Tr. 33/17898. To make it crystal clear, this point bears a final reiteration: The TPH in machine-based operations are taken directly from machine counts and are not subject to the concerns raised in the audit report.

It is true that a *portion* of the TPH in *manual* operations are determined from conversion factors and are thus subject to possible measurement error.[37] By pursuing an "errors-in-variables" econometric approach, Dr. Bradley conclusively demonstrated in his direct and rebuttal testimonies that this measurement error is not material and does affect his econometric results (Postal Service Brief at III-57-59). In his direct testimony, Dr. Neels raised some concerns about Dr. Bradley's initial "errors-in-variables" analysis. Tr. 28/15635. Dr. Bradley put those concerns to rest in his rebuttal testimony. Tr. 33/17897-900. UPS apparently agrees with the points made by Dr. Bradley in his rebuttal testimony and accepts the "errors-in-variables" analysis presented there, as it raises no criticism of that analysis in its brief.

In sum, measurement error is not a problem for the accurate estimation of mail processing variabilities. It is not a factor in machine-based activities because of the manner in which the TPH data are collected. While it could have potentially been a

[37] It is only a portion because TPH counts for pieces coming to manual operations from other machine-based operations will be based on machine counts. Tr. 18/8278.

problem for manual operations -- albeit likely a limited one -- Dr. Bradley has demonstrated empirically that it is not.

Finally, both the OCA and UPS fret about the accuracy of the MODS data because there are "hundreds" of instances in which only a single data point is recorded for a particular activity for a particular site. OCA Brief at 187; UPS Brief at 22. Given that MODS is a real-world operational data system, it is not the least bit disconcerting that a few data entry errors could occur. However, the UPS and OCA concern must be put into perspective. The MODS data set presented by Professor Bradley contains *hundreds of thousands* of data points, so the existence of only "hundreds" of single-observation data points means the problem is *de minimis.* Ironically, this criticism actually supports the accuracy of the MODS data as it shows how rarely the potential data entry errors could have occurred.[38]

In similar fashion, the UPS brief decries the existence of "gaps" in the data in which a site fails to report data for one or more accounting periods over the nine year period analyzed by Dr. Bradley. UPS Brief at 22. Given that the MODS data base covers hundreds of different mail processing sites, it should be expected that some will miss reporting in a few accounting periods over the course of a decade. Yet Dr. Neels' own calculations show that this "problem" is also a relatively rare

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[38] The MODS data set presented by Dr. Bradley has over 282,000 individual data points for the various sites over the various time periods, which in turn represent a distillation of a far larger data set at the 3-digit operation level. Tr. 28/15611. The 549 instances in which Dr. Neels finds single period observations amounts to less than 2 tenths of one percent of the data. In other words more than 99.8 percent of the data do not come from single accounting period observations.

phenomenon, occurring on the same order of magnitude as the alleged single-period observation "problem" raised by Dr. Neels. Tr. 28/15604. The rarity of these gaps in the data thus also speaks to the overall reliability of the MODS data.

One last issue raised in the OCA brief requires attention. The OCA first presents Dr. Bradley's discussion of the fact that some volumes of mail essentially bypass mail processing. It then goes on to say:

> However, it is clear that at least in some minimal way the mail is on postal premises; accordingly, we are left wondering where the hours are accrued, for apparently all of the labor is accounted for in one of the activities.

OCA Brief at 186.

The OCA's apparent bewilderment dramatically demonstrates that it does not understand the Postal Service's mail processing analysis at even a basic level, and its criticisms of that analysis must therefore be discarded. Mr. Degen has made very clear that his cost pools account for the costs *where they are actually incurred.* For example, to the extent a particular volume of mail is only cross-docked in a facility, the related workhours and costs would show up in the platform cost pool. As the OCA states, all labor is accounted for and the cost for mail processing labor cost for a particular mail class or subclass will reflect the degree and nature of handling that it receives.

j. Dr. Bradley's data scrubbing procedures were valid and ensured the best possible data upon which to estimate variabilities.

Like UPS, the OCA challenges Professor Bradley's data scrubbing procedures. The criticisms of Dr. Bradley's data scrubs have been addressed in full and shown to be baseless in the Postal Service's Brief. Postal Service Brief at III-60-64. Nonetheless, some points bear repeating here. In addition, the OCA has managed to make a number of misleading statements as well as to construct several new arguments based on what can only be characterized as frenzied speculation. All of these matters are discussed below.

The OCA asserts that "[t]he testimony of witnesses Neels and Smith *show* that witness Bradley's data scrubbing procedures were incorrect, and that witness Bradley has excluded large amounts of data which should have been considered in the analysis." OCA Brief at 187 (emphasis added). Dr. Smith's testimony did not *show* any such thing; he merely stated that Dr. Bradley's data scrubbing "needs additional research" and then posed a list of questions that should be addressed in such research. Tr. 28/15853.

The next misleading statement made by the OCA is its pronouncement that Dr. Ying indicated that "Dr. Smith has a few good comments about the data." OCA Brief at 187. Actually, Dr. Ying did make that statement, but the OCA neglects to mention the *conclusion* reached by Dr. Ying. His conclusion was that, in spite of the questions raised by Dr. Smith, Dr. Bradley's data scrubs contained "no obvious rules of selection which might skew the results." Tr. 33/18146-47. Dr. Ying obviously brought an objective and balanced perspective to his review, but left no doubt that only one conclusion was reasonable.

The OCA's statement concerning the possibility that "'unusual' observations contain the most information on the true relationship between cost and volume" is speculation, and questionable speculation at that. OCA Brief at 188. Certainly, data points that reflect recording error reveal nothing about the relationship between cost and volume. From the conundrum over the "500 pieces per minute" observation, the one thing that can be learned is that such an observation has no bearing on operational reality. *See* Tr. 33/18092-102. Moreover, as MPA witness Higgins has stated:

> It is the measurement errors in the tails of the data distribution ("outliers"), however, that tend to cause the greatest mischief when the goal of the research is to obtain reliable estimates of slope parameters. Therefore, it is incumbent upon the researcher to focus attention on possible data errors in the outliers, and to correct or eliminate them where possible

Tr. 33/18013 (footnote omitted).

The OCA next takes the slenderest of threads and attempts to weave an elaborate tapestry of allegations concerning elimination of critical data from large sites with major investments in automation. Upon careful examination, however, the tapestry proves to be torn and tattered.

The OCA begins its tale with an exchange during Dr. Bradley's oral cross-examination, which, of course, is not quoted in its entirety. *See* OCA Brief at 188. The exchange between the OCA counsel and Dr. Bradley follows:

> Q Did you consider that such a requirement of a minimum of three years of data might eliminate the most important sites -- that is, the sites which have undergone major technological change with the installation of new equipment?
>
> A Yes, I did consider that, and I don't think that will be a problem, because as equipment's being introduced, it usually goes to larger sites first, and those are the sites through which we've collected data over a long period of time.

Tr. 33/17916. The OCA takes this simple, clear exchange and builds an argument consisting of faulty layer upon faulty layer of speculation. The OCA claims that because large sites receive the major automation investments, and because there is a "ramping up" period after a major investment, and because Dr. Bradley did not use data from "ramping up" periods, and because Dr. Bradley's "continuity" scrub requires 39 consecutive observations, he "could very well eliminate the post-investment operations at sites which had participated in major investment and automation from the analysis." OCA Brief at 188-89. And because Dr. Bradley "could very well eliminate" these sites, "his study is not representative of activities at any major processing site which has had major investments for an activity within the past three years." *Id.* at 189. One's first reaction is to yell, "Whoa!"

This is rampant conjecture, none of which is supported on the record. It should be noted that the OCA has had Dr. Bradley's dataset in USPS LR-H-148 since July 10, 1997. It has had ample opportunity to examine the data, see where "continuity" breaks occurred, and conduct any sort of analysis desired. It has chosen not to do so, preferring to make unsupported allegations on brief, when it is too late for parties disputing the allegations to bring hard evidence to bear on them. For this reason alone, the OCA argument is not entitled to any consideration.

Moreover, a little thought reveals the fallacy of the OCA's deductions. Larger sites that received equipment first obviously received the equipment more than three years ago. For purposes of Dr. Bradley's analysis, this would mean a particular site would have had to have received equipment and "ramped up" prior to FY 1994.

Certainly this is true of the large sites, as the Postal Service's automation program started in the 1980's. Thus, the larger sites would have data for 39 consecutive APs after receiving equipment and would be included in the data base. Also, since large sites got equipment first, subsequent equipment deployments to those sites -- for example, a third and fourth OCR -- would not require "ramp up" time since the site would already have a track record of operating the equipment. Furthermore, the OCA seems to vastly overstate the stringency of Dr. Bradley's threshold scrubs. For instance, an OCR operation would achieve 100,000 TPH (the threshold level) with less than four *hours* of continuous operation of a single machine.[39] Also, in his rebuttal testimony, Dr. Bradley presented alternative results for the MODS direct activities with a 26 AP scrub. For purposes of this analysis, a site would have had to have received equipment and "ramped up" prior to FY 1995 -- which is certainly true of the larger sites. Dr. Bradley's results with this scrub were very consistent with his results from the 39 AP scrub. *See* Tr. 33/17893. Thus, the OCA's argument clearly is not based on reality.

In addition, it must be kept in mind that Dr. Bradley's analysis is *not* a site by site analysis, but rather an activity by activity analysis. The sheer number of observations per activity used in Dr. Bradley's analysis, even with a 39 AP continuity scrub, is massive. There are, for instance, 18,497 observations for the OCR activity, representing 234 sites. USPS-T-14 at 54. These figures alone should allay any disquiet over potential unrepresentativeness.

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[39] This assumes a throughput of approximately 30,000 pieces per (clock) hour.

The OCA next argues that the 39 AP continuity scrub was too restrictive, indicating that far more data could have been used by Dr. Bradley, and that Dr. Bradley did not statistically justify this scrub. OCA Brief at 189-90. The OCA cites to UPS witness Neels for its conclusions that a limited number of consecutive observations are needed to correct for serial correlation and to account for seasonality, and summarized by saying that "witness Bradley provides no statistical analysis of the number of periods that a data set should be, but *witness Neels makes a compelling case for 3, not 39*." *Id.* (emphasis added). Dr. Neels is probably as astonished by this statement as the Postal Service is. Although Dr. Neels did dispute Dr. Bradley's continuity scrub, he never "made a compelling case" that data for only 3 APs were required.[40] In fact, what Dr. Neels actually said was that "only two consecutive observations are needed to contribute to the estimation of the Baltagi-Li serial correlation coefficient" and "[t]o contribute to the estimation of the final fixed effects model with serial correlation correction, three consecutive observations are required." Tr. 28/15616. Further, Dr. Neels admitted that the set of data must "contain adequate numbers of usable observations in each of the different seasonal periods" to allow accurate estimation of seasonality. *Id.* Two or three APs of data simply would not allow seasonal effects to be adequately appraised.

Moreover, as pointed out above, Dr. Bradley's re-estimation using a less stringent 26 AP scrub showed results very similar to his initial analysis. Furthermore,

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[40] In fact, had Dr. Bradley included sites with data for only 3 APs in his analysis, no doubt both the OCA and UPS would complain that his study was too "short run."

even Dr. Neels's re-estimation of Dr. Bradley's equations including all useable observations showed similarities with Dr. Bradley's initial equations, despite the OCA's claim to the contrary. *See* OCA Brief at 190. As Dr. Bradley stated, "[T]here is no mistaking the pattern of similarities. 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.

The OCA's final volley on the issue of data scrubbing is to baldly proclaim "that the correct approach to data verification is follow-up via telephone or on-site inspection." OCA Brief at 190. This is simply ludicrous with an immense dataset. Was Dr. Bradley to visit or call every one of the hundreds upon hundreds of MODS offices? *See* Tr. 12/6353. The OCA cites to Dr. Smith as support for its general argument in this regard, but much of Dr. Smith's evident experience and discussion related to follow up phone calls to non-respondents in market research efforts. *See* Tr. 33/18095.[41] Frequently with a market research undertaking, follow up may be done within weeks or months of the initial data collection, not years later. Also, market research may encompass a single goal and thus have a limited scope of inquiry. This is unlike Dr. Bradley's effort which involved data from multiple sites for

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[41] At one point, Dr. Smith suggested that what Dr. Bradley "should have done was to take a select number of those on a statistically random sample basis and have physically examined in the field what the situation was so that the accuracy of the data could be examined on a site-by-site, point-by-point basis." *Id.* at 18092. Of course, this still would have been an enormous and impractical undertaking. Also, had Dr. Bradley done this, the OCA would no doubt be claiming that the "statistically random sample" was flawed, that the selected sites were not representative, and that more sites should have been visited.

multiple activities over multiple years.[42]

When asked if it would even be possible to determine the accuracy of Dr. Bradley's data, for example, from 1990 and 1991, Dr. Smith had this to say, "Well, there may be some records at the facility. Alternatively, there may be some people at the facility who could explain how the reading came to be derived . Those would be two possible sources, and there may be additional ones." Tr. 33/18095. It is quite a stretch to assume that facilities retain hard copy of, for example, OCR machine counts from five years earlier. It is even more of a stretch to presume that an employee at a particular site will today be able to recall why the numbers for the manual letter operation in AP 11 of FY 1990 look the way they do.

Dr. Bradley's data scrubs have been shown to be both objective and appropriate based upon the credible testimony of other economists in this proceeding, and by the robustness of his results and the general consistency obtained when re-estimating the equations based on a less restrictive scrub. The OCA arguments must thus be rejected.

k. Dr. Bradley's data do not demonstrate an attenuation problem.

The OCA states that Dr. Bradley's study is flawed because "[i]t is a well-established econometric principle that measurement error in an independent variable causes downward bias in coefficient estimates." OCA Brief at 190-91. In fact,

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[42] What appears to be the major -- though unpublished -- econometric study which Dr. Smith performed involved only *sixteen* sites, not hundreds. Tr. 28/15900-02 and 15956-57.

standard econometrics says otherwise. Where there is serial correlation in the measured variable -- here, TPH -- measurement error will *not* automatically result in an understatement of variability. Apparently, the OCA has forgotten Dr. Bradley's rebuttal testimony on this very subject. Dr. Bradley quoted from an established authority on this point:

> "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.

Moreover, Professor Bradley demonstrated in both his direct and rebuttal testimonies that measurement error in the piece handling variable was not a problem. In his direct testimony, Dr. Bradley performed an errors-in-variables analysis which demonstrated that the errors-in-variables estimator was quite close to the fixed-effects estimator. USPS-T-14, at 83-84. In his rebuttal testimony, Dr. Bradley presented an errors-in-variables analysis comparing the fixed-effects estimator with 13 accounting period differences and concluded that the analysis "supports an absence of large and material measurement error." Tr. 33/17900. Therefore, the OCA's concerns about attenuation are completely misplaced.

I. The Bonbright criteria discussed by Dr. Smith have no relevance in this proceeding; the relevant factors are set out in the Postal Reorganization Act.

On brief, the OCA takes up the Bonbright banner, which Dr. Smith ingloriously dropped on oral cross-examination. The OCA declares that Professor Bradley's analysis "fails to meet several of the standards which Professor Bonbright, a renowned commentator on regulatory practices, has stated a regulatory study should meet." OCA Brief at 204. In fact, the OCA expands the Bonbright criteria to such lengths that even Dr. Smith would no longer recognize them. The truth is that the Bonbright criteria apply to rate structures, not cost studies, and cannot be used to evaluate Dr. Bradley's or any other costing study. The relevant costing criteria for purposes of these proceedings is found in section 3622(b)(3); it assumes that the best available costing information should be used.

The Bonbright criteria were first raised in Dr. Smith's testimony. He claimed that Dr. Bradley's study failed to meet five of eight criteria which Dr. Bonbright allegedly said a regulatory study should meet. Tr. 28/15856. In fact, Dr. Bonbright said nothing of the kind. As Dr. Smith was forced to concede on oral cross-examination, Dr. Bonbright presents the criteria in his book under the heading of *rate structure*, not cost studies. *Id.* at 15947. In fact, the page from the Bonbright book cited in Dr. Smith's testimony does not even mention cost studies. As Dr. Smith said:

> Well, we might turn to the previous -- to the same paragraph, previous page, and say -- What then are the good attributes to be sought and the bad attributes to be avoided or minimized in the development of a sound rate structure? *I believe that Dr. Bonbright is talking about rates at that point.*

Id. at 15946-47. Dr. Smith's feeble riposte to being forced into this admission was:

> And, of course, costs translate into rates one way or another. So I would think that, to the degree that one is a subject, that the same standards would be applicable.

Id. at 15947.

An examination of each of the criteria discussed by Dr. Smith and the OCA only serves to highlight their inapplicability to cost studies. First, both Dr. Smith and the OCA allege that Dr. Bradley's analysis fails to meet the "simplicity/understandability/public acceptability/feasibility of application" criterion because it is incomplete. *See* OCA Brief at 204. The very wording of the criterion makes manifest that it applies to rates or prices, not cost studies. Dr. Smith's discussion on oral cross-examination further made clear that the issue was rates, not costs:

> Q But are you saying that the ratemakers should ignore -- in deciding how to deal with a situation, they should ignore the true cost and use something other than the true cost in determining what are the best prices that they can come up with under that situation?
>
> A I didn't say that. I said sometimes it is necessary to have such concepts as gradualism, incrementalism, understandability and acceptability implemented at the same time.
>
> Q Again, are we talking about prices here or costs?
>
> A Well, we are talking about the translation of costs *into prices*, and a cost study has to meet the standards that would permit it *to be translated into a price or a set of rates.*

Tr. 28/15942 (emphasis added).

Next, Dr. Smith and the OCA claim that a study should be free from controversy. Again, the overall point is that this criterion applies to the entire rate structure, not just costs. Moreover, its applicability to even postal prices can be questioned. The rates proposed by the Postal Service are never free from challenge from any number of intervenors. Frequently, even in instances where the Commission's recommended rates are adopted by Governors, there is a court challenge. In fact, even though he wrongly concluded that this criterion applied to cost studies, Dr. Smith was inconsistent in his interpretation of what it meant. At one point, he stated that the mere fact that someone files testimony challenging a study does not preclude its adoption. *Id.* at 15952. Nonetheless, he went on to say that he defined controversy to be when "there is *no immediate agreement* -- when I see a wide variety of numbers without any apparent agreement on the modeling techniques, the underlying database. . . . *Id.* at 15953 (emphasis added). Elsewhere, speaking of gas and electric utility regulation, he states:

> [B]ut it is usually possible for the Commission to arrive at some conclusion as to whether the witness is correct or not and it becomes fairly obvious after a complete airing of the situation, *possibly over a number of years*, as to what's what, so to speak. . . .

Id. at 15952 (emphasis added). Thus, even if this criterion were applicable, Dr. Smith seems unable to consistently explain what it means or how it should be applied.

The OCA Brief is even more unsatisfactory in this regard. The OCA claims that Dr. Bradley's analysis is not "free of controversy" for all sorts of bogus reasons. First, the OCA suggests that it is controversial because Dr. Smith's "eyeballing" of data plots suggests a 100 percent variability. OCA Brief at 204. This, of course, is in conflict with at least one of Dr. Smith's definitions, *i.e.,* mere filing of opposing testimony does not make something controversial. Even worse, the OCA attempts to invent controversy among the supporters of Dr. Bradley's analysis, where none exists. For example, the OCA claims that MPA witness Higgins believes that future capital expenditures could influence Dr. Bradley's results, but acknowledges that Mr. Higgins made clear that these expenditures should not be taken into account "beyond the extent to which he [Dr. Bradley] had already done so." *See id.* at 206-07. The OCA then claims that "[i]n contrast, witness Bradley has consistently maintained that the alpha term in this fixed effects equation accounts for facility differences." *Id.* at 207. To summarize, Dr. Bradley says he has accounted for something and witness Higgins says he does not think Dr. Bradley needs to take further account beyond what he already has done. So, where is the controversy?

The OCA's next phony controversy involves the tiresome OCA-manufactured issue of cost functions versus cost equations. Without even attempting to parse the OCA's convoluted argument alleging a controversy on this matter between witness Higgins and Dr. Bradley, all that needs to be done is to look at the following statement from witness Higgins:

> In the remainder of this testimony, I explain the basis for my conclusions that witnesses Neels and Smith are wrong in their criticisms of witness Bradley's approach and results. Witnesses Neels and Smith have both tried to attack the theoretical underpinnings and analytical approach of witness Bradley. In Section II, *I rebut their criticisms, showing that they lack merit.*

Tr. 33/17990 (emphasis added). Not content with only one phony controversy on the cost function versus cost equation front, the OCA charges on to declare that Dr. Ying specified the proper variables to be included in a proper *cost function*. The OCA then chides Dr. Bradley because he "does not meet the standards proposed by witness Ying." OCA Brief at 208. Of course, he does not -- because, as has been repeated ad nauseam in these proceedings, Dr. Bradley estimated a *cost equation.*

Probably the most incredible OCA argument concerning controversy, however, is evidenced in its statement, "[w]itness Higgins even disagrees with witness Bradley *on terminology*." *Id.* at 208 (emphasis added). Unbelievably, the OCA alleges that Dr. Bradley refers to a "Gauss-Newton regression" test whereas witness Higgins calls it a "LaGrange [sic] multiplier" test *Id.* The OCA cannot seriously be claiming that the Commission would determine that a study should be rejected for this reason.[43]

The OCA further argues that Dr. Bradley's study is controversial for virtually all of the reasons specified by both Dr. Smith and Dr. Neels. *Id.* at 208-10. Again, the mere filing of opposing testimony cannot equate with a true controversy in adversarial proceedings such as these. Further, all of the criticisms raised by Drs. Smith and Neels have been fully addressed in rebuttal testimony, in the Postal Service's initial brief or elsewhere in this one. Raising meritless issues certainly does not generate genuine controversy.

Another of the Bonbright criterion of concern to Dr. Smith and the OCA is the *stability of rates*. *See id.* at 205. First, by its very terms, the criteria applies to rates and not cost studies. Moreover, the stability of rates is *not* always affected by the underlying cost allocations, as the OCA claims. *Id.* For example, in Docket No. R94-1, the Commission adopted a new approach for distribution of air transportation costs, separating them between distance and non-distance related, and accordingly

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[43] One is reminded of the old standard (phonetically rendered):

> You say tomayto, I say tomahto
> You say potayto, I say potahto
> Tomayto, tomahto!
> Potayto, potahto!
> Let's call the whole thing off!

incorporated rate design adjustments. To avoiding upsetting existing rate relationships, the Commission incorporated only 50 percent of the adjustment in that case. *See* PRC Op., R94-1, at III-54-56.

A fourth criteria is fairness in the apportionment of total costs of service among different consumers. OCA Brief at 205. Again, this clearly directly relates to the rates paid by different consumers. The final criteria is that "*rates* should promote efficiency by discouraging the wasteful use of resources through the proper *pricing* of products." *Id.* Again, the concern is with prices, not costs or cost studies.

The Bonbright criteria are basically moot. Section 3622(b)(3) of the Act requires that each subclass should bear the costs it causes as well as make a reasonable contribution to the other costs of the system. The Act thus requires costs to be accurate, as Dr. Smith agreed. Tr. 28/15942-43. Dr. Smith admitted that if rejection of Dr. Bradley's analysis were to result in a failure to causally relate costs correctly to the appropriate class or type of mail, then there would be no compliance with section 3622(b)(3). *Id.* at 15943-44. Dr. Smith ultimately agreed that if the Commission determined that Dr. Bradley's analysis disproved the prior 100 percent assumption and lead to improved estimates of costs, then there is nothing in the Bonbright criteria which would preclude the Commission from implementing Dr. Bradley's analysis. *Id.* at 15954.

2. Arguments of intervenors that Mr. Degen's methodology is flawed as applied, or that Mr. Degen's methodology can be readily transplanted outside the context of the integrated mail processing analysis presented by the Postal Service, should be rejected.

In their briefs, intervenors have attacked witness Degen from all sides. Some of their challenges are based on their failure to fully appreciate the links between the work of Mr. Degen and Prof. Bradley; while other challenges are based more directly on the details of his distribution procedures. What such challenges share is a common failure to identify any valid reason to depart from the integrated approach presented by the Postal Service for developing mail processing volume variable costs by subclass. Equally invalid as a rational basis to question either the mail processing costs presented in this case generally, or Mr. Degen's proposed distribution keys specifically, are the claims made by mailers concerned about cost trends for Periodicals mail.

a. Properly accounting for the connections between the Bradley and Degen analyses voids intervenor criticism that their analyses are incomplete.

In this proceeding, two parties— the OCA and UPS—recommend that the mail processing method presented by witness Degen be adopted but witness Bradley's variability analysis be rejected, while a coalition of Periodicals-related intervenors[44] recommend the reverse. While each party presents a laundry list of alleged shortcomings with the disfavored part of the analysis, they ultimately pin their arguments on bigger picture issues. UPS argues that Dr. Bradley has supposedly not

[44] Initial Brief of ANM, ABP, CRPA, Dow Jones, MPA, NNA, McGraw-Hill, and Time Warner (hereinafter Joint Periodicals or JP Brief).

measured the relationship between costs and "volumes" (an opinion parroted by OCA). UPS Brief at 18; OCA Brief at 185.[45] The Periodicals intervenors complain that Mr. Degen has not analyzed the causal relationships underlying his cost distributions. Joint Periodicals Brief at 16-17.

On a purely superficial level, these observations may appear to be correct. However, as criticisms of the completeness or propriety of the Postal Service's cost methodology, they are utterly devoid of substance, since in each instance they improperly extend the scope of the disfavored portion of the methodology. Dr. Bradley does not, and has not claimed to, analyze the relationship between mail processing costs and mail volumes. He estimates the relationship between mail processing costs (measured by workhours in various operations) and the relevant cost drivers (measured by piece handlings in various operations). Dr. Bradley's analysis is no more, and no less, than an ingredient of the well-documented "volume variability/distribution key" method of computing volume-variable costs that has been employed for years in many cost segments. Tr. 33/17889. It is pointless to criticize him for not addressing the relationship between the cost driver and mail volume when that is clearly Mr. Degen's charge. Similarly, Mr. Degen does not, and has not claimed to, analyze the causal relationships underlying each cost pool's costs. That task rests squarely with Dr. Bradley. Mr. Degen simply computes the costs associated with each cost pool and distribution keys consistent with Dr. Bradley's

[45] Notwithstanding the efforts of UPS and the OCA to sow confusion on this matter, the term "volume-variable cost" is used below in its correct technical meaning.

variability analysis, and thus provides the remaining ingredients of the "volume variability/distribution key" method. Tr. 34/18221-4 (Christensen); Tr. 36/19325 (Degen).

The complete Postal Service method—that is, Prof. Bradley's and Mr. Degen's methods combined—is the mechanism that yields economically meaningful cost estimates. The intervenors' "completeness" critiques of Dr. Bradley and Mr. Degen are tantamount to criticizing the locomotive and the box cars for not being, individually, the entire freight train. The real problem with the intervenors' pick-and-choose approaches to the Postal Service's methodology is that they must show how their alternatives replace the omitted component of the Postal Service's cost presentation. In this regard, the Periodicals intervenors, despite the numerous flaws in their alternative distribution methods, at least deserve credit for acknowledging that a fully consistent variability and distribution system is needed. See, e.g., Tr. 36/19224 (Cohen). OCA and UPS show no such depth of thought. Incredibly, UPS claims that neither Dr. Bradley nor Mr. Degen empirically estimated the relationship between piece handlings and volume. UPS Brief at 20 (footnote 15). While UPS' argument will be demonstrated to be factually incorrect, it is worth considering its implications for their own witnesses. Neither Dr. Neels nor Mr. Sellick (nor, for that matter, Dr. Smith for OCA) presents an empirical analysis of volume variability that they are willing to recommend to the Commission; they merely rest on some interpretation of past assumptions. So, the UPS argument is that their own witnesses offer nothing more than an assumption of causality combined with a "sensible" distribution formula. *Id.* at 20, 33. Both OCA and UPS rely on statements by Dr. Christensen to support their arguments that the variability and distribution methods can be separated in principle. OCA Brief at 217, UPS Brief at 32. OCA's quote is most telling: Dr. Christensen's statement is that separating the methods requires that any substitute method also constitute a linked and consistent whole, and this requires a "cautious" approach. *Id.* None of the intervenor proposals meet this standard.

b. The argument of UPS that "Mr. Degen's distribution keys stand on their own" is not correct.

At pages 30-33 of its brief, UPS argues that rejection of Dr. Bradley's variabilities does not necessarily preclude use of a MODS-based approach to the distribution of mail processing labor costs. At one level, this assertion is correct. If one had an alternative empirical measure of variabilities for each MODS cost pool, based on reasonable and reliable econometric analysis of the quality of the research conducted by Prof. Bradley, and if Mr. Degen's distribution keys still represented the subclass distributions of the cost drivers specified in that analysis, such cost pool variabilities could be used consistently with the MODS-based cost distribution methodology presented by witness Degen.

The binding constraints are that, for each cost pool, there must be presented a reliable empirical measure of the causal relationship between the cost driver and costs, and a reliable connection between the cost driver and the distribution key, in order to use Mr. Degen's methodology to complete the estimation of the ultimate causal relationship between mail processing costs and subclass volumes. If, for example, such variabilities were available at the cost pool level, and one or more of those variabilities were estimated to be (or virtually be) 100 percent, use of Mr. Degen's methodology would still be appropriate, exactly as Dr. Christensen testified at Tr. 34/18258, as quoted by the UPS Brief at 31-32.

Of course, in this case, there are no reasonable or acceptable alternative econometric variability estimates that very closely approach 100 percent for any significant number of cost pools.[46] UPS witness Sellick, for example, does not rely on any empirical estimate of such cost pool variabilities, but relies instead on Dr. Neels' conclusions that the Commission should retreat to the previously untested (and non-cost-pool-specific) assumptions relied upon in earlier cases. And therein lies the problem because, as explained in the Postal Service initial brief at III-120 - 126, Mr. Degen's methodology requires some reliable independent basis to assert that the variable cost pool costs that would be distributed are actually *caused* by the piece handlings of the subclasses whose tallies are recorded in the cost pool. Most simply stated, his distribution keys do not stand on their own, contrary to UPS' assertion at 33.

A rather puzzling portion of the UPS brief on this matter is found on the bottom

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[46] Probably the only alternative variability measures on this record which might meet the reasonable and acceptable standard would be the site-specific variability estimates provided by Dr. Bradley and MPA witness Higgins in response to NOI No. 4. Those estimated variabilities, generally lower than those proposed by Dr. Bradley in his direct testimony, are less preferable for all the reasons stated by Prof. Bradley in his NOI response, and Prof. Ying in his rebuttal testimony. Yet the possibility of the use of these particular alternatives, for example, explains why Dr. Christensen, as quoted by the UPS Brief on 32, could not testify that complete acceptance of Postal Service initial subclass costs estimates, based on the direct testimonies of Dr. Bradley and witness Degen, would be "the only way to proceed," and why he could only testify that it was the "far preferable" way to proceed. Tr. 34/18280-82.

of page 32 and the top of page 33. In this part of its brief, UPS appears to be trying to assert that there is some linkage between Dr. Bradley's work and Mr. Degen's work which would not apply if the intent were to estimate subclass incremental costs, rather than subclass marginal (volume variable) costs. The transcript pages which are cited by UPS (Tr. 34/18255-56, 18287) support the proposition that Dr. Christensen believes that marginal costs are the "appropriate basis" for the development of economically efficient rates, and that the correct linkages between Dr. Bradley and Mr. Degen are necessary to obtain causally-based economic measures of marginal costs from the available analyses. But Dr. Christensen on those transcript pages was asked nothing about incremental costs, or about whether or not the same linkages would be necessary to derive incremental costs from the available analyses.

In fact, however, it is obvious from the record that such causal linkages are just as necessary for the correct estimation of incremental costs as for marginal costs.[47] Mr. Takis uses Prof. Bradley's estimated parameters and functional form to estimate the change in cost pool costs associated with the removal of the entire amount of the cost driver associated with each subclass. USPS-T-41 at 16. He uses witness Degen's proportions as the measure of how much of the cost driver is associated with each subclass. The resulting figure is the incremental costs of the subclass for that cost pool.

[47] When asked whether it was possible to measure incremental costs without measuring marginal costs, Dr. Christensen testified that it is not, because marginal cost "is a component of incremental cost." Tr. 34/18291-92.

Therefore, using witness Degen's cost pool proportions to calculate either volume variable or incremental costs requires establishment for each cost pool of the exact same causal linkage between the cost driver and costs that only Dr. Bradley's analysis provides. Contrary to what UPS appears to be trying to assert, whether marginal or incremental costs are considered by the Commission to be the more relevant for any particular analysis of economic cost causation, either would require a reliable empirical variability analysis in order to, if nothing else, properly estimate the functional form of the cost equation (on which both marginal and incremental costs are based).

c. The IOCS provides the "empirical investigation" of the relationship between TPH and subclass volumes in each cost pool.

UPS erroneously claims that Mr. Degen "did not do any empirical investigation" of the relationship between total piece handlings and volume. UPS Brief at 20, n.15. In fact, however, Mr. Degen does precisely such an analysis by using IOCS tallies to determine the proportion of time in each cost pool spent handling the volume of each of the subclasses of mail. Moreover, UPS in its brief actually cites to the pages of the transcript in which Mr. Degen explains this portion of his analysis in great detail, in his response to Item 5 of POIR No. 4. Tr. 12/6598-6604. UPS also cites to the pages in which he explained this again orally in response to questions from the bench. Tr. 12/6687-89. Although obviously Mr. Degen did not collect the IOCS tallies himself, his use of those tallies clearly constitutes an "empirical investigation" of the relationship between the cost driver (piece handlings) in an operation, and the volumes of each subclass handled in that operation.

UPS next asserts that "the Postal Service's case rests on an assumption that total piece handlings are proportional to volume." UPS Brief at 20,n.15. To support this claim, UPS cites Dr. Bradley and Dr. Christensen. This is surprising, because both of those witnesses in the same or nearby portions of the transcripts that UPS has cited deferred to witness Degen as the proper source of detailed information on what analyses he may or may not have done to support his distribution methodology. See, e.g, Tr. 33/17964-66 (Bradley), Tr. 34/18256, 18265 (Christensen). Yet when witness Degen appeared on the stand two days later, UPS chose not to explore this issue with him. In any event, the information provided earlier by witness Degen fully explains the nature of the relationship.

To begin, it is perhaps important to clarify a rather subtle potential source of semantic confusion. The cost driver used by Dr. Bradley is piece handlings (USPS-T-14 at 6), but since the particular measure of piece handlings he used from MODS is referred to as Total Piece Handlings, or TPH, that terminology was also used to refer to the cost driver. It is important to recognize that Total Piece Handlings in the MODS sense is not necessarily the same as some aggregation of all piece handlings (e.g., in the whole system) that some could refer to as "total" piece handlings. It should be assumed (unless the context suggests otherwise) that any place in the transcript that the spoken words "total piece handlings" appear, the term was interpreted (at least by the postal witnesses) simply as TPH in the MODS sense. For example, during questioning of Dr. Bradley, he was asked questions about "total piece handlings," and he responded in terms of "TPH." Tr. 33/17965.

Applying this same presumption to the UPS brief, the claim in footnote 15 can be translated into one that the Postal Service's case rests on an assumption that TPH are proportional to volume.[48] With this clarification in mind, we can now turn to witness Degen's POIR response to examine the merits of the UPS claim. Such an examination reveals the claim to be true only in a very narrow and limited sense. Witness Degen explains the only assumption that he makes in this regard as follows:

> The proportionality 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). He also notes that this number (i.e., "the number of TPH a typical piece of subclass j receives in cost pool i") will not be equal, in general, within a subclass for different cost pools, or within a cost pool for different subclasses. Tr. 12/6603. And, quite importantly, he makes no assumption (as he has no need to make any such assumption) that this number would remain constant from one year to the next. *Id.* All he assumes, in other words, is that within the same year, *additional* pieces of a particular subclass within a given cost pool are assumed to generate, per piece, the same number of TPH in that cost pool as the "typical" piece of the *existing* volume of that subclass in that cost pool.

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[48] If the presumption does not apply, and UPS actually intended to claim that total piece handlings, in the sense of the sum of all piece handlings in the system, were assumed to be proportional to all RPW volume in the system, then the claim is demonstrably untrue, as discussed below.

Therefore, even within a given year, witness Degen's distribution methodology <u>does *not* assume</u>:

- that a systemwide increase in total RPW volume of x percent will cause a systemwide increase in TPH (across all cost pools, across all facilities) of x percent;
- that a systemwide increase in total RPW volume of x percent will cause an increase in TPH in any cost pool (across all facilities) of x percent;
- that a systemwide increase in total RPW volume of x percent will cause an increase in TPH in any facility (across all cost pools) of x percent;
- that an increase in RPW volume of any particular subclass of x percent will cause a systemwide increase in TPH (across all cost pools, across all facilities) of x percent;
- that an increase in RPW volume of any particular subclass of x percent will cause an increase in TPH in any cost pool (across all facilities) of x percent; or
- that an increase in RPW volume of any particular subclass of x percent will cause an increase in TPH in any facility (across all cost pools) of x percent.

Instead, the only consequence of the proportionality assumption incorporated into Mr. Degen's methodology is that, within a particular cost pool, if RPW volume for a subclass increases by x percent, TPH for that subclass in that cost pool is implicitly assumed to also increase by x percent. Of course, the actual TPH level for that subclass in that cost pool (represented by the total proportion of time within that cost pool devoted to handling that subclass) is not assumed, but is derived empirically from IOCS data for the year, as explained above.

Therefore, although the claim made by UPS is true in a very narrow and limited sense, this in no way somehow "undercuts the Postal Service's total mail processing volume variable cost measurement," as UPS asserts further along in footnote 15. The assumption, on its face, is reasonable. There is no particular reason to believe that, within a given year, additional pieces of subclass volume would have any different characteristics which would for some reason require more or less handlings per piece, in a specific activity, than the existing pieces of subclass volume. Moreover, as witness Degen explains, this so-called "proportionality assumption" is generally part of any application of the "volume variability/ distribution key" method. Tr. 12/6699-6601. It is, therefore, the exact same assumption which has been implicitly applied for years under the previous methodology for distributing mail processing cost. Tr. 12/6601.

UPS appears to ignore not only that the "proportionality" assumption is neither new nor unique to the proposed methodology, but also that the fundamental importance of the assumption relates only to the *interpretation* of the distributed volume variable costs -- the assumption is required to equate volume variable costs with economic marginal costs. *Id.* If the assumption were not true, the volume variable costs would still be the volume variable costs; they just would not necessarily be economic marginal costs. Since UPS elsewhere argues vehemently (albeit incorrectly) that economic marginal costs are not "the relevant costs for attribution purposes" (UPS Brief at 32), it is ironic that UPS would attempt to hang so much importance on the "proportionality" assumption.[49]

Thus, the statement of Dr. Neels from Tr. 28/15598 quoted by UPS ("using [total piece handlings] as a proxy for volume can easily lead to erroneous conclusions regarding the volume variability of costs") is wrong any way you look at it. First, the Postal Service does not use TPH as a proxy for volume, so the premise of the entire statement is misplaced. Second, if by "volume variability of costs" Dr. Neels intended to refer to the final product of the two-part variability/ distribution analysis, his statement is incorrect because, as explained above, whether or not the result of the proposed methodology is correct economic marginal costs, it certainly will provide the correct estimate of volume variable costs. Third, if by "volume variability of costs" Dr. Neels intended to refer only to the variability analysis conducted by Dr. Bradley, Dr. Bradley himself explained in his own response to Item 5 of POIR No. 4 that his analysis does not depend on any assumptions regarding the relationship of the cost driver to mail volume. Tr. 11/5434-35.

To summarize, UPS is in error to allege that Mr. Degen did not do any empirical investigation of the relationship between the cost driver and volume. The

[49] By the same token, however, the proportionality assumption is just as necessary to derive economic incremental costs as it is to derive economic marginal costs, because of the inextricable link in the methodologies for their estimation, described by witness Takis at page 16 of USPS-T-41. See also Tr. 34/18291-92 (Christensen). Thus, if the goal is to be able to interpret certain costs produced using the framework of the "volume variable/distribution key" method as incremental costs, as UPS apparently wishes to be able to do, then the proportionality assumption is equally as important in that context as it is in the context of the Postal Service's application of the new methodology to produce marginal (as well as incremental) costs.

IOCS provides the "empirical" portion of his analysis. Of course, if one digs deeply enough, behind virtually any empirical analysis of any complexity there must be some foundational assumptions. Mr. Degen clearly stated that there is one assumption required by his methodology (as well as by the previous mail processing distribution methodology) in order to be able to interpret the resulting subclass unit volume variable costs as economic marginal costs. That "proportionality" assumption is the very reasonable one that within the same year, *additional* pieces of a particular subclass within a given cost pool are assumed to generate, per piece, the same number of TPH in that cost pool as the "typical" piece of the *existing* volume of that subclass in that cost pool. The validity of this assumption, however, has no bearing on the validity of Dr. Bradley's econometric estimates of the variability of mail processing cost pool costs with respect to the cost driver.

d. Periodicals intervenors pay lip service to consistency between the variabilities and distribution keys, but their efforts are undermined by questionable use of the tally data for cost distributions.

The Periodicals intervenors argue that there is a "necessary link" between the testimonies of Prof. Bradley and Mr. Degen, and that Mr. Degen's "premise of distributing volume-variable costs by operating cost pools" is "reasonable." Joint Periodicals Brief at 3-4. On these points the Postal Service and the Periodicals intervenors are in complete agreement. However, the record does not support the contention that the alternative presented by Ms. Cohen and Mr. Stralberg is merely a "modification" of the Degen method that, by tinkering with cost distribution assumptions "use[s] all available information on cost causality" without breaking the link with the variabilities. *Id.*

At the heart of the Periodicals intervenors' conceptual lapse is their self-deconstructing belief that there are volume-variable costs "for which no proof of causality exists." Since the volume-variable costs are by definition the portion of a cost pool's costs that are causally related to the identified cost driver, causality immediately follows from the very fact that the volume-variable costs are "volume-variable." The "proof of causality" is the relationship of costs to the cost driver.

As Dr. Christensen showed, once the cost driver has been established, the only relevant issue for distribution of the pool of volume-variable costs is determining the subclass distribution of the cost driver. Tr. 34/18221-2. It is not important whether the volume-variable costs are direct, mixed, or not-handling costs. The direct, mixed, and not-handling volume-variable costs in each cost pool are caused by the same cost driver, so even if these categories could be broken out reliably and analyzed separately, each would necessarily receive the same cost distribution.

For the eleven MODS cost pools where Dr. Bradley uses the cost pool's TPH as cost driver, the volume-variable cost distribution goal is extremely simple: compute the best estimate of the subclass distribution of the TPH in that cost pool. There simply is no other volume-related cost driver. The manual ratio, which Degen is unjustifiably criticized for not incorporating in his analysis for the sorting operations (see Joint Periodicals Brief at 30), is not a measure of mail volume. The tallies of employees handling mail contain information on what kinds of mail were handled in the operation. The not-handling mail tallies, by definition, do not contain information on the types of mail being handled. So, Mr. Degen's method accordingly places the greatest reliance on the subclass distribution of the handling tallies. The real question is, what relevant information on the cost drivers (i.e., handlings) do witnesses Cohen and Stralberg think they are extracting from the not-handling tallies?

The Periodicals intervenors' inclination is to focus on certain subsets of not-handling tallies, such as not-handling tallies for employees in Express Mail areas, where the "precise" causal relationships are supposedly obvious. Joint Periodicals Brief at 13. The Cohen/Stralberg method suggests that, in such cases, the activity code of such tallies should override Mr. Degen's volume-variable cost distribution based on mail handlings in the cost pool. Tr. 28/13847-8. In doing so, they tend to ignore an implication of an otherwise important lesson that they convey in this proceeding: that the tally coding does not indicate causality. See, e.g., Tr. 28/14087-8. The analyst can tell what an employee was doing from the tally data, but not necessarily why the employee was doing it.

Consider the "not handling" activities of employees assigned to the MODS Express [Mail] cost pool. Assume further that the costs associated with those activities are volume-variable to some extent. The logic of the economic distribution approach described by Dr. Panzar and Dr. Christensen is clear. The volume-variable costs are presumed to be caused by the mail handlings (the cost driver) in the MODS Express cost pool. The IOCS tally data clearly show that handlings in the Express Mail areas are predominantly – but not exclusively – Express Mail handlings. See

USPS-T-12, Table 5, column "MODS Express." So, it is appropriate to distribute the volume-variable costs in a way that recognizes that the cost driver does not consist exclusively of Express Mail. The appropriate treatment of the non-volume-variable portion of this particular cost pool is the responsibility of Mr. Takis. There, we see that the incremental costs of Express Mail from the MODS Express cost pool total $70.4 million. USPS-T-41 at 28. Not by coincidence, this amount is the difference between the total MODS Express cost pool costs and the MODS Express volume-variable costs distributed to other subclasses. See USPS-T-12, Table 4 and Table 5. In other words, all MODS Express cost pool costs, except the volume-variable costs correctly assigned to other subclasses, are classified as incremental to Express Mail by witness Takis. USPS-T-41 at 25-28. This is exactly what both theory and common sense would dictate.[50]

At a more fundamental level, the Periodicals intervenors claim to be mystified by Mr. Degen's statement that he effectively ignores most of the not-handling tallies. Joint Periodicals Brief at 15. There are two senses in which his statement is true. The first sense is that the MODS cost pools are based on non-IOCS data; for the formation of the cost pools, the not-handling tallies are not ignored as such, but rather are not needed. The second sense is that Mr. Degen's goal is to determine the subclass distribution of handlings in the cost pools. In this case, the answer to

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[50] Mr. Takis' treatment of these costs in his incremental cost analysis is but one manifestation of the care with which the Postal Service attempted to integrate a complete and consistent costing proposal. Such coordination is one of many advantages to using a comprehensive economic framework, explained in this case by Prof. Panzar, to guide the costing exercise.

the 'mystery' lies in the mechanics of the pool-by-pool distribution of the not handling tallies on the handling total. The subclass distribution resulting from distributing the not handling tallies in proportion to the handling tallies (and combining the distributed handling and not handling tallies), and the subclass distribution resulting from handling tallies alone, are identical.[51]

The Periodicals intervenors insist that the distribution goal does not constrain the distributions to be carried out by cost pool. Joint Periodicals Brief at 3-4. This appears reasonable enough, but it completely glosses over the critical question of which observations from (say) manual letters are informative for the distribution of OCR volume-variable costs. Even though it is well-known that different sorting activities tend to handle different types of mail, witnesses Cohen and Stralberg insist that when it comes to mixed-mail, any existing operational knowledge must be nullified. In their method, a mixed-mail tally is presumed to be the same whether it is observed at a cancellation operation or at an automated sorting operation. As indicated by witness Degen in his rebuttal testimony, the effect of the Cohen/Stralberg approach is to induce biases in the mixed-mail distributions. USPS-RT-6 at 12-14. As Mr. Sellick correctly points out, admitting these biases also induces finger-crossing that the biases somehow cancel to produce an accurate final product. Tr. 36/19479. While the distribution method described by witness Degen may not necessarily make maximal use of the available information, Mr. Degen

[51] The distribution keys are not quite this simple, but this characterization has been accurate enough for discussion purposes.

clearly indicates that the thrust of his analysis is to eliminate bias in the distributions. USPS-RT-6 at 12-19. He shows that the efficiency loss relative to the LIOCATT system is small. *Id.*

e. The Postal Service's allied labor cost distributions are accurate. The suggestion that allied labor costs must be distributed across all cost pools overstates the support nature of those operations and would result in biased cost distributions.

In the case of the allied labor cost pools, where Dr. Bradley's variability regressions use several TPH variables as indirect measures of workload level, the Periodicals intervenors claim that costs must be distributed across cost pools. Joint Periodicals Brief at 29-30. In particular, Ms. Cohen and Mr. Stralberg take a particularly direct interpretation of Dr. Bradley's indirect workload measures, and Mr. Stralberg more specifically claims in his rebuttal testimony that the Postal Service over-distributes volume-variable costs in the allied operations to flats-heavy subclasses. Tr. 36/19227, 19282-3. As Dr. Christensen showed, Mr. Stralberg's argument is weak in several respects, particularly for not taking account of the fact that distribution workload is not the only component of allied labor workload. USPS-RT-7 at 10-11.

The simple and intuitive theory underlying the Postal Service's analysis of volume variability is that handlings of mail cause the costs in the associated cost pools. USPS-RT-7 at 5, 10-11. In the case of sorting operations, Dr. Bradley has available to him a direct measure of handlings -- i.e., piece handlings -- in the form of MODS TPH. For the allied operations, the basic concept is the same, though the handlings will be of items and containers as well as pieces of mail. However, data on these types of handlings are not available. Dr. Bradley thus employs measures of TPH in sorting activities as an indirect measure of the level of allied labor workload. Dr. Bradley's indirect workload measures are powerful because they have operational meaning: an important function of allied labor operations is to support piece sorting operations. USPS-T-14 at 18. But while they provide a basis for accurate estimation of variabilities -- as long as changes in the indirect workload measures reflect changes in the unobserved actual workload measures -- they cannot fully account for workload composition. This is because the indirect workload measures cannot be used to identify the portions of allied labor workload that bypasses piece sorting. USPS-RT-7 at 10-11. Mr. Degen does not need to use of indirect measures of handlings for distribution purposes, since the IOCS contains data with which handlings of items and containers can be reliably associated with subclasses of mail.

Ironically, a centerpiece of Mr. Stralberg's claims of bias in mail processing costs has been the fact that some of the mail (the highly presorted part, specifically) bypasses piece sorting operations and, to the extent it is handled, it is handled in allied labor operations. Tr. 26/13916. According to Mr. Stralberg's own story, Periodicals and Standard (A) bulk flats make up a large portion of this mail stream. Tr. 26/13846. An unbiased distribution key should combine the subclass distribution of the sorting-related allied workload (the letter-flat mix of which Mr. Stralberg accurately describes) and the more Periodicals-heavy and Standard (A)-heavy subclass distribution of the mail that bypasses sorting. Mr. Degen's allied labor cost distributions, unlike the alternatives based only on sorting operations suggested on rebuttal by Cohen and Stralberg, incorporate information on all mail handlings in the allied labor operations, and thus correctly account for the composition of the allied labor workload.

f. DMA's criticism of Mr. Degen's distribution keys, to the extent that it differs from that of the Periodicals intervenors, serves mainly to highlight the importance of integrating the cost distributions with Dr. Bradley's variability analysis.

In its brief, DMA alone advocates the continued use of the LIOCATT cost distribution system as approved by the Commission in Docket No. R94-1. DMA Brief at 11, 13. Many of DMA's arguments regarding Mr. Degen's assumptions, which stem largely from the witness Buc's testimony, closely follow arguments presented by the Periodicals intervenors. Also, the distribution assumptions of LIOCATT closely resemble those of the Cohen/Stralberg alternative. The extensive overlap of DMA's views with those of the Periodicals intervenors means that much of the Postal Service's evidence discrediting the Periodicals intervenors' presentation, described at length above and in the Postal Service's initial brief at III-89 to III-121, applies (often a fortiori) to DMA's as well.

Still, DMA's brief contains a number of arguments that merit individual attention. First, their criticism of Mr. Degen's distribution analysis, unlike that of the Periodicals intervenors, is virtually without reference to Dr. Bradley's variability work. DMA's efforts to find fault with Mr. Degen's distributions absent his method's causal underpinnings ultimately serve to highlight the essential role played by the variabilities. In addition, DMA raises a few old canards, including the effects on Mr. Degen's results of "misclocking," "tally reweighting," and the statistical reliability of the distributed volume-variable costs, that must be dispatched. *Id.* at 13.

i. DMA's conundrums regarding the propriety of Mr. Degen's cost distributions can only be adequately resolved through a theoretically and empirically sound variability analysis.

Straight from the blocks, DMA assails the Postal Service for having "performed no quantitative studies on the... causes of... not handling costs." DMA Brief at 11. Since DMA has somehow managed to miss the fundamental purpose of Dr. Bradley's analysis, the Postal Service mentions again that Dr. Bradley's econometric analysis studied the causes of all mail processing costs, including those that would be categorized as direct, mixed, and not-handing costs by a sampling system such as IOCS. USPS-T-14. That Dr. Bradley did not conduct a separate analysis of not-handling costs in no way invalidates the causal link between the volume-variable costs and their cost drivers.

DMA's contention that Mr. Degen is wrong to distribute costs within cost pools is also unfounded. DMA Brief at 12. The economic framework presented by Dr. Panzar and Dr. Christensen clearly indicates that distribution keys must be tailored to the cost driver specified for each cost pool. USPS-T-11 at 21-23, USPS-RT-7 at 5-11. Since the cost drivers are not identical for any two pools, the corresponding distribution keys will not be identical. Even the Periodicals intervenors, who otherwise are hardly enamored of Mr. Degen's analysis, correctly recognize that his underlying economic framework, including the distribution of volume-variable costs "by operating cost pools," is sound. Joint Periodicals Brief at 3.[52]

DMA's suggestion that evidence on the record exists showing "some not handling costs are not related solely to the mail handled in the same cost pool" (DMA Brief at 12) is correct in the sense that, in applying Dr. Bradley's variability results, Mr. Degen identifies costs in the vast majority of mail processing cost pools that are not volume-variable and therefore should not be distributed to any subclass to estimate volume-variable costs. However, as described above, correct interpretation of the cost drivers does not support the contention that there are volume-variable costs related to handling of mail of various subclasses in other cost pools.[53]

DMA's failure to grasp the linkage between Dr. Bradley and Mr. Degen is evident in the abundant references to Mr. Degen "distributing not handling costs" and "distributing mixed mail costs." See, e.g., DMA Brief at 17, 18. The Periodicals intervenors, for their part, correctly understand that Mr. Degen only distributes volume-variable mail processing costs. Joint Periodicals Brief at 28. The clarification is critical. Had Mr. Degen simply distributed to subclass all of the costs in a cost pool, as proposed by UPS and the OCA, his method would have indeed flown in the

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[52] DMA is also incorrect if its statements are to be interpreted to mean that Mr. Degen never uses cross-cost pool information in his distribution keys. As pointed out by Dr. Christensen, such a statement is an oversimplification of Mr. Degen's method. For cost pools where Dr. Bradley specifies a cross-pool causality pattern, Mr. Degen employs information from the appropriate set of cost pools to form the distribution keys. USPS-RT-7 at 3-4.

[53] The exception, again, is for mail processing support operations.

face of extensive evidence that there are costs that should not be distributed at all. However, as explained above, what makes the volume-variable costs "volume-variable" is their causal connection to the cost driver, as demonstrated empirically in Dr. Bradley's econometric results. There is no causality shortfall for any costs empirically identified as volume-variable costs.[54]

ii. "Misclocking" does not materially affect the reliability of Mr. Degen's distribution keys.

DMA contends that Mr. Degen's distribution method is flawed because "misclocking" can result in a mismatch between the sampled activity of an employee tallied in IOCS and the employee's clocked-in activity. DMA Brief at 29-30. The only data DMA cite to is a spreadsheet filed by the Postal Service, DMA-17.xls, which they claim shows "inappropriate tallies" in certain operations, such as flat tallies in letter operations. *Id.*

DMA gravely misinterprets these data. The "inappropriate tallies" according to their definition appear even when the definition of the mail processing operation is based on the employee's sampled operation from IOCS question 19. Tr. 26/14139.[55] In fact, DMA's witness Buc effectively disavowed the type of argument

[54] This is not to say that all possible variability analyses are created equal. The old Postal Service assumptions may have identified all costs as volume-variable, making the distribution problem look simple after a fashion. But the fact that all the cost drivers were implicit makes it inherently difficult under such a system to figure out precisely which cost drivers drive which costs.

[55] Claims by Ms. Cohen and Mr. Buc that they were unable to confirm the data at Tr. 26/14139 are somewhat disingenuous. Tr. 26/14140, Tr. 28/15416. Both had access to (and, in fact, utilized) SAS programs that could query the IOCS tally file and "roll up" tally costs. See MPA-LR-1 and DMA-LR-2.

now made on brief by DMA. Tr. 28/15415.

DMA incorrectly asserts that "misclocking"-type phenomena do not affect the LIOCATT system. DMA Brief at 29. No one with detailed knowledge of the coding rules for "basic function" -- the main concept of mail processing operation in LIOCATT -- could make such a statement. USPS-RT-6 at 9-10. Instructions for coding basic function indicate that data collectors are to code the "predominant" basic function of an operation. So, if incoming and outgoing mail are being processed simultaneously, it is possible that outgoing mail could be assigned to the incoming basic function or vice versa. Tr. 26/13985. IOCS tally data indicate that there is considerable concurrency of processing in all basic functions, so this is not an academic concern. Mr. Stralberg conceded that basic functions are impure in essentially the same way as the MODS cost pools. *Id.* Mr. Degen's stated goal is merely to maintain consistency between the tally sets used to form distribution keys and the cost pools. USPS-T-12 at 6-7. The fact that the MODS cost pools are not perfectly "pure" does not imply that this approach is inappropriate, especially insofar as all other available cost classifications have similar, if not worse, "impurities."

iii. DMA's so-called "tally reweighting problem" is actually a problem for the LIOCATT system. Remedying the problem requires some form of Mr. Degen's cost pools.

Much as they are alone in advocating the continued use of LIOCATT, DMA also stands alone in opposition to the use of data from Postal Service accounting systems, claiming that the resulting "tally reweighting" is flawed. DMA Brief at 30. The "tally reweighting" issue as presented by DMA, in its entirety, a manifestation of DMA's fundamental misunderstanding of the IOCS system and, more specifically, of the meaning of the cost weights assigned to tallies. Specifically, Mr. Buc erroneously conflates the design of the IOCS time sampling system with the mechanical process by which labor costs are allocated to tallies. Tr. 28/15406.

The "reweighting" issue, in fact, is merely a reflection of the fact that distributing the volume-variable cost pool costs using a distribution key based on IOCS tally proportions is mathematically equivalent to "reweighting" the tally costs. It is something of a misnomer to say that Mr. Degen "must" reweight the tallies, as do DMA in their Brief at 31, since the proportions are all Mr. Degen is really interested in for distribution purposes, and the proportions are obviously unaffected by the reweighting. Really, "reweighting" is a non-issue for the Postal Service's cost system. However, evidence on the record shows that "reweighting" indicates a serious problem for a system, such as LIOCATT, that derives cost estimates directly from the tally cost weight recorded in IOCS field F9250.

Some background is in order to frame the problem. The sampling part of the IOCS system produces a random sample of work activities in each of several sampling strata, based on Cost Ascertainment Group (CAG)[56], for each of several employee crafts, including clerks and mailhandlers. USPS-ST-47, Exhibit USPS-47A. The basic idea is, if there are N tallies in a craft/stratum combination (or just "stratum"

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[56] CAG A is further divided into additional sampling strata.

for short), each tally represents 1/N of the work time for that stratum.[57]

The main purpose of IOCS has, of course, been to estimate the costs associated with the time spent at various activities. To facilitate such calculations, as part of the post-sample tally processing, a tally cost weight is computed for each tally. This tally cost weight is calculated as follows. If the wage costs for a stratum is $X, then each tally in that stratum receives a cost weight of $X/N. This assumes that each unit of time within a stratum represents the same amount of cost. Tr. 28/15404. While it is reasonable to control the cost of the tallies in a stratum to the costs recorded in the Postal Service accounting system for the stratum, in no way does the tally cost weighting system interact with the sample design, as suggested by Mr. Buc. Tr. 28/15406. In fact, the SAS field descriptor for the tally cost weight, F9250, indicates that the tally cost weight was introduced to the tally file in FY 1992, long after the IOCS system was developed. See Tr. 36/19243-4.

A deficiency of the tally cost weight, which is rectified by using data from the Postal Service's accounting systems (the Pay Data System and MODS) is that the assumption that each unit of time in a stratum represents the same amount of cost is demonstrably false. As Mr. Degen explained, "[t]he cost associated with a unit [of] time for a full-time clerk at a CAG A office keying at an LSM or FSM (LDC 12) is higher than the cost associated with a full-time clerk at a CAG A office operating an OCR or BCS." Tr. 17/8137-8. This has major implications for the measurement of

[57] In actuality, not all tallies represent the same amount of labor time because certain activities are sampled at higher rates. This is properly accounted for in all of the actual tally processing.

the total cost of an operation -- say, mechanized flat sorting -- using IOCS tally cost information alone. The tally costs for observations of mechanized flat sorting will understate the true costs of the operation, because the tally costs improperly assume a unit of time spent in this operation costs the same as any other unit of time. Conversely, the costs of lower-wage operations will tend to be overstated. *Id.* DMA denies that data provided by Mr. Degen displays this pattern (see DMA Brief at 31), but all they do is misidentify the high-wage LDC, which is actually LDC 12, and the low-wage LDC, which is actually LDC 11. See USPS-LR-H-348, spreadsheet NWRS.xls.

This leads directly to a source of bias in the LIOCATT system. Since LIOCATT costs are based on the tally cost weights, LIOCATT will tend to underestimate the costs of subclasses that receive the bulk of their processing in high-wage operations, and to overestimate the costs of subclasses that receive the bulk of their processing in low-wage operations. USPS-RT-6 at 19332-3.

Witness Buc's response to this issue does not square with the facts. While the stated design of IOCS is, as described in USPS-ST-47, Exhibit USPS-47A, to estimate the costs associated with time of various postal activities -- the multitude of uses to which IOCS has been put indicating that activities is meant in the most generic sense -- Mr. Buc says, in effect, that estimating the costs of "specific mail processing operations" is a pursuit outside the scope of the sample design of the IOCS. Tr. 28/15405. Mr. Buc is certainly entitled to his opinion, but it is not in accord with the longstanding use of the system.[58] The Postal Service contends, and parties with diverse interests such as UPS and the Periodicals intervenors agree, that accurate knowledge of the costs of specific operations is important, and that the method proposed by Mr. Degen is the best route there.

Finally, DMA tries to pin the differences between the MODS cost pool costs and the costs of the associated IOCS tallies largely on "misclocking" and sampling error. DMA Brief at 31. As mentioned above, there is no credible evidence that "misclocking" is a problem for associating IOCS tallies with cost pools. However, the other factor, sampling error is strictly a problem with estimating costs via a sampling system. In this case, the sampling system is IOCS. It is not credible to contend that differences between the Postal Service's mail processing cost pool amounts and the corresponding IOCS cost totals resulting from sampling error represent a flaw in the new system. Clearly, the ability to identify without sampling error quantities that were formerly known only with sampling error represents an improvement.

iv. Mr. Degen's bootstrap estimation of the standard errors of the distributed mail processing volume-variable costs puts to rest Mr. Buc's misleading partial analysis of the statistical properties of the distribution keys.

DMA refers to the "significant increase in the number of distributing sets" resulting in "statistically unreliable distribution keys" as a further reason to reject Mr. Degen's distribution keys. DMA Brief at 24-25. The basis for DMA's claim is a

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[58] The exchange at Tr. 278/15438-15444 indicates Mr. Buc's awareness of the semantic subtleties regarding the types of activities, operations, or "cost categories" IOCS is actually used.

detailed enumeration of Mr. Degen's distribution keys in Mr. Buc's testimony. Id. The number of distribution keys employed by Mr. Degen for mixed-mail item and container tallies is not a point of contention in this proceeding. This is because the number of distribution keys is not, in itself, a matter for concern, as Mr. Buc agrees. Tr. 28/15469-70.

Incredibly, DMA is aware of Mr. Degen's coefficients of variation (CVs) for his distributed volume-variable cost estimates, and responds with the strained contention that Mr. Degen's analysis somehow missed the point by not considering the CVs of an intermediate product, the mixed-mail distributions. DMA Brief at 26 (footnote 17). When asked whether he had computed CVs of the mixed-mail distribution key entries or the final distributed costs, Mr. Buc candidly admitted he had not. Tr. 28/15417. Mr. Degen recognized the statistical allegations swirling about the distribution keys as a result of Mr. Buc's and Ms. Cohen's partial analyses and responded with a definitive answer as to the statistical properties of his final distributed volume-variable cost estimates. USPS-RT-6 at 17-19. No other data purporting to address the statistical reliability of Mr. Degen's results is relevant.

g. Past Periodicals cost increases are of minimal relevance for an evaluation of the Postal Service's current mail processing cost analysis.

The initial brief of the Periodicals intervenors devotes over half of its text to discussion of the rate of increase in Periodicals costs. That measured Periodicals costs have increased since FY 1986 is not in dispute. However, the Periodicals intervenors have inflated the Periodicals cost increase into a broad-based indictment not only of the previous Postal Service method, under which the past cost increases were actually recorded, but also of the Postal Service's substantially new mail processing cost distribution method presented by witness Degen. The core of their argument is that the Periodicals cost increases are "excessive and unexplained," the cost increases stem primarily from the cost system's treatment of "mixed-mail" and "not-handling" costs, and the Postal Service "pretend[s] the problem does not exist." They further imply the Postal Service's mail processing variable costs are computed in an unfair and inequitable way. Joint Periodicals Brief at 2.

The record in this proceeding shows that these arguments, rather than shed light on the true nature of Periodicals costs, instead obscure the fact that the volume-variable cost estimates are not unreasonable on their face[59] and that their own preparation practices may be driving the allegedly inexplicable cost increases.

i. The Periodicals intervenors' depiction of the Periodicals cost increase exaggerates the alleged "problem."

In this proceeding, the Periodicals intervenors provide essentially the same picture of Periodicals cost increases presented by witness Stralberg in Docket No. R94-1, only now using industry witnesses to bear the news. Joint Periodicals Brief at 5. In response, Mr. Degen has pointed out that the packaging of the cost increase data plays a significant role in the appearance of "out of control" Periodicals costs.

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[59] The Periodicals intervenors surely cannot contend that it is impossible for the marginal mail processing cost of a Regular Rate Periodicals piece to be 6.7 cents, as shown by witness Alexandrovich's BY 1996 CRA Exhibits USPS-5A, page 19, and USPS-5C, page 8.

USPS-RT-6 at 26-28.

The Periodicals intervenors are simply wrong to state that Mr. Degen -- even initially -- denies that mail processing cost increases for Periodicals exist. Joint Periodicals Brief at 9. Mr. Degen's rebuttal testimony clearly shows that the true story is more complicated than the Periodicals intervenors would have one believe, with mail processing costs for Periodicals rising relative to clerk and mailhandler wages during some periods and declining relative to wages in others. Mr. Degen also points out that, adjusting for wage inflation, Periodicals mail processing costs have been essentially flat over the time span of the past two rate cases. USPS-RT-6 at 26-28. The Periodicals intervenors do not dispute this (see Joint Periodicals Brief at 9), rather they choose to accentuate the negative. The graphs they provided as ABP-XE-1 and ABP-XE-2 only reinforce Mr. Degen's essential point that how one draws the pictures shades the conclusions one is invited to draw from them. Tr. 36/19422, 19427.

Finally, the Periodicals intervenors refer to Mr. Degen's "specious" comparison of wages and mail processing costs, without suggesting what is specious about it. Joint Periodicals Brief at 9. If they mean the choice of how to base the comparisons, they are wrong as explained above. If they mean Mr. Degen's construction of a wage index appropriate to Periodicals mail processing patterns, Mr. Degen's index is clearly superior, as it is obvious that Periodicals make essentially no use of remote encoding, and thus low labor costs in remote encoding centers do not affect Periodicals processing costs. USPS-RT-6 at 27.

ii. The mailing practices of Periodicals mailers may adversely affect Periodicals costs.

The Periodicals intervenors contend that Periodicals cost trends are inconsistent with the mail preparation efforts of the mailers. Joint Periodicals Brief at 17. Their argument hinges on the cost effects of drop shipping, palletization, prebarcoding, and presortation. *Id.* As the Periodicals intervenors are proud to point out, for good common sense reasons there is no disagreement that increases in any of these factors should reduce unit costs, other things equal. *Id.* at 18. The catch is, if other things are not equal, results may very well run counter to simple intuition.

The best example of this is the effects of palletization and presorting. Pallets should be cheaper to process than sacks (other things equal), and mail in more highly presorted packages should be cheaper to process than mail in less highly presorted packages (other things equal).[60] So why, the Periodicals intervenors ask, haven't our costs decreased? The answer provided by Mr. Degen is simply that neither palletization nor package presort level tells the whole story in itself: the presort level of containers (sacks or pallets) also plays an important role in determining how much processing this mail actually requires. See USPS-RT-6 at 28-33.

The Periodicals intervenors have tried to blunt Mr. Degen's evidence that pallet presort levels have decreased. See Joint Periodicals Brief at 10-11. Their

[60] The Periodicals mailers cannot overplay the package presortation argument, though. Billing determinants data show that carrier-route presortation of Periodicals is essentially unchanged since FY 1993. See USPS-LR-H-145; Docket No. R94-1, USPS-T-11, Workpaper I.D.

arguments are not especially strong: data presented by Time Warner on pallet presort profiles in 1991 and 1997 for several publications fails to show the levels of pallet usage in each year or to indicate the sack/pallet mix. See ABP-XE-4, Tr. 36/19451. Most importantly, this exhibit shows that, even for Time Warner's most widely circulated publications, nearly 90 percent of the palletized volume is on 3-digit pallets. *Id.*[61] Time Warner's own data, provided in response to USPS interrogatories, shows that the portion of their mail prepared in sacks has a finer container presort level than their palletized mail. Tr. 31/16826-35. This leads to Mr. Degen's real point. Under a sack-based system, much of the mail on Time Warner's 3-digit pallets would have to be prepared in carrier route or 5-digit sacks to qualify for the corresponding presort rates. USPS-RT-6 at 28. Other things equal, the bundles in more finely presorted containers require less handling (as bundles) than those in less finely presorted containers. *Id.* at 31. Thus, the bundles on 3-digit pallets require more handling as bundles than the bundles in 5-digit or especially carrier route sacks. The costs of this additional handling could readily offset or even overwhelm potential cost savings from other initiatives. *Id.* Even if Mr. Degen did not quantify the magnitude of this cost effect, its direction is clear.

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[61] Since Time Warner's 1997 pallet profile is roughly consistent with the 1996 mail characteristics survey data, it is also no surprise that the Periodicals intervenors make no representation as to whether Time Warner is at the leading or trailing edge of preparation practices. It is, further, disingenuous to assign motive to the Postal Service's objection to the eleventh-hour attempt to introduce 1993 pallet information from Time Warner into the record. The Postal Service filed timely interrogatories on Time Warner and other Periodicals intervenors requesting that data, the responses to which were, variously, objections and claims that the requested data did not exist.

The Periodicals mailers seem to regard Mr. Degen's straightforward and reasonable analysis as an affront of some sort.[62] But, as Mr. Degen points out, the cost of mailing includes the cost of postage and the cost of mail preparation, and it is the total cost of mailing that matters. USPS-RT-6 at 32. Thus, the proper objective of a profit-maximizing mailer might be to minimize total mailing costs, rather than just the cost of postage. It is not an adverse moral reflection on the preparation efforts of mailers to note that, if they can save more money through certain preparation practices than it costs them in increased postage, for them to do just that would not be inconsistent with good business practices.

Other preparation changes cited by the Periodicals intervenors would be expected to have middling effects on mail processing unit costs. Drop shipped mail, for instance, would indeed avoid some handling such as cross-docking in originating facilities, but their own witness, Mr. Stralberg, indicates that the cost per piece of handling mail that bypasses piece sorting is small. Tr. 36/19285. The cost reductions from drop-shipping should primarily stem from transportation cost savings, which are not germane to the mail processing analysis. Similarly, while prebarcoding should not increase sorting costs of Periodicals, the fact that Periodicals mail is highly presorted (at the package level) means that much piece sorting is being avoided in the first place. Not surprisingly, the Periodicals mailers do not attempt to

[62] In a footnote on page 10 of their brief, the Periodicals intervenors mistakenly allege that Mr. Degen's written response of March 24 fails to address so-called "carrier route" pallets. In fact, his response clearly indicates that Mr. Degen "did include 'carrier route' ... pallets in the numerator." Tr. 37/19906.

demonstrate or highlight the magnitude of these types of savings.

3. ANM's repeated denouncement of the Postal Service's volume and cost systems does not create the problem it alleges.

a. ANM charges of Postal Service "stonewalling" are contradicted by manner in which it has sought information to support its theory.

Woven throughout its arguments regarding the alleged "mismatch" between the IOCS and RPW systems, ANM's Brief makes a number of insinuations alleging that their need to file the testimony of witness Haldi was the result of Postal Service suppression of information that could have satisfied their curiosity regarding the degree to which IOCS tallies failed to correspond to RPW volumes of Nonprofit Standard (A) mail. For instance, ANM explains that it undertook the survey described in witness Haldi's testimony "[i]n the absence of Postal Service data shedding light on" its concerns. ANM Brief at 20. ANM laments that "the Postal Service has refused to produce data quantifying the full extent of the problem," *id.*, and asks "What should Dr. Haldi have done in the wake of the Postal Service's stonewalling?" ANM Brief at 35. Finally, ANM admonishes that "[w]hen a party with peculiar knowledge or control of information chooses not to produce it, it is appropriate to draw the inference that the information is adverse to the withholding party." ANM Brief at 36, citing 2 Wigmore on Evidence §§ 285-91 (Chadbourne Rev. 1979).

ANM's imputations are nothing but conspicuous and intentional misrepresentations of the belated discovery efforts surrounding its own eleventh-hour decision to develop and pursue Dr. Haldi's mismatch theory. In order to set the record straight, it may be enlightening to review ANM's procedural maneuvering in order to lend some context to its claims.

On July 10, 1997, the Postal Service filed the Request for a Recommended Decision that opened this Docket. With its Request, the Postal Service filed forty-two pieces of testimony, including the testimony of Bradley V. Pafford, USPS-T-1, who presented the Postal Service's RPW System, and the direct testimony of Carl G. Degen, USPS-T-12, who presented the Postal Service's IOCS. Discovery on the Postal Service's direct case was required to be completed on September 17, 1997.

On November 5, 1997, the Presiding Officer required the Postal Service to identify witnesses to sponsor portions of Library Reference USPS-H-89, which contained the documentation for the Postal Service's statistical systems, including the RPW and the IOCS. Presiding Officer's Ruling No. R97-1/56. The sections of Library Reference H-89 that concerned the RPW System were adopted as supplemental testimony by witness Pafford (USPS-ST-48); the material in Library Reference H-89 regarding the IOCS was adopted as supplemental testimony by witness Degen (USPS-ST-47). Discovery on the supplemental testimony was permitted until November 14, 1997. *Id.* at 2.

Witness Pafford was available for cross-examination at the Postal Rate Commission on October 16, 1997, regarding his direct testimony, and on December 2, 1997, regarding his supplemental testimony. Witness Degen was available for cross-examination on October 21, 1997, to respond to oral cross-examination regarding his direct testimony, and on December 4, 1997, regarding his supplemental testimony. ANM declined to conduct cross-examination, either orally or in writing, on witness Pafford, but directed interrogatories to and participated in oral cross-examination of witness Degen during each of his appearances at the Commission. In fact, during the December 4 hearing, counsel for ANM specifically asked witness Degen about the operations of the RPW and IOCS. Tr. 17/8192-97.[63]

On December 9, 1997, ANM filed a set of interrogatories about the RPW and IOCS.[64] The Postal Service objected to ANM/USPS-20-23 and 25-26, on the bases

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[63] In fact, the Postal Service objected at that hearing that the questions posed to witness Degen could have been asked during discovery on his direct testimony. Tr. 17/8194-95.

[64] Further Interrogatories of Alliance of Nonprofit Mailers to United States Postal Service (ANM/USPS-18 through 26). Specifically, Interrogatory ANM/USPS-20 asked the volume, in pieces and pounds of "mail prepared for entry at Standard A (formerly third-class) nonprofit rates were in fact entered at commercial rates . . . because the Postal Service determined, before or during entry of the mail, that it did not qualify for Standard A (or third-class) nonprofit rates" for three separate time periods. Interrogatory ANM/USPS-21 asked the Postal Service to indicate "how many mailings, pieces and pounds of mail originally entered at Standard A (formerly third-class) nonprofit rates later generated back postage payments to the Postal Service . . . after the Postal Service found that the mail was ineligible for commercial rates" for the same time periods.

Interrogatory ANM/USPS-22 asked the Postal Service to provide all Postal Service publications and regulations concerning "the accounting treatment (in RPW and elsewhere) of mail" described in questions ANM/USPS-20 and -21. ANM/USPS-23 asked the Postal Service to describe the instructions provided to statistical data collectors regarding the identification, for IOCS purposes, of pieces marked as Standard A nonprofit mail, but which were actually entered at another rate.

ANM/USPS-25 asked about revisions made to mailing statements in instances where Standard A mail was entered at nonprofit rates "but [which were] later assessed additional postage under another rate class or subclass." ANM/USPS-26 sought similar information regarding mailings that were not accepted by the Postal Service for mailing at nonprofit rates.

of timeliness and burden.[65] ANM moved to compel responses to the interrogatories, and additionally asked that it be permitted to file supplemental testimony two weeks after the Postal Service provided a response to the questions.[66] In its Motion to Compel, ANM also claimed, for the first time, that its discovery should be permitted under Rule 2.E. of the Commission's Special Rules of Practice, and that it had proposed a technical conference as a means for alleviating some of the Postal Service's burden that would be incurred in responding to the discovery.[67]

The Presiding Officer ruled that, while ANM's discovery was "arguably supported, rather than precluded, by Special Rule 2.E.," ANM's delay in posing its discovery requests, coupled with the burden that would be involved in providing responses to its interrogatories, argued against requiring the Postal Service to provide the responses.[68] The Presiding Officer noted:

> the essence of due process is "a reasonable opportunity to ask relevant questions and get responsive answers." P.O. Ruling R97-1/69 at 3. All parties are therefore obligated to make a reasonable effort to focus discovery requests, submit them in a timely fashion and accordingly respond to complying submissions, particularly in light of the compressed schedule.

Id. at 7. He specifically held that responding to interrogatories ANM/USPS-20-21

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[65] Objection of United States Postal Service to Interrogatories of the Alliance of Nonprofit Mailers (ANM/USPS-20-23, and 25-26), December 19, 1997.

[66] Motion of the Alliance of Nonprofit Mailers to Compel Answers to Interrogatories and for Permission to File Supplemental Testimony within Two Weeks of Receipt of Answers from the USPS, December 22, 1997.

[67] ANM Motion to Compel at 6.

[68] Presiding Officer's Ruling No. R97-1/86.

and 25-26 would require extensive investigation by the Postal Service, which was not warranted, particularly in light of his finding that the questions "should have been submitted during discovery on the Postal Service's direct case." *Id.* at 8.

The Presiding Officer granted ANM's motion with respect to two of the discovery requests, ANM/USPS-22-23, provided that the Postal Service was permitted to limit the scope of its inquiry and response to nationally-applicable information and headquarters personnel. *Id.* at 9. ANM appealed this ruling, relying on a new argument: namely, that its delay in filing the subject interrogatories was the fault of the *Postal Service.* ANM raised, as a explanation for its tardiness, its contention that

> the Postal Service had submitted voluminous supplemental testimony, much of it in the form of enormous Library References, as well as massive and repeated errata, well into the month of December -- more than five months after the Service's direct case was required to be filed. The burden of reviewing and analyzing these supplemental filings was compounded by the Postal Service's failure to comply with the workpaper requirements of subsection 54(o), which requires a road map to the data and citations sufficient to enable a reviewer to trace any number used but not derived in the associated testimony and exhibits. Under the circumstances, the timing of ANM's discovery efforts was more than reasonable.[69]

This reference was to the challenge ANM had made, along with several other participants, to the longstanding practice of designating certain studies and data as

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[69] Appeal of the Alliance of Nonprofit Mailers from Presiding Officer's Ruling No. R97-1/86 (January 16, 1998) ("ANM Appeal".) True to form, ANM's appeal was filed seven days after the Ruling for which it sought review, which was two days after the deadline for appeals specified in Rule 32(b)(2) of the Commission's rules of Practice. 39 U.S.C. § 3002(b)(2).

library references without formally moving them in their entirety into the evidentiary record.[70] As the Postal Service pointed out in its response to ANM's appeal,[71] however, the glaring flaw in ANM's claim was that the information about which ANM belatedly sought to inquire had not been subject to ANM's earlier quarrel regarding the Postal Service's library references. The testimony describing the RPW system and the IOCS never appeared in the form of "voluminous supplemental testimony," as maintained by ANM's appeal.[72] It was not the subject of "massive and repeated errata." *Id.* The direct and supplemental testimony concerning the Postal Service's data systems consisted of straightforward explanation and documentation of the systems' designs and operations; it was not subject to "the workpaper requirements of subsection 54(o) [of the Commission's Rules of Practice], which requires a road map to the data and citations sufficient to enable a reviewer to trace any number used but not derived in the associated testimony and exhibits." *Id.* In short, the RPW and IOCS testimony at which ANM launched its December 9 discovery was virtually the identical presentation made by the Postal Service on July 10, 1997. None of the procedural fights that occupied ANM in the early parts of the proceeding would have prevented it from fully understanding and conducting discovery on the data systems testimony.

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[70] This dispute, and the Commission's resolution of it, was discussed in the Procedural History section of the Postal Service's initial brief, at iii-iv.

[71] Response of the United States Postal Service to Appeal of the Alliance of Nonprofit Mailers from Presiding Officer's Ruling No. R97-1/86 (January 28, 1998).

[72] ANM Appeal at 5.

ANM's appeal also attempted to fashion a new rationale for untimeliness of its discovery, by describing the theory of its witness, Dr. John Haldi, ANM-T-1, for the cost behavior of nonprofit Standard (A) mail. The appeal included the innovative argument that, because the Postal Service had not divined ANM's theory and incorporated it into Postal Service witnesses' discovery responses earlier in the proceeding, the Postal Service must therefore be suppressing information and affirmatively forestalling ANM's discovery formulation. *Id.* at 6-7.

The Commission did not agree with this maneuvering, and affirmed Presiding Officer's Ruling No. R97-1/86, agreeing that, in establishing the 10-month deadline for the delivery of Commission recommended decisions on Requests for Recommended Decisions,

> Congress clearly and intentionally chose prompt decisions . . . in preference to extended inquiry which might or might not refine the accuracy of the data used to develop rates. In light of this clear Congressional preference, and in the absence of any indication that the ANM questions will generate usable, probative information, we will not disturb P.O. Ruling R97-1/86.

Commission Order No. 1207. Thus, rather than Postal Service "stonewalling", as ANM now alleges (and disappointingly, will likely continue to allege, should it be in any way unhappy with the outcome of this Docket), the inaccessibility of the information that it claims to seek is the result of its own lackadaisical methods in formulating and pursuing its litigation strategy.

b. ANM's criticisms of the Postal Service's survey are uninformed.

ANM conducted a survey of its mailers in order to support its "mismatch" theory. The Postal Service discussed its position on this survey, and of the conclusions that ANM's witness Haldi draws from it, both in the testimony of witness Leslie Schenk, USPS-RT-22, and in its Brief. Postal Service Brief at III-129-143. ANM's Brief includes some specific and misleading critiques of the survey conducted by witness Schenk, as well as a number of evident misstatements, quotations taken out of context, commentary by ANM which clearly demonstrates their lack of familiarity with acceptance procedures and general difficulty in interpreting forms, and unsubstantiated "facts." When all is said and done, ANM's brief fails to show that any sizable inconsistency between cost tallies and reported volumes exists.

Contrary to the assertion of ANM, the Postal Service did not dispute the possible existence of witness Haldi's "mismatch" problem; it does not agree that ANM has demonstrated the magnitude of the problem. Tr. 36/19609. Dr. Schenk's testimony utilizes the survey she conducted of thirty postal facilities as well as national databases and accounting procedures to show that the Postal Service's reported volume figures do not change when mail is retroactively disqualified for nonprofit rates (for example, because of the revenue investigations that witness Haldi cites in his testimony, Tr. 22/11808). Tr. 36/19602. Moreover, witness Schenk demonstrated in her testimony that the practice of reversals accounts for volumes and costs being mismatched for only a very small percentage of nonprofit mail. Tr. 36/19604. ANM has not disputed either of these findings.

The Postal Service's Brief described witness Schenk's survey. Postal Service Brief at III-139-42. She relied upon the informed estimates of acceptance unit personnel at these sites; the acceptance logs that were later obtained in response to the Presiding Officer's order at hearings on March 20, 1998, provided evidence that these estimates were indeed "informed," and therefore supported the findings of witness Schenk. Tr. 37/19996.[73]

[73] Of the ten sites that provided acceptance logs after witness Schenk's March 20 hearing, one site's logs (#28) did not have information on the disposition of the mailing for many entries, so its logs did not provide enough information to determine the volumes of disqualified nonprofit mailings. For the other sites, the log entries were examined, and the volumes of mail entered at regular rates with nonprofit indicia are given in the right-most column below.

Volumes entered at regular rates with nonprofit indicia

Site (survey number)	Estimates	Volumes from logs
1	4,077	4,077
4	25,010 ($1,720.31)	$2,248.
6	292,500	0 (returned all to mailer for correction)
8	37,500	0
10	195,000	131,707
13	0	0
16	9,600	0
22	0	One possible disqualification (for $21.46)
27	3,000	0 (problem mailings are returned to the mailer)

As this table shows, only two sites (#4 and #22) underestimated the volumes in question, and the difference was not significant. The remainder of the sites either estimated correctly, or overestimated the volumes in response to the survey. This information demonstrates that the estimates given by experienced Postal Service personnel, as was the case here, are indeed "informed" estimates.

i. Dr. Schenk gathered survey information from informed, reliable sources.

ANM's contention that witness Schenk's survey relies solely on the "unrefreshed recollections of busy Postal Service employees" is a deliberate mischaracterization of the manner in which she conducted the survey. First, the survey sought information from employees who had been working in acceptance units in FY96, whose job it is and had been to actually work with nonprofit and other bulk mailers. Tr. 37/19953, 19961, 19967, 19954, 19956. The survey was designed to commence with a series of filter questions (the very feature that ANM claimed was lacking, ANM Brief at 24), that were intended to assist in stimulating these employees' memories. Tr. 37/19964-65. Moreover, the time period, FY 1996, about which the employees were asked, was a memorable time for acceptance unit personnel, because of the Postal Service's introduction of Publication 417, which concerned new content restrictions applicable to nonprofit mailings. Tr. 37/19969. In addition, witness Schenk found that the instances of discrepancies within mailings tended to be particularly notable to acceptance unit employees, as they required the employees to undertake procedures that varied considerably from the routine of their jobs, such as conferring with their supervisor and/or contacting the mailer to clear up any discrepancy. Tr. 19933, 19957, 19968.

Generally, ANM's contention that witness Schenk's survey was devoid of filter questions merely belies its unfamiliarity with survey methodology. The types of questions ANM cites are just two examples of filter questions; questions 1-5 in Section A of the Postal Service's survey form were written to filter out whether the contact at each site would be able to make informed estimates. Although Dr. Schenk repeatedly emphasized this point during her questioning by counsel for ANM, ANM evidently refused to accept it. Tr. 37/19964-65.

ANM cites an example where it contends that witness Schenk accepts a "don't know" response for inclusion in the survey. ANM Brief at 23. ANM's observation selectively ignores the remainder of witness Schenk's response, that after further probing, the respondent was able to recall information. Tr. 37/19961 (lines 22-25).

ii. The use of midpoints is sound.

Witness Schenk used the midpoint of the ranges of volumes provided in survey responses, to estimate the numbers of mailings in her survey. ANM argues that this method of estimation was arbitrary and improper. ANM Brief at 24. Additionally, ANM claims that she "simply overlooked the 250-piece minimum for entry of any mailing." *Id.*, fn 12. However, witness Schenk's determination that conservative estimates result from using the midpoint to develop volume estimates from the intervals given in the LRCA survey is supported by the characteristics of nonprofit mail reported in Library Reference H-195, as shown in the table below:

Distribution of Nonprofit Standard (A) Pieces Within Mailing Size
PFY 1996
(LR-H-195)

Mailing Size	Total Pieces (000's)	Total Transactions	Average Pieces per Transaction	Estimate Used in USPS-RT-22
0-500	396,944	1,312,708	302.39	250
500-1,000	396,876	563,623	704.15	750
1,000-5,000	1,448,631	665,806	2,175.76	2,500
5,000-1,0000	950,460	135,533	7,012.75	7,500
10,000-50,000	2,971,208	141,304	21,027.06	30,000
50,000-100,000	1,423,831	20,618	69,057.65	75,000
>100,000	3,213,201	14,248	225,519.46	500,000

In all cases except the 0-500 piece interval, the estimate used in USPS-RT-22 is higher than the average mailing size for that interval. For example, for the interval 5,000-10,000 pieces, the average pieces per transaction are 7,012.75, whereas the midpoint of that interval is 7,500. Note especially that the estimate for the average mailing size over 100,000 pieces used in USPS-RT-22 is almost twice as high as the average pieces per transaction for that range. From this, one can conclude that the use of the midpoint in deriving estimates of volumes sent at regular rates with nonprofit indicia leads to an overestimate in volumes for all intervals except 0-500 pieces.

If Dr. Schenk's minimum mailing size were adjusted to the 200 piece minimum for bulk Standard (A) mail,[74] the midpoint for the 0-500 mailing size range becomes 350,

[74] It should be noted that the minimum number of pieces per mailing specified by the DMM was 200 pieces FY96, not the 250 cited by ANM. See DMM 49, E330.

which is higher than the average number of pieces per transaction reported above of 302.39. Using this new midpoint will still result in an overestimate compared with using the average number of pieces per mailing, and will not appreciably impact witness Schenk's results.

iii. ANM overstates witness Schenk's survey's susceptibility to respondent bias.

ANM cites as a "major defect" in the Postal Service's study its concern that the survey suffers from respondent bias. ANM Brief at 26. ANM worries that because there was a chance that employees responding to the survey could know that the survey was being conducted by individuals who were somehow related to Postal Service Headquarters, they would be likely to underreport the degree to which they and their colleagues had accepted mail whose markings did not match the rates paid. *Id.* ANM's depiction of deceitful postal acceptance unit employees, cowering in the face of Dr. Schenk and her survey-administering colleagues, is not supported by the record or by actual experience.

Just as ANM contends that it conducted its survey "in a great hurry," Tr. 22/11894,[75] the Postal Service conducted its survey in the press of time required for writing rebuttal testimony. Tr. 37/19991, 20015. The inevitable references to Headquarters made in the initial contacts with the survey sites were necessary both to obtain prompt responses, Tr. 37/20013, and to ensure that the employees at the facilities

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[75] Of course, this time pressure was at least partially self-imposed, because of the tardiness with which ANM identified the possibility of exploring its "mismatch" hypothesis.

would feel free to share with the survey takers information regarding specific mailers (information generally considered to be not releasable). Tr. 37/20009-10. Dr. Schenk reported that the employees with whom she and her colleagues spoke showed no hesitation or fear of reprisal in working with them on the survey. Tr. 37/20011. In fact, most of the respondents volunteered that they did not know the reason why the survey was being done; their supervisors had simply requested that they cooperate fully with witness Schenk and her associates. Tr. 37/20014. Finally, other than to invoke "common sense", ANM is unable to support its portrayal of acceptance unit employees toiling in fear of the twin specters of the DMM and Postal Service Headquarters. It is more likely that acceptance unit personnel would see the "one-time accommodation" provided to nonprofit mailers as an extension of customer service; the fact that many respondents volunteered the information that they make such accommodations, Tr. 37/20004-05, 20007, indicates that they were not afraid to report it, in spite of whether ANM would consider that information to be "negative."

c. The Postal Service survey fully accounts for "voluntary mail."

ANM's initial brief crows that Dr. Schenk's analysis is weakened by a "complete failure . . . to investigate by far the most significant cause of the IOCS/RPW mismatch identified by Dr. Haldi: the *voluntary* entry of mail with nonprofit markings at commercial rates, without any attempt by the mailer to enter the mail at nonprofit rates, and without any action by the Postal Service to disqualify the mailing at such rates." ANM Initial Brief at 26-28. These claims are obviously untrue, and are contradicted by the record in this proceeding. They clearly ignore Dr. Schenk's responses to oral cross-examination concerning her survey. Witness Schenk distinctly, conclusively and repeatedly described how her survey took account of the mailings that ANM's counsel referred to as voluntarily entered at commercial rates but which bore nonprofit indicia, see, e.g. Tr. 37/19932-34, 19936, 19939, 19943, 19955-56, 19959, 19989-93; for ANM to now argue otherwise is clearly disingenuous.

ANM is correct in its oft-repeated observations, ANM Brief at 28-31, that the wording on the survey forms used for questioning survey respondents, and in witness Schenk's testimony, do not precisely specify and segregate mailings that are voluntarily entered with nonprofit markings at commercial rates. However, there are three reasons why this fact is not as damnable as ANM would have the Commission believe. First, the survey sheets were not supplied to the respondents for them to fill out; they were used by Dr. Schenk and her colleagues to question the respondents over the telephone. Tr. 37/19958-59, 19971, 19990-91. Moreover, the questions simply did not need to break out the mail that was voluntarily entered commercially; whether entered voluntarily at commercial rates with nonprofit indicia, or disqualified for nonprofit rates during acceptance, the end result is the same - the mail was sent at regular rates, with nonprofit indicia. *This* was the phenomenon that witness Schenk sought to measure with her survey. There is simply no distinction, as far as acceptance procedures are concerned. Tr. 37/19956-57. Finally, it is clear that the acceptance logs produced by witness Schenk, ANM-XE-2a-b, back up the estimates obtained by the survey, and indicate that these voluntary mailings were included. Tr. 37/20003.

During oral cross-examination of witness Schenk, counsel for ANM prefaced his questions by asking her to confirm that "the phenomenon of mailing nonprofit pieces at commercial rates is the most widespread phenomenon alleged by Dr. Haldi in his testimony." Tr. 37/19935. However, a review of Dr. Haldi's testimony reveals that he does not identify the voluntary entry of mail with nonprofit markings at commercial rates as the most significant cause of the IOCS/RPW mismatch. The volumes reported in ANM-Exhibit 1 (revised) show that 1,655,730 pieces were originally entered at commercial rates with nonprofit indicia, while 9,197,178 were disqualified retroactively. Tr. 22/11830. Of the total number of pieces reported by ANM's respondents with nonprofit indicia but paying regular rates (10,852,908 = 1,655,730+9,197,178), only 15.3 percent were voluntarily entered at commercial rates, thereby hardly qualifying as "the most significant cause" of witness Haldi's phenomenon.

Perhaps this confusion was created by ANM's misunderstanding of Dr. Haldi's testimony. The citation to the testimony upon which ANM's Brief relies for its position that voluntary mailings constituted the most significant contributor to the occurrence of mismatches, Tr. 22/11812, does not refer to the number of *mailings* at all, but rather to the number of *organizations* reporting mismatches. A review of the volumes paints a different picture, as is shown above.

Finally, it should be noted that ANM fashions an allegation out of whole cloth, "that voluntary entry is *encouraged* by USPS personnel at several cites where the survey reports little or no mismatched volume." ANM Brief at 32 (emphasis in original). This contention is not supported by any references to the evidentiary record. Similarly, ANM alleges, without reference to the record, that "*at [certain] sites . . . survey forms indicate* *that this practice is widespread.*" ANM Brief at 33 (emphasis in original).

d. ANM's characterization of witness Schenk as inexperienced with bulk mail entry procedures is ironic.

In its Brief, ANM dismisses witness Schenk and her colleagues as being uninitiated in the operation of nonprofit mail acceptance criteria. ANM Brief at 23. ANM evidently belittles the experience and background to which Dr. Schenk testified during oral cross-examination. Witness Schenk and her colleagues who conducted the survey on behalf of the Postal Service have performed a number of surveys in mail acceptance units, spending time at numerous postal facilities, interviewing employees and familiarizing themselves with the processes involved in mail acceptance. Tr. 37/19951. Each of the survey takers had spent several years working with the Postal Service and the type of information that was collected in the survey. *Id.* In fact, witness Schenk's firm was the originator of the Standard (A) Regular and Nonprofit Mail Characteristics Studies that were filed as Library References H-105 and H-195, respectively, by the Postal Service in this Docket.

Moreover, ANM's charges of inexperience are ironic, in that ANM's brief goes on to betray its own unfamiliarity with acceptance procedures. For instance, ANM postulates that witness Schenk's survey forms show that "instead of formally rejecting the mail, the postal employee will hold it until the mailer comes and fixes it," ANM Brief at 27 (quoting witness Schenk), indicating, in the collective mind of ANM, that these mailings would have been voluntarily entered with mismatched indicia rather than be disqualified. ANM Brief at 27. A plain reading of this citation clearly indicates, instead, that the mailing in question was *"fixed,"* and therefore *was not entered* at one rate bearing indicia that showed another rate was paid. Moreover, ANM's statement that the Postal Service had made accommodations to allow certain mailings to "go all the way through with a nonprofit marking even at commercial postage," ANM Brief at 27 (quoting counsel for ANM), is a circumstance that the Postal Service has not disputed; the Postal Service has stated and shown that the magnitudes of this phenomenon, as measured by witness Haldi's analysis, are biased upward. Tr. 36/19610.

e. The comparison of the IOCS/RPW "mismatch" with the R94-1 within-county programming error is not appropriate.

ANM's brief hints that the "mismatch" that it blames for nonprofit cost behavior in FY 1996 was also responsible for the high costs reported for within-county newspapers in Docket No. R94-1. ANM Brief at 19, fn. 8. This comparison is misplaced, and does not imply the pattern of problems insinuated by ANM. The R94-1 issue involved a programming error, which resulted in certain tallies being mistakenly identified as within-county mail. The issue about which ANM complains, is, by ANM's own admission, a problem that occurs in the manner in which volume information is recorded at the time that mailings are submitted. ANM Brief at 19. As such, it is much different in nature than the within-county issue.

In an evident effort to be inclusive, ANM also makes an unsubstantiated claim that there may be problems similar to its "mismatch" issue plaguing First-Class Mail. ANM Brief at 19, fn. 8. ANM's only support for this contention is the testimony of its own witness, which is similarly unsupported. See Tr. 22/11806, fn. 16.

f. ANM's estimate of the costs that should be shifted away from nonprofit Standard (A) mail are incorrect and unsupported.

To say that Witness Haldi's proposed adjustments should be accepted as the best evidence of record only disparages the state of the record. ANM asserts the superiority for its survey because it contends that it utilized information taken directly from "mailing statements or other contemporaneous business records", rather than the informed opinions of experienced Postal Service personnel. ANM Brief at 34. What is the support for this statement? ANM neglects to provide one. Interestingly, although ANM castigates the Postal Service for not accounting, on each survey instrument, for every conceivable distinction regarding mismatched rates and indicia, ANM Brief at 31, its own survey is downright mysterious about the source of its respondents' figures. Dr. Haldi does not explain the source in the description of the survey. Tr. 22/11811-11812. Nor is it stated on the forms themselves that the ANM survey's volume data are derived from mailing statements or business records. Tr. 22/11833-34. The instructions for the ANM survey neither instruct respondents to provide volumes from mailing statements, nor to provide supporting documentation. Tr. 22/11833. Of the 108 "responses" received, only eleven provide volume data that appears to be anything other than estimates (see, e.g., the number of survey results reporting volumes rounded to the hundreds); and ANM provides no reassurance that these are not simply guesswork. Twenty of ANM respondents *confessed* that they were estimating volumes.[76]

[76] For example, ANM survey responses numbered 24, 25, 41, 54, 65, 67, and 76 all used the term "approximately" in referring to volume figures, and response 33 noted that "This is my best estimate." ANM-LR-1.

ANM concedes that its sample is not representative, ANM Brief at 34, and does not (because it simply cannot) dispute the other criticisms of its survey that the Postal Service described in the testimony of witness Schenk and in its initial Brief (e.g., ANM's atrociously low response rate, the clear incentives that ANM members had to supply biased responses, and the misrecorded responses upon which Dr. Haldi made his conclusions).

As an example of the casual methodology that prevailed in the conduct of ANM's survey, ANM's explanations of the double-numbered responses that appear in its library reference are clearly contradicted by the library reference itself. See ANM Brief at 35, fn. 18. Neither the first explanation that ANM's counsel provided to counsel for the Postal Service (i.e., that these represented responses from firms that mailed at both commercial and nonprofit rates, Tr. 36/19658), nor their second explanation, offered by counsel for ANM during his cross-examination of witness Schenk (i.e., that the double numbering refers to mail entered bearing both commercial and nonprofit indicia, Tr. 36/19659), can be true, since a number of the surveys that bear only one identifying number reflect similar circumstances to each of the double-numbered responses.[77] Both of these explanations are easily refutable, leading one to wonder if anyone

[77] Library Reference ANM-LR-1 contains the following ANM survey forms bearing one or more response numbers, which reported mailings sent at both nonprofit and commercial rates: 2-4, 6-12, 14-17, 22, 25, 28, 30, 33, 37-41, 43-47, 49-51, 54, 60-64, 66-67, 71, 75-79, 81, 83, 87, 104-06. It also contains the following survey forms bearing one response number, but which report having entered mail with both regular and nonprofit *indicia*: 4, 12, 15-16, 23, 39, 45-47, 51, 62. Of those survey forms with two numbers, the forms numbered 18/19 and 55/56 indicated that they did *not* mail with both kinds of indicia, and respondents using forms numbered 58/59, 89/90, 92/93, 94/95, 97/98, 99/100, and 107/108 were never asked which indicia they used.

sponsoring ANM's survey really knows their own data. There is no reasonable explanation for using one form to represent two responses; the double-numbering would clearly have the effect of inflating ANM's response rate.

ANM protests that the Postal Service was "free to ask for clarification of items of this kind when Dr. Haldi was on the stand for cross examination." ANM Brief at 35, fn. 18. Perhaps the Postal Service could have *recalled* Dr. Haldi to respond to questions regarding the mysterious numbering of his survey responses; the library reference including the multi-numbered responses was filed on February 26, one week after Dr. Haldi took the stand to respond to oral cross-examination regarding his testimony. More importantly, ANM evidently misses the irony in its own statement; it claims that the Postal Service should have to rely upon further clarification in order to decipher Dr. Haldi's numbering of survey responses, a position that flies in the face of its own charges that it should not have to rely on Dr. Schenk's description of her own survey. Compare ANM Brief at 35, fn. 18, to ANM Brief at 30-31.

ANM offers the Commission two alternative methods for correcting for its "mismatch" phenomenon. ANM Brief at 20-21. First, it suggests that Dr. Haldi's "data support a reduction of 7.85 percent in the mail processing costs (including piggybacks) attributed to Standard (A) nonprofit mail." *Id.* The inappropriateness of this adjustment, based on ANM's survey, was fully addressed in the Postal Service's initial brief, at III-142-43. As an alternative, ANM advocates a limitation "in the Postal Service's proposed increase in unit attributable mail processing costs for nonprofit Standard (A) mail to the ratio of nonprofit and commercial unit attributable mail processing costs that has prevailed in recent years before FY1996." ANM Brief at 21. This analysis is brand new, having only appeared previously in ANM's trial brief. See Pretrial Brief of the Alliance of Nonprofit Mailers (February 10, 1998). Moreover, despite ANM's claim that its new calculation is a "straightforward exercise," ANM Brief at 21, fn. 10, it is evidently not so "straightforward" that its results may be accurately calculated, even by the party advocating it.

ANM derives from its alternative adjustment an "estimate" that Base Year unit Clerks and Mailhandlers cost for Standard (A) nonprofit mail should be 3.8 cents. ANM Brief at 22. According to the proposed methodology, this figure is the result "[l]imiting the Base Year Clerks and Mailhandlers costs for Standard (A) Nonprofit mail to 0.7115 times the unit cost for Standard (A) Regular mail." *Id.* However, 0.7115 (ANM's suggested ratio) multiplied by 0.0604 (the FY 1996 Unit Attributable Clerks and Mailhandlers Cost reported for Standard (A) Regular, ANM Brief at 21) yields 4.3 cents, not the 3.8 cents that ANM claims. ANM's suggested unit cost figure that *it* obtains from its new methodology is the result of 0.0604 multiplied by 0.6291, clearly a much smaller percentage than what ANM's brief shows.

The fact that ANM, the participant sponsoring this new methodology, does not obtain accurate results from its own proposal, merely illustrates the fallacy in sponsoring such analyses without testing on the record. The Commission should, accordingly, disregard this portion of ANM's Brief.

Finally, the judgement needed from the Commission is not which of any of ANM's proposed adjustments is the correct one to use, but rather that no problem has been demonstrated for which a remedy necessary. ANM has not demonstrated that the Postal Service's "attributable cost data . . . are corrupted with tallies from other subclasses," ANM Brief at 36, and Dr. Haldi's theory of IOCS/RPW mismatches may be prudently laid to rest.

g. The analysis that ANM provides in Attachment A to its brief is ill-timed and full of errors.

ANM includes, as Attachment A to its Brief, a catalogue of its criticisms regarding the acceptance log materials provided in response to the Presiding Officer's order at witness Schenk's March 20, 1998 hearing. This analysis demonstrates, first and foremost, ANM's difficulty with reading and understanding fairly straightforward documentation. It also betrays ANM's surprising lack of understanding of basic mailing information appearing on the acceptance logs. In addition, and more importantly, ANM had this information when witness Schenk was on the stand for oral cross on March 30, 1998, yet did not ask her any of the question it now poses as criticisms. In ANM's own words (where they falsely accuse the Postal Service of sandbagging Dr. Haldi's study), they have clearly "waited to criticize [her] methodology as unclear or unexplained until [she] was off the witness stand and no longer able to respond." ANM Brief at 35, fn. 18.

Most of the questions raised in Attachment A concerning the survey forms were not asked of witness Schenk during her March 30th appearance at the Postal Rate Commission, even though such questioning was the sole purpose of calling her back after the official end of oral cross. Clearly, ANM had ample opportunity to raise the concerns and questions it relegates to Attachment A with witness Schenk during oral cross-examination. Instead, ANM has chosen to obfuscate its brief with misstatements of fact. It is a logical conclusion that ANM preferred to make its Attachment A charges, rather than have the truth about the disqualification logs stated on the record.

The Postal Service responds generally below to the points that ANM raises in its Attachment A. This information mirrors that which would have been provided by witness Schenk during oral cross, which was the proper forum for this line of questioning. It should be noted that the information from the logs that refute ANM's claims in Attachment A are quite clear, and do not need an expert in acceptance practices to interpret. In addition, the Postal Service provides, as Attachment A to this Brief, a more detailed response to each of the site-specific allegations leveled by ANM in their Attachment A.

ANM regards with extraordinary skepticism sites that said they had no mailings sent at commercial rates with nonprofit indicia in FY96. Why is this so unbelievable? Even Dr. Haldi's Exhibit 1 indicates that there are some mailers who had no problems with depositing this mail. In addition, it does not speak well of nonprofit mailers (or of the informational efforts of ANM) that there must be so many mailers that are ignorant of the rules for nonprofit mailings that they would be as pervasive as claimed by ANM.

Mailers have strong incentives to prepare their mailings correctly (monetarily, so they do not have to pay regular rates, which are almost double nonprofit rates, as well as to receive timely service). Therefore, one would expect *a priori* that the rule, rather than the exception, would be for nonprofit mailings to be prepared correctly, with the proper contents and properly endorsed.

In several places in Attachment A, ANM implies that increased numbers of disqualifications naturally follow from increased scrutiny of nonprofit mail contents. ANM's "logic" here is that their hypothesis proves itself.

In analyzing the log entries, ANM never looked at the "disposition of mailing" column. Witness Schenk explained the importance of the information on mailing disposition. Tr.37/19973. Had ANM looked at that information, they would have discovered that most of the mailings they identified as being disqualified and mailed at regular rates were actually mailings that had been disqualified and returned to the mailer (and therefore never sent through at regular rates; returned to mailer is code "C" in that column). Witness Schenk addressed the distinction between mailings disqualified and sent through, and mailings returned to the mailer. Tr. 37/19977. The other disposition code ignored in ANM's Attachment A analysis was code "A," which indicates that the problem was corrected. Witness Schenk discussed this disposition of certain mailings. Tr. 37/19974.

ANM's logic in interpreting entries is faulty. On page 3, of Attachment A, for example, ANM states that the "fourteenth entry on page 0000138 uses Reason Code for Disqual. 11 in a case were [sic] there is 'advertisement in N.P.' This means [code] 11 is used to indicate a disqualification for nonprofit rates." This logic is used throughout ANM's analysis of Attachment A, but it fails to recognizes a major problem with the logic: if all code "11" entries were nonprofit mailings, then that would have been the description for this code on the form. Instead, a general description for code "11" is provided, with the obvious implication that the code is used for multiple purposes.

Given that code "11" is used for multiple purposes, the clerk recording mailings in the acceptance log had to include an explanatory note for some of the entries that had potential problems with nonprofit mailings, to clarify that this was the problem to focus on in subsequent discussions with the mailer. Obviously, codes 6, 8, and 11 especially are used for multiple purposes, and when the use of any of these codes relates to nonprofit mailings, an explanation to that effect is written in the notes section. Under ANM's reasoning, at least 3 of the 11 codes used for explanation of the potential problem with the mailing would be used exclusively to report nonprofit content problems. Certainly ANM is not implying that its members have so much difficulty in preparing their mailings, that they need three different codes to cover content-related problems?

The other general insight not made by ANM is that they did not recall that there was a rate change in 1995, and so entries noted as "wrong rates" indicate that the mailer was still using the old rates.

C. The Joint Parties' Critiques Of City Carrier Load Time And Rural Carrier Cost Distribution Are Erroneous And Must Be Disregarded.

On brief, the Joint Parties attempt to discredit various aspects of the Postal Service's treatment of city and rural carrier costs. As explained below, the bulk of their arguments are not only confused, incomplete or misguided, but also lack needed testing on the record. The Commission must disregard them, and utilize the approach advocated by the Postal Service.

1. The Joint Parties' critique of Mr. Baron's load time analysis continues to ignore key aspects of his testimony.

On pages 7 through 14 of their brief, the Joint Parties make a number of attacks on witness Baron's analysis of load time variability. When viewed in light of the entire evidence of record, these criticisms can be shown to lack persuasive force.

a. "Jensen's Inequality" invalidates witness Crowder's mathematical derivations of load time variability.

In response to Mr. Baron's observation that witness Crowder's mathematical derivation of load time contains a fundamental flaw, the Joint Parties now attempt to convert that flaw into a virtue. The flaw identified by witness Baron concerned the fact that Ms. Crowder's load time analysis depends critically on the equality of two expressions ("$E(g(x)) = g(E(x))$"), which are not, in fact, equal. The Joint Parties now concede this inequality, (which they refer to as "Jensen's Inequality") and point out that for load time, the direction of the inequality is known: $E(g(x)) < g(E(x))$, where, in witness Crowder's analysis, $E(g(x))$ is the average of load times over all stops, and $g(E(x))$ is the load time at the stop that receives the average volumes. Witness Baron agreed that this was in fact the case, because it is just this inequality which makes Ms. Crowder's derivations concerning load time incorrect.

The Joint Parties do not now dispute that Ms. Crowder's mathematics are flawed. Instead, they make much of the fact that Ms. Crowder's modeled load time analysis, if it has any validity, actually produces an overstatement of total load time. Joint Parties Brief at 9.

But this misses a key point of the Baron rebuttal to Ms. Crowder's approach. Merely to point out that one error in Ms. Crowder's *total* load time estimate runs in a particular direction does nothing to address Mr. Baron's fundamental concern with her analysis, which involves a system of derived equations used by Ms. Crowder to define and estimate system-wide *volume variable* load time. In Mr. Baron's rebuttal testimony, he focuses on the inequality between E(g(x)) and g(E(x)) solely for the purpose of demonstrating the invalidity of Ms. Crowder's mathematical derivation of her definition of this volume-variable load time. He shows that Ms. Crowder begins this derivation by assuming not that E(g(x)) < g(E(x)), but by assuming that E(g(x)) = g(E(x)). He demonstrates that this equality must hold in order for Ms. Crowder's equation defining aggregate system-wide accrued load time to hold. Next, he shows that Ms. Crowder derives her definition of volume-variable load time by differentiating both sides of her equation defining system-wide accrued load time. Thus, the fact that Ms. Crowder's assumed equality between E(g(x)) and G(E(x)) does not hold necessarily implies that Ms. Crowder's equation for accrued load time is invalid. This, in turn, guarantees that, because Ms. Crowder's equation defining volume-variable load time is derived from an invalid accrued load time equation, it too is incorrect. *See* Tr. 33/17735-39.

It is important to recall why the incorrectness of Ms. Crowder's derivation is critical. This derivation is purported to be Ms. Crowder's proof that volume-variable load time cost equals elemental load time cost (the product of accrued load and the aggregate elasticity with respect to volume) plus the product of the traditional concept of coverage-related load time (accrued minus elemental) and the stops elasticity. Thus, the derivation is offered as the sole proof that volume-variable load time really does include a coverage-related cost. Mr. Baron's demonstration that the proof fails is affirmation of his initial argument that there is no coverage-related element within properly measured volume-variable load time. It affirms as well his point that Ms. Crowder's definition of coverage-related load time as accrued load minus elemental load (which is the definition embedded in Ms. Crowder's definition of volume-variable load time) is really institutional cost. Finally, the fact that coverage-related load time is institutional cost validates Mr. Baron's decision not to include any portion of it in volume-variable cost.

b. The Joint Parties confuse the load time issues

The tendency of the Joint Parties to focus away from the fundamental issues extends beyond its discussion of Jensen's Inequality. They make much over the label used by Mr. Baron to describe what Ms. Crowder calls "fixed-time at stop" or "fixed-time at stop cost," alleging that Mr. Baron is confused. Joint Parties Brief at 9-10. But as Ms. Crowder herself concedes, whether the excess of STS-measured load time over LTV-modeled load time is called "access cost" rather than just "fixed time at stop cost" is not very important. *See* Tr. 34/18435. One can only wonder why this issue was briefed, if it is considered to be of "no consequence." *See* Joint Parties Brief at 10. The key point to be appreciated is that Ms. Crowder's own definition of accrued fixed-time at stop as time that varies only with stops coverage, is exactly the same as the definition of accrued access time. Furthermore, the stops elasticity she herself chooses to apply to her accrued fixed-time at stop measure is also exactly the stops elasticity that has always been applied to accrued access time. Thus, with respect to the two most critical components of the definition of fixed-time at stop, the measure of accrued fixed-time and the choice of elasticity to apply to it, access time and fixed-time at stop are unequivocally identical in Crowder's analysis. *See* Tr. 29/16198-200, Tables 1-3.[1] Thus, Ms. Crowder treats "fixed stop time" as if it were "access time" (which she acknowledges at Tr. 29/16253), and it was hardly unreasonable for Mr. Baron to do the same in describing her approach.

The Joint Parties also falsely allege that Mr. Baron is in some way confused on the issue of fixed time at stop. Joint Parties Brief at 10. The cited passages reveal no such confusion. Indeed, Mr. Baron's definition of fixed time at stop has been clear and consistent. He defines it as an interval of time at an actual stop that is fixed with respect to the volume and actual deliveries at that stop, and varies only with the number of actual stops. *See* USPS-T-17 at 9, 13; Tr. 10/5182; and Tr.

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1 Each of these tables provides witness Crowder's measure of "fixed stop time" accrued cost. Each table also derives volume-variable fixed stop cost through multiplication of this accrued cost by the same aggregate elasticity (from LR-H-138) of actual stops with respect to volume that the Postal Service applies to accrued access cost. *Id.* at note 4.

33/17747-48. Far from indicating confusion, the cited passages reveal that Mr. Baron has a justifiable concern regarding aspects of Ms. Crowder's analysis, especially insofar as it would treat LTV time as including fixed time at stop, or would treat model-based load time strictly as a function of volume. The Commission's attention is respectfully directed to the discussion of these issues in the Postal Service's initial brief, as well as the relevant portions of the transcript. *See, e.g.,* Tr. 29/16150. These sources present a consistent and substantially unrefuted interpretation of the load-time regressions (that is, the LTV model) as a set of equations that define "true load time as a function of volume and deliveries." As Mr. Baron explained in responding to NOI No. 3:

> [I]f instead, one views the dependent variable in the regressions as non-fixed time (i.e. pure load time) **plus** fixed-time at stop, then one must view the sum of the products of the slope coefficient estimates and corresponding right-hand-side variables as a valid measure of non-fixed time. This would, in turn, necessarily imply that the sum of the intercept plus relevant container and receptacle dummy variable coefficients equals a valid measure of the fixed time only. The problem, of course, is that for many combinations of container and receptacle types, this sum is negative. To prevent being forced to adopt such a negative estimate of fixed time at stop, one must view the dependent variable in the load-time regressions as strictly the pure load time – the time that **does** vary [only] as volume loaded changes.

Tr. 29/16150. *See also,* Tr. 10/5193-94. This logical demonstration of why modeled load-time must indeed be viewed as time that contains no fixed-time increment, and that varies only with volume loaded, not coverage, is totally ignored by both witness Crowder and the Joint Parties on brief. They are, of course, free to view modeled load-time as including fixed time at stop, if they insist on doing so. They are equally free to accept the negative estimates of fixed time that such a view compels. Mr.

Baron correctly chose not to adopt such an absurd position, and the Commission would be well-advised to follow suit.

The Joint Parties similarly fail to address, let alone refute, what Mr. Baron really said about coverage-related load time. As Mr. Baron has repeatedly shown, coverage-related load time, as traditionally measured, is the excess of accrued load time over the product of the aggregate elasticity with respect to volume and that accrued load time. He has shown that this excess, the so-called residual, is not a valid measure of fixed-time at stop simply because it is not fixed with respect to volume. Moreover, because the Commission's past decision to calculate volume-variable coverage-related load time as the product of accrued coverage-related load time and the stops elasticity is based on the erroneous interpretation of accrued load as fixed time at a stop, Mr. Baron showed that this measure of volume-variable coverage-load must also be rejected. USPS-T-17 at 34-37; Tr. 10/5191-92, 5218-20. Given these facts, the Commission should feel no qualms over finally applying to load time the well-established definition of the excess of accrued over volume variable as institutional. This interpretation would view the residual just like the comparable residuals found in dozens of cost components throughout the 20 Postal Service cost segments. Tr. 29/16160-65. *See also,* Tr. 10/5191-92.

c. The Commission should adhere to its prior inclusion of a deliveries effect in the load time model.

In its brief, the Joint Parties also seek to support witness Crowder's failure to estimate properly a deliveries effect variability of load time, by reiterating Ms. Crowder's belated claim that " the deliveries effect Baron tried to capture is already subsumed in the elemental variabilities." Joint Parties Brief at 12. But the mere fact that Ms. Crowder makes this claim does not adequately address the issue of the proper specification of the load time equation. As Mr. Baron demonstrated in his rebuttal testimony, Ms. Crowder's assertion that the deliveries effect is subsumed in the volume variabilities rests on two incorrect assumptions.

The first such assumption is that actual deliveries are appropriately defined solely as a function of volume, contrary to the established methodology which includes a separate coefficient to measure the deliveries effect. While it may be that the incorrect omission of an independent variable may force the remaining coefficients to reflect the impact of that variable, this is not a proof that the independent variable was properly excluded. At no point has Ms. Crowder, or any other witness, demonstrated that actual deliveries are *appropriately* defined solely as a function of volume. Instead, what Crowder appears to assert is that *if* actual deliveries are *erroneously* defined solely as a function of volume, the "b" coefficient will be forced to pick up the omitted possible deliveries effect, as well as the volume effect. In fact, as the Commission has recognized in prior cases, the correct specification of the equation for actual deliveries includes possible deliveries, as well as volume, as an explanatory variable. Thus, it has already been demonstrated that possible deliveries affects the number of actual deliveries, independent of volume.

The second incorrect assumption that Ms. Crowder repeatedly makes is that the time taken to deliver pieces of mail is a simple linear function of volume. As Mr. Baron has shown, Ms. Crowder requires that this assumption be correct in order to define time per piece at each delivery as a constant, p. Since the assumption is unfounded, her definition of time per piece as p must be rejected. *See* Tr. 33/17742. Neither the Joint Parties nor Ms. Crowder have presented any persuasive evidence why the Commission should abandon the established load time specification in favor of a linear approach without an explicit deliveries effect.

In summary, we urge the Commission to focus not on the unsubstantiated allegations of the Joint Parties Brief but on the arguments made by witness Baron in his initial testimony, which are affirmed in his interrogatory responses and his rebuttal testimony, and are summarized in his response to NOI No. 3. His arguments, which have largely been ignored by the Joint Parties and stand unrefuted, clearly establish that load time as presented in the Commission's regression models must be viewed strictly as time that is dependent on volume, and that contains no fixed time element. His testimony also establishes that the volume-variable portion of load time is simply the product of the aggregate elasticity of load time with respect to volume and accrued load time.

2. Witness Baron's rural carrier cost distributions, as proposed in his direct and rebuttal testimonies, are correct and should be used.

a. The Postal Service has provided the most appropriate and correct rural carrier cost distribution keys.

The Joint Parties have attacked the rural carrier cost distribution keys used by Postal Service witness Baron in two ways.[2] First, they claim that in using system

[2] Note that the Joint Parties' brief, for simplicity, refers to DPS and sector segment letters collectively as "DPS," unless the context requires separate identification of DPS and sector segment (See Joint Parties Brief at page 15, footnote

wide volume proportions from Docket Nos. MC95-1 and MC96-2, witness Baron has overstated DPS proportions on rural routes. *Id.* at 17-18. Second, they claim that the proportion of ECR and Periodicals DPS is understated within the total rural DPS volume used by witness Baron to distribute costs. *Id.* at 20. Upon examination, neither claim presents a serious challenge to Mr. Baron's proposed distribution methods or results.[3]

At first impression, the Joint Parties' observation that the use of "system wide" volume proportions could to overstatement of DPS proportions on rural routes would seem to identify a problem. However, there are substantial reasons to believe that the problem, if any, is not a significant one. First, it must be recognized that the difference in percentages which might have been used is not large. The "system wide" percentage used by Mr. Baron was 25.34 percent, only slightly higher than the rural delivery proportions "reflected in NMC data" which the Joint Parties appear to prefer.[4] *See* Joint Parties Brief at 19. Second, even if the lower percentage had been used, as Mr. Glick apparently suggests, the overall change in costs would have been relatively very small, amounting to a shift of about $4 million. *See* Tr. 28/15485. Third, as the Joint Parties recognize, the proportions used by Mr. Baron were test

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7). In the discussion that follows, the Postal Service adopts this convention as well.

3 In order to evaluate this issue, it must be clearly recognized that Mr. Baron revised his proposed distribution key in response to criticisms raised by MPA witness Glick. *See* Tr. 33/17754-56. It is this corrected distribution key that should be used by the Commission.

4 The percentage reflected in the Rural National Mail Counts data is approximately 22.48 percent. *See* LR-H-129 at I-5.

year 1995 figures derived from the recent reclassification dockets. These were the only figures available to Mr. Baron when the base year costs were being prepared for filing. As witness Moden has explained, however, DPS proportions have been growing since that time period. *See* USPS-T-4 at 8. Thus, the DPS "system wide" proportions for 1995 may not overstate the DPS proportion for rural routes in 1996, the base year for which the distribution key is used. Depending on the subsequent growth in DPS volumes on rural routes, some might contend that the proportion may actually be understated. As it is, witness Baron used the best available data, and his method has not been shown to be erroneous to any degree.

Finally, it is unclear exactly what approach the Joint Parties would recommend to correct the alleged problem. They do not explicitly endorse use of the rural percentage advocated by witness Glick.[5] Neither do they present an alternative percentage which they would contend is more accurate, other than to refer obliquely to "NMC data." Instead, they cite the last half of the final sentence of a footnote contained in witness Crowder's rebuttal to witness Donlan, which suggests, but does not propose, that one way to distribute DPS savings among subclasses would be to "simply sum all rural letter costs together and distribute them on the basis of total letters." *See* Joint Parties Brief at 20-21, Tr. 34/18342, n.1.

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[5] But these parties later say that witness Glick appropriately corrected the letter/flat percentages for each volume type. Joint Parties Brief at 21. If witness Glick supposedly made correct adjustments to the percentages for both letters and flats for each volume type, it is unclear why the Joint Parties would seek to construct a new extra-record adjustment based on a throw-away comment made by witness Crowder in a footnote.

Needless to say, no such analysis was presented on the record, and was not subjected to full adversarial testing. If witness Crowder believed an alternative approach to the distribution keys used by witness Baron was superior, she had every opportunity to present such an alternative in direct testimony, which would have been subject to discovery, cross-examination, and rebuttal. To bury such a speculative suggestion in a footnote to rebuttal testimony directed at witness Donlan does not serve the creation of a complete and reliable record, and the Commission should be wary of relying on such a suggestion, even if the Joint Parties do make much of it on brief.

Even if the footnoted suggestion were to be seriously considered, it is apparent that such an approach would only introduce new problems. It appears that Ms. Crowder is suggesting that the Commission should aggregate volumes so as to ignore the distinction between DPS and non-DPS rural letter costs. Such a procedure would ignore the substantial cost difference, based on different evaluation factors, that the Joint Parties otherwise acknowledge on page 19 of their brief. To ignore this cost difference would serve only to overstate the rural carriers letters-delivered costs of high DPS subclasses, and correspondingly understate rural carriers letters-delivered costs of low DPS subclasses such as Standard (A) ECR. Although this result might be desirable from the point of view of the Joint Parties, it would hardly make rural carrier cost distributions more accurate.

The second criticism directed by the Joint Parties at the distributions used by witness Baron is equally unavailing. The Joint Parties claim that Mr. Baron erroneously failed to move any carrier route pieces from the letters-delivered category to the DPS category in the base year. They further contend that Mr. Baron agreed that "both ECR letter automation mail and ECR letter non-automation mail are DPS processed, and that the volumes of such excluded DPS mail could be substantial." Joint Parties Brief at 20.[6]

This argument made by the Joint Parties is misleading, principally because it confuses the relevant time periods involved. The distribution keys at issue pertain to the base year, FY1996. What the Joint Parties imply, without substantiation, is that there were significant DPS carrier route volumes during that time period.[7] This assumption must be evaluated in light of the fact that prior to July 1, 1996 (about the middle of AP10 or 11 of FY96) there was no prebarcoded carrier route presort category in First-Class Mail or Standard (A). Given this fact, the Joint Parties have little basis to contend that significant DPS volumes existed but were excluded, or that Mr. Baron failed to make a needed adjustment.[8]

b. The Postal Service has presented the correct flats adjustment.

The Joint Parties also attempt to develop, on brief, an argument which would

6 The Joint Parties do not present any quantification of the supposedly excluded volumes.

7 While it is true that Mr. Baron confirmed that some carrier route mail goes through DPS sorting, it is clear that he was speaking about conditions as they were at the time of his appearance on the witness stand. *See* Tr. 33/17805-09.

8 It should also be noted that the Postal Service *did* apportion DPS savings (cost reductions) to carrier route presort automation letter mail for FY97 and FY98. *See* pages I-1, I-8 and I-9 of LR-H-129.

support the contention that the Postal Service's rural carrier flats distribution key is flawed and over-attributes costs to flats. Because the Joint Parties base their argument on a misreading of the record, however, their argument fails.

The crux of the Joint Parties' argument is that, ideally, the per piece "markup" -- the ratio of distributed cost to actual evaluated cost -- should be relatively equal across shapes.[9] They claim that MPA witness Glick has shown that the Postal Service's "markup" for non-DPS letters is 9.6 percent, and 15.3 percent for flats. Based on this disparity, the Joint Parties urge the Commission to adopt the flats adjustment advocated by witness Glick. Joint Parties Brief at 21-22.

Unfortunately for the Joint Parties, the evidence of record indicates that the 9.6 percent figure attributed to witness Baron does not flow from Mr. Baron's proposed correction to the distribution error detected by witness Glick. In fact, the 9.6 percent figure is solely the result of an analysis performed by *witness Glick*, an analysis which does not reflect Mr. Baron's proposed correction.[10] *See* Tr. 28/15495-96.

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9 On cross-examination, Mr. Baron confirmed that in an ideal world, it would be preferable if "in all ten variable evaluation factors or categories the ratio of distributed cost per piece to the allowance factor cost per piece would be the same, and the first would be higher than the second." Tr. 28/17827. He pointed out that the approach suggested by the Joint Parties, however, did not address all ten categories and that to do so would be a major undertaking whose potential advantages and negative consequences have not been explored to any degree in this case. Tr. 28/17828.

10 Mr. Glick derives this 9.6% in the table 1 presented in his response to interrogatory USPS/ MPA-T3-3. Tr. 28/15495-97. This table should be distinguished from table 2 at page 42 of witness Baron's rebuttal testimony. Mr. Glick's table 1 shows the letters-delivered cost and markup that Mr. Glick calculates after deleting his estimated DPS volume of 3,899,010,000 pieces. Mr. Baron's table 2 shows what Mr. Glick's results would have been if the DPS pieces Mr. Glick deleted had instead equaled the 4,841,841,000 pieces estimated in Mr. Baron's analysis.

The percentage actually produced for non-DPS letters by Mr. Baron's proposed analysis is 13.8 percent. Tr. 33/17756, Table 1. When comparing this figure with Mr. Baron's 15.3 percent flats "markup," one finds a difference of only 1.5 percent, far from the "huge disparities in cost markups" which the Joint Parties allege as the basis for recommending witness Glick's adjustment. *See* Joint Parties Brief at 21. This disparity seems trivial, in fact, when compared with the 4.3 percent difference which would flow from the Glick analysis, as shown in Table 2 of Mr. Baron's rebuttal testimony. *See* Tr. 33/17758. The basis for the Joint Parties' proposal is, therefore, a mirage, an illusion produced by the Joint Parties' misconstruction of the record.[11]

In fact, it is clear that Mr. Glick's flats adjustment, contrary to the assertions of the Joint Parties, hardly "equalized the ratios of per piece distributed cost to evaluated cost for each volume type." *See* Joint Parties Brief at 22. As support for their mischaracterization of Mr. Glick's adjustment, the Joint Parties rely on page 9 of his testimony, as well as his Exhibits MPA 3-1, 3-2, and 3-3. *Id.* It must be noted, however, that the revised versions of Mr. Glick's Exhibits MPA 3-1 through 3-3 (filed with his errata of February 11, 1998) estimate a post-flats adjustment letters-delivered

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[11] The Joint Parties similarly mischaracterize the record when they allege that Mr. Baron "ignored Glick's flats correction." Joint Parties Brief at 22. It is plain that far from ignoring Mr. Glick's proposal, Mr. Baron went to considerable length to analyze its merits, and found it to be misguided. *See* Tr. 28/17756-58. In a similar vein, the Joint Parties imply that Mr. Baron backed off from defending his proposed flats distribution key. Joint Parties Brief at 22. A fair reading of the transcript will reveal no such reluctance to defend his methods or results, which he steadfastly advocated as superior to the problematic approach suggested by counsel. *See* Tr. 28/17815-30. Given this lack of record support, it is not surprising that the Joint Parties do not provide actual quotes from Mr. Baron's testimony in support of their erroneous reading of his testimony.

volume of 18,709,226,000 pieces. Tr. 28/15488. This estimated total includes DPS pieces. In his response to interrogatory USPS/MPA-T3-3, Mr. Glick also presents a table (table 1) showing that 14,810,216,000 pieces of letters-delivered volume remain after his estimated volume of DPS pieces are moved out of the letters-delivered category into the DPS category. *See* Tr. 28/15495-96. The necessary implication is that Mr. Glick has estimated these DPS pieces to equal 18,709,226,000 minus 14,810,216,000, or 3,899,010,000 pieces. The ratio of the $62,459,000 in BY 1996 volume-variable DPS costs to these 3,899,010,000 pieces produces a volume-variable cost per piece of $0.0160.[12] Thus, Mr. Glick's markup of this "distributed" DPS cost per piece over the DPS evaluation factor cost per piece of $0.0134 actually equals 19.5 percent.

For flats-delivered volume, meanwhile, Mr. Glick's proposal estimates a post flats-adjustment volume of 13,542,500,000. Tr. 28/15488 (Revised Exhibit MPA 3-2). The ratio of the volume variable flats-delivered cost of $753,785,000 to this piece estimate equals a volume-variable cost per piece of $0.0557, which produces a markup of about 11.9 percent.[13]

Thus, to determine the true disparity across all of Mr. Glick's markups, his 11.9 percent flats-delivered markup must be compared with his 19.5 percent DPS markup,

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12 This $62,459,000 in volume-variable DPS costs equals the sum of $56,257,000 for evaluated routes (Tr. 33/17766) and $6,202,000 for "other routes" (Tr. 33/17771).

13 This $753,785,000 in volume-variable flats costs equals the sum of $687,490,000 for evaluated routes (Tr. 33/17766) and $66,295,000 for "other routes" (Tr. 33/17771).

and with the 9.6 percent markup that he calculates for post-flats adjusted letters-delivered volume, after removing his estimated DPS volume of 3,899,010,000 pieces (See Tr. 28/15495-96, table 1). This comparison reveals clearly that the three Glick markups deviate substantially from one another. The disparity between the 19.5 percent DPS markup and the 11.9 percent flats markup is 7.6 percentage points. The disparity is even greater between this DPS markup and the 9.6 percent letters-delivered markup, totaling nearly 10 percentage points. Thus, the Joint Parties' assertion that Mr. Glick has "equalized the ratios of per piece distributed cost to evaluated cost for each volume type," is plainly wrong, and its falsity completely undercuts the contention the Mr. Glick's flats adjustment should be accepted in place of Mr. Baron's distribution key correction.

The erroneous nature of the Glick method is further revealed by close examination of the actual cost distributions across mail subclasses that Mr. Glick proposes in his Revised Exhibits MPA 3-2 and MPA 3-3. *See* Tr. 28/15488-89. Consider the distribution key that column 3 of Exhibit MPA 3-2 proposes for post-flats adjusted letters-delivered. This key applies to the total of all 18,709,226,000 DPS plus non-DPS pieces that Mr. Glick estimated for the letters-delivered category after implementing his flats adjustment. Yet, in column 7 of this exhibit, Mr. Glick applies this combined DPS plus non-DPS distribution key to the $450,698,000 of volume-variable cost that applies strictly to the non-DPS pieces in the letters-distributed category. Moreover, Mr. Glick does not even indicate how he proposes to distribute the $62,459,000 of volume-variable cost that applies just to DPS. In addition to his proposed distribution for the non-DPS letters-delivered cost of $450,698,000, he shows only proposed cost distributions for post-flats adjustment flats-delivered cost (column 8 of the Exhibit MPA 3-2) and for total segment 10 costs (column 10 of Exhibit MPA 3-3). *See* Tr. 28/15488-89.

Thus, Mr. Glick's proposals are, on their face, both erroneous and confusing. They are incorrect in distributing the $450,698,000 cost of the non-DPS only letters-delivered pieces using a percentage distribution of total non-DPS *plus* DPS letters across mail subclasses. Instead, this $450,698,000 should be distributed solely based on the percentage distribution of the non-DPS letters-distributed pieces.[14] Moreover, Mr. Glick's failure to present a distribution for the separate pool of $62,459,000 volume-variable DPS can only leave one guessing as to what his proposed distribution key for DPS pieces really is. This combination of inaccuracy and ambiguity constitutes yet another reason to reject the Glick methodology, and instead use the traditional flats-adjustment and the updated cost distribution methodology applied in Mr. Baron's rebuttal testimony.

D. The Postal Service Properly Determines and Distributes the Volume Variable Portion of Purchased Transportation Costs to the Subclasses of Mail.

In this proceeding, the Postal Service makes several changes in the treatment of purchased transportation costs, that are explained in the testimony of its witnesses

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[14] Indeed, Mr. Glick himself stated that this should be done: "The Postal Service should exclude sector segment and DPS letters form the distribution key for the 'letters delivered' route evaluation item." Tr. 28/15495.

and which have been discussed in the Initial Brief of the United States Postal Service ("Postal Service Brief"). In particular, Professor Bradley (USPS-T-13) introduces an updated and improved analysis of the variability of purchased highway transportation costs.

This analysis is a direct result of a Commission request, and consists of an update and refinement of the Commission's Docket No. R87-1 econometric study of purchased highway transportation costs. The new study makes use of Highway Contract Support System ("HCSS") data, which allows it to encompass virtually all contracts in existence, rather than a sample of contracts. Although Dr. Bradley's analysis uses more extensive data and also includes a number of other refinements, it follows the basic outline and most of the details of Commission's Docket No. R87-1 analysis, including the Commission's use of cubic foot-miles as the cost driver in the variability equations.[15]

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[15] In Docket No. R87-1, the Commission discussed use of cubic foot-miles as a standard measure of output in transportation economics. It stated:

> In measuring output, transportation analysts have long recognized that freight service has both volume -- cube or weight -- and distance components. These are reflected in the number of cubic feet or pounds of freight loaded and the distance over which the freight is hauled. Traditionally, measures of output have been formed by multiplying the volume -- cube or weight -- and distance components, resulting in cubic foot-miles or pound-miles. The reason for this is that freight service involves the movement of volume over distance and both volume and distance contribute to the cost of providing the service. *See* D.W. Caves, L.R. Christensen, and J.A. Swanson, "Productivity in U.S. Railroads, 1954-1974," *Bell Journal of Economics* (Vol. 11. No. 1, 1980) at 170.

PRC Op., R87-1, Vol. 2, App. J, CS.XIV, at 11.

In this proceeding, the Postal Service extensively documented and relied upon TRACS, as it had since Docket No. R90-1, to distribute the volume variable purchased highway transportation costs to the subclasses of mail. In that Docket, the Commission noted that TRACS represented a "major improvement" in the distribution of costs to the various mail subclasses. PRC Op., R90-1, Vol. 1, at III-154. The Commission also concluded in Docket No. R90-1 that the methods used by TRACS for expansion to container and to truck size resolved previous problems. *See id.* at III-161-62.[16]

1. The moribund issues raised by intervenors must finally be laid to rest.

Selected intervenors in this proceeding are unhappy with their particular shares

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[16] The Commission stated:

> Another problem that TRACS answers is what to do with respect to the capacity in the vehicles which is not holding mail at any particular time. . . .
>
> With TRACS, all unused capacity is accounted for and distributed to the mail on a sampled vehicle. *The sampled mail is allocated its "fair share" of empty space* by multiplying a ratio of the percent unloaded divided by the percent unloaded plus the percent remaining times the percent empty. The mail that is loaded on the truck further upstream is charged more. . . .
>
> The analogous question of what to charge the subclass in a container when the container is not completely full is also answered. The entire cost of transporting the selected container is charged to those classes of mail sampled from the container according to the ratio of the classes' cubic-feet to the total cubic-feet of all the subclasses in the container. . . .

Id. (emphasis added) (citations omitted).

of purchased highway transportation costs. In urging the Commission to reduce those costs, these intervenors either attempt to resuscitate theories that were dismissed long ago or construct ever more fantastic arguments out of whole cloth. Some intervenors want to revive the institutional cost treatment of latent capacity, which was twice rejected by the Commission in the early 1980's. Others want new distribution keys developed off the record. One wants no increase at all for its subclass, as if transporting its mail costs exactly the same as it did five years ago. One even wants all purchased highway transportation costs to be treated as institutional, as if there were no relationship whatsoever between the mail carried on trucks and the cost of contracting for those trucks. All of these arguments, as well as others raised by the intervenors, must be rejected for the reasons discussed below.

2. Court of Appeals precedent precludes the Commission from developing distribution keys off the record.

FGFSA concludes that TRACS cannot be used for the development of a distribution key due to various flaws, and thus hints that an alternative distribution key should be developed. FGFSA Brief at 8. FGFSA states, "The record in this case does not offer alternatives, but the total cubic feet of each class of mail is available and could be used in the establishment of distribution keys." *Id.* FGFSA is quite correct -- the record in this case does *not* offer alternatives, and it is this very fact that precludes the development or use of distribution keys other than those presented by the Postal Service. Lest FGFSA has forgotten, the D.C. Circuit Court of Appeals held that the procedure used by the Commission in deriving city carrier costs in its Docket No. R90-1 Recommended Decision was defective, as the methodology used had not been subjected to the full scrutiny on the record required by law. *Mail Order Association of America v. United States Postal Service*, 2 F.3d 408 (D.C. Cir. 1993). FGFSA does not explain how these distribution keys should be developed. It merely states that total cubic feet by mail class are "available" and "could be used." FGFSA Brief at 8. This is wrong. Total *sampled* cubic feet are available in TRACS. FGFSA offers no explanation how the sampled cubic feet should be expanded to represent total actual cubic feet.[17] This is an issue that dictates full examination and argument on the record, and, as such, this type of adjustment cannot legally be made by the Commission in its Recommended Decision.

ANM also urges that

> [g]iven the data that are available from the TRACS sample data, the Commission could develop a distribution key that does not expand the sample beyond what the data collector initially records. That is, the expansion step or steps that unjustifiably assign absolutely empty floor space on the truck should be eliminated.

ANM Brief at 45. Such a suggestion is particularly disingenuous coming from ANM, the same party who stated, in the dispute over the proper treatment of library references earlier in this docket:

> [D]ue process entitles parties affected by a proposal to adequate *notice* of the evidence relied on by the proponent of changes, and an adequate opportunity to *respond* to that evidence, including the right to "conduct such cross-examination as may be required for a full and true

[17] It is ironic that FGFSA, while complaining that TRACS is flawed because it only measures *samples* of unloaded mail, apparently has no problem with the Commission using *samples* of cubic feet by mail class to develop distribution keys. *Compare* FGFSA Brief at 6 *with* FGFSA Brief at 8.

disclosure of the facts." 5 U.S.C. § 556(d); 5 U.S.C. § 3624(b).

Motion of Alliance of Nonprofit Mailers and American Library Association to Stay Proceedings, October 16, 1997, at 2 (emphasis in original).

ANM does not explain exactly what "expansion step or steps" to which it refers, nor does it explain precisely how the distribution keys are to be developed.[18] Witness Pickett showed the results of removing the TRACS empty space allocation algorithm in Exhibit USPS-RT-2B for intra-BMC and inter-BMC costs for certain mail, including Standard A, using data from Library Reference FGFSA-H-3. Tr. 35/18776-82. ANM, however, makes no reference either to the FGFSA library reference or to witness Pickett's exhibit.[19] Therefore, it is unclear exactly how the distribution keys proposed by ANM are to be developed. The strictures of the *MOAA* decision accordingly apply, and the Commission cannot develop new TRACS distribution keys off the record.

3. The FGFSA attempt to repeal well-established principles of product costing must be rejected.

The FGFSA brief attempts to put forward the spurious argument that the

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[18] In fact, it is not entirely clear that ANM believes that development of new distribution keys would be worthwhile. ANM indicates that it "would be a step in the right direction," yet goes on to say that it would not "rehabilitate the TRACS data as a lawful basis for recommending the Postal Service's proposed rate increases for nonprofit mail." ANM Brief at 45.

[19] In fact, in reading the section of the ANM brief concerning transportation costing issues, one could easily form the impression that ANM was unaware that the Postal Service had filed the rebuttal testimonies of witnesses Pickett and Young. In any event, witness Pickett's exhibit demonstrated that removal of the empty space algorithm had an insignificant effect.

measurement of volume variable purchased highway transportation costs requires the explicit specification of an equation relating transportation costs to some measure of "volume." This argument not only contradicts years of Commission precedent in many areas of postal costing, it offends the basic principles of modern product costing.

FGFSA seems oblivious of the fact that the entire field of cost accounting has been revolutionized in the past decade by recognition that costs should not be allocated to products solely on the basis of raw volume. The widespread acceptance of activity-based costing has established the essential principle that in many activities costs are caused not by raw volume but by a cost "driver."[20] In this two-step process,[21] costs are distributed to products by first identifying the driver and specifying the relationship between costs and the driver. In the second step, the amount of the driver is associated with the individual products that caused the driver to be needed.

The methodology is directly applicable in the case of purchased highway transportation. It is intuitively obvious, as the Commission has recognized, that costs are not directly caused by a measure of piece volume, but rather by the requirement

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[20] The link between activity-based costing and the Postal Service and Postal Rate Commission method of costing has been explained in Bradley, Michael D., Colvin, Jeff and Smith, Marc, "Measuring Product Costs in Ratemaking: 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).

[21] This process is described in the Summary Description, USPS LR-H-1, at App. H.

to transport mail (cubic feet) over distance (miles).[22] Thus, the clear cost driver is cubic foot-miles of transportation. It is in this sense that cubic foot-miles is a good "proxy" for volume; it represents the actual factor that causes the cost.[23]

The first step in the costing analysis is accomplished by the unopposed econometric analysis presented by Professor Bradley, in which he relates the purchased highway transportation cost to the cubic foot-miles of transportation that generated the cost. The second step in the cost analysis links the driver, cubic foot-miles of transportation, to the products causing that driver to be needed. The TRACS System accomplishes this second step, by accurately determining the proportions of cubic foot-miles of transportation caused by each mail class and subclass. Taken together, these two steps produce the volume variable purchased highway transportation cost for each product. When that volume variable cost is divided by the piece volume of each mail subclass, unit volume variable or marginal cost is the result.[24]

In sum, the Postal Service and the Commission have been applying well-accepted costing principles in their agreed-upon method of calculating volume

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[22] "The reason for this is that freight service involves the movement of volume over distance and both volume and distance contribute to the cost of providing the service." PRC Op., R87-1, Vol. 2, App. J, CS XIV, at 11.

[23] Cubic foot-miles should always be used as the cost driver. However, as indicated by witness Bradley, in certain circumstances it could be useful to have the actual cubic foot-miles of transportation of mail instead of the cubic foot-miles of capacity that is currently available. *See* Postal Service Brief at III-164.

[24] For a mathematical demonstration of this point see Bradley, Colvin and Smith, *supra*.

variable purchased highway transportation costs. The methods used are correct and appropriate, and the FGFSA's shrill protestations do not alter this fact. Simply because the FGFSA cannot understand how volume variable costs can be accurately calculated without "direct measurement of volume" does not mean that they cannot be so calculated. Its repeated statements of its ignorance are no evidence of infirmity of the costing methodology.

4. FGFSA and ANM continue to make erroneous assertions concerning actual mail volumes and TRACS distribution keys.

In its initial brief, FGFSA continues to demonstrate its misunderstanding of sampling and what TRACS is intended to measure. It insists that "the outbound samples should receive a weighting to reflect the relative volume of mail." FGFSA Brief at 6. TRACS does not attempt to directly measure actual volumes of mail; rather it estimates *proportions* of cubic foot-miles in the development of distribution keys.

Perhaps it is its failure to understand this distinction which leads FGFSA to the misguided conclusion that the results of TRACS are "clearly in error." FGFSA Brief at 6. FGFSA continues to erroneously use volumes to attempt to dismiss the TRACS results, when volumes are not what TRACS even purports to measure. Dr. Merewitz constructs a volume ratio of Standard A to Standard B cubic feet of 4.25 to 1. Tr. 22/11427-28. He compares this ratio to the TRACS distribution key ratio of Standard A to Standard B of 1.08 to 1. *Id.* As was demonstrated during his oral cross-examination (Tr. 22/11596-11614), and discussed in the Postal Service's initial brief, this comparison is both inappropriate and irrelevant. *See* Postal Service Brief at III-

176. To add insult to injury, Dr. Merewitz's calculation of the volumes in the ratio itself is full of errors and inconsistencies.

FGFSA relies upon Merewitz's ratio comparison to argue that "the TRACS result conflicts with reality." FGFSA Brief at 6. However, FGFSA seems to have conveniently forgotten Dr. Merewitz's observation that dropshipping, especially in Standard (A) mail, has reduced the use of transportation services for that class of mail. Tr. 22/11409. Ironically, this activity should result in a lower distribution key for Standard (A), just as the TRACS distribution keys show.

FGFSA makes this same mistake when it compares DBMC volumes to Parcel Post volume as further evidence that TRACS results are wrong. FGFSA Brief at 6. FGFSA asserts that DBMC volumes are higher than non-DBMC parcel post volumes. TRACS, however, shows lower transportation usage for DBMC than for non-DBMC Parcel Post. *See* USPS LR-H-288.

FGFSA goes on to say that "TRACS does not measure the volume of mail which is unloaded. It merely takes samples from the mail unloaded." FGFSA Brief at 6. Yet it is this *sampled* mail which FGFSA uses to make its misleading comparison without any regard to weighting these samples to reflect their item type sampling proportions, container sampling proportions, or inbound/outbound sampling proportions. FGFSA also seemingly ignores the nature of sampling when it discusses the "absurd results" of TRACS, which in one example, "expands" three pieces of parcel post to 1620 cubic feet. FGFSA Brief at 7. Like any other sampling system, TRACS takes a representative sample of items to derive estimates of the *proportions* of mail unloaded. The distribution keys are based on proportions, so it does not matter whether the proportions of one mailcode to another in a truck are calculated with a ratio of 100,000 cubic feet to 200,000 cubic feet, or with a ratio of 1 cubic foot to 2 cubic feet. At the end of the day, the proportion of transportation service used remains the same.

ANM says the TRACS results are distorted and biased because TRACS "neither measures nor records the actual volume of mail (in pieces, pounds, or cube) that is off-loaded." ANM Brief at 41. Surely, ANM cannot be suggesting that TRACS data collectors count or weigh every single piece of mail which is offloaded from a truck. Not only would this be operationally impossible since it would result in unacceptable delays to the mail which is counted, but it is also ludicrous considering that, already, "each TRACS test can take hours to conduct." Tr. 35/18771. Weighing and recording every single piece of mail unloaded would obviously greatly increase the time required to take a TRACS test.

As the above discussion has demonstrated, FGFSA and ANM either fail to understand what TRACS does, or they expect it to do the impossible. The Commission must disregard their criticisms.

5. FGFSA's allegations concerning TRACS weighting ignore substantial record evidence.

The initial brief of FGFSA challenges the Postal Service's weighting of the TRACS sampled cubic foot-miles to the actual occurrence of route trips "so that the sampling is essentially weighted equally." FGFSA Brief at 6. With little further elaboration (and no evident record support), FGFSA simply argues that the Postal

Service's weighting is inappropriate, and that "the outbound samples should receive a weighting to reflect the relative volume of mail." *Id.*

The issue of applying weights to the samples obtained from TRACS is one that has been the subject of considerable attention by FGFSA, and therefore, by the Postal Service, in this proceeding. FGFSA questioned Postal Service witness Nieto extensively on the matter, both in written and oral cross-examination. Tr. 7/3266-67 (witness Nieto explains the operation of weighting factors) and 3478 (witness Nieto provides an example to explain how the weighting factor reflects the population sampled: "if ... 70 percent of our tests are taken at inbound movements and 30 percent of our tests are taken at outbound movements, then we have to weight them back to exactly what happens in the population"). *See also, id.* at 3486-87.

During oral cross-examination by FGFSA counsel, witness Nieto explicitly described how weighting factors account for the manner in which the Postal Service samples route trips. She stated that because the Postal Service weights cubic foot-miles

> back to the actual occurrence of the route trips on which they traveled, then ... they're not weighted equally, but they're weighted back to the occurrence of those movements in the frame.
>
> So if there was 100 route trips in, 100 route trips out, and ... we sampled 70 of those route trips that were going in and we sampled only 30 on the way out ... [then] the costs of those trips would be multiplied by a factor of 100 over 30, and ... the costs of the mail on those inbound trips would be multiplied by a factor of 100 over 70, such that when we combine them, they would be equally weighted in the calculation of the distribution key.

Tr. 7/3483-84.

In addition, the testimony of Postal Service rebuttal witness Pickett, USPS-RT-2, explains how the Postal Service's "weighted average" compensates for TRACS' relatively heavy inbound sampling, and correspondingly lighter outbound sampling. Tr. 35/18768. Like witness Nieto, he provides an example to demonstrate how the weighting of the cost information received from TRACS correctly reflects the occurrence of the movements in the population. *Id.* at 18768-69. And like witness Nieto, he discussed the matter with counsel for FGFSA on oral cross-examination:

> FGFSA: Is it correct that, from your testimony, that the imbalance in sampling ... is 70 percent on the in-bound and 30 percent on the outbound; is that right?
>
> WITNESS PICKETT: Those numbers ring a bell, yes.
>
> FGFSA: So if there is an imbalance, the weighting is such that the sampling is equalized inbound and outbound. That's the example you give; is that right?
>
> WITNESS PICKETT: It's not that the sampling is equalized; it's that the sample totals are adjusted in such a way that you represent the population according to the proportions that things occur in the population.

Tr. 35/18810. *See also, id.* at 18811.

In light of the extensive discussion on the record of this proceeding regarding the appropriateness of the Postal Service's method for weighting the sampled movements for the TRACS intra-BMC highway component, FGFSA's bare assertion that it is improper is not convincing. It simply reflects FGFSA's lack of understanding of fundamental statistical sampling concepts.

6. The expansions used by TRACS are valid and appropriate.

Both FGFSA and ANM vehemently object to the expansion process in TRACS which accounts for empty space in the container and the truck. In its initial brief, ANM says that TRACS does not distribute highway transportation costs according to "the transportation service provided to whatever mail is found to be off-loaded from the truck." This is precisely what TRACS does, except that ANM's definition of "transportation service" is quite different from that used by the Postal Service. Unlike passenger air transportation, where the Postal Service pays by the pound-mile for what is flown, providing highway transportation service requires an *entire* truck traveling on a particular route, and the Postal Service incurs costs for providing the entire truck. Postal Service witness Nieto clearly explained why TRACS accounts for the full cube of the truck. Tr. 7/3312-13 and 3348-49. Moreover, this ensures the mailers pay their fair share of the costs of the transportation service provided to them. *See* Tr. 35/18833-34.

ANM also gives an example of how TRACS treats containers, complaining that even if a container is only partially filled with nonprofit mail, TRACS will unfairly assign all the space in the container to nonprofit mail. ANM Brief at 41. Postal Service witnesses Nieto, Pickett, and Young have all discussed why the space in and above a container is not generally usable for other mail. *See* Postal Service Brief at III-174-175. Despite this, both ANM and FGFSA deny that their mail is in any way responsible for any use of space other than that which it physically occupies. In addition, both parties imply that it is only *their* mail which receives this "unfair" treatment, when neither party has presented any evidence on the record that TRACS singles out their mail in this fashion. ANM and FGFSA propose that distribution keys be based only on the actual physical cube of the mail itself.[25] The fallacy of this argument may be demonstrated with the use of a hypothetical example.

Suppose the Postal Service contracts for a 2400 cubic-foot truck containing 14 over-the-road containers (OTRs), of 110 cubic feet each, filling all of the floor space of the truck (*i.e.*, empty space will be disregarded for now). Five of the OTRs are completely filled with Nonprofit Standard (A) mail, and the remaining nine are each one-quarter filled with First-Class Mail, and three-quarters empty. Currently, under TRACS, the 2400 cubic-feet of the truck would be assigned 5/14 to nonprofit mail, and 9/14 to First-Class Mail, resulting in a distribution key of approximately 36% to nonprofit mail and 64% to First-Class Mail. This distribution key would remain the same regardless of whether or not the space above the containers is included in its calculation. This result is a consequence of the fact that TRACS does not estimate *volumes* of mail which are found on trucks; rather, it develops cubic foot-mile-based *proportions* of the mail found on trucks.

Under FGFSA's and ANM's suggestion, if the Postal Service were to measure and use only the cubic feet of space taken up by mail, we would have the following:

> 5 x 110 cubic feet of nonprofit mail = 550 cubic feet for nonprofit mail;
>
> 9 x 0.25 x 110 cubic feet of First-Class Mail = 247.5 cubic feet for First-Class Mail.

This would result in a distribution key of 69% for nonprofit mail and 31% for First-Class Mail for the truck. If this proposed distribution methodology were used, no

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[25] As discussed above, however, the Commission cannot legally develop distribution keys off the record.

doubt FGFSA and ANM would argue that it was unfair to charge their mail for 69% of the costs when containers of First-Class Mail occupied 64% of the truck!

FGFSA also claims that the Postal Service "appears to be completely unsympathetic for the mailers who happen to send their mail on trips which tend to be emptier." FGFSA Brief at 7. It is not the function of an objective data collection system to be "sympathetic" to certain mailers. In addition, the Commission already has indicated that the TRACS expansions to both truck size and container size are appropriate. *See* PRC Op., R90-1, Vol. 1, at III-161-62. In any event, as demonstrated by witness Pickett in this docket, removal of the TRACS empty space algorithm has only a negligible impact on costs. *See* Tr. 35/18776-82.

7. ANM compares postal highway transportation to a ski lift. The comparison is fundamentally flawed and bears no relevance to the distribution of highway costs.

The Alliance of Nonprofit Mailers (ANM) compares the TRACS assignment of cubic foot-miles to the allocation of the cost of a ski lift. ANM Brief at 43, n. 24. This analogy is completely inappropriate, because it ignores an important fundamental characteristic of transportation capacity: flexibility.

In the ANM analogy, the ski lift is a simple piece of fixed mechanization. It cannot be moved or expanded to meet daily volume fluctuations. When additional skiers are added, the chair lift cannot be altered to accommodate them. The resort cannot buy a smaller ski lift, nor can it re-route the ski lift. And, in the example cited, it cannot add a second lift on peak days.

In postal highway transportation, capacity can be and is routinely changed in response to volume changes. There are three means by which the Postal Service can vary highway capacity. First, the number and frequency of trips can be altered. Tr. 7/3569. Second, routes can be reconfigured. Tr. 35/18858. And third, within limits, the size of the truck can be increased or decreased. Tr. 35/18855-58. Highway transportation capacity is purchased to move mail volumes that, unlike the ski lift, vary by day of week. Tr. 35/18869. Clearly, a ski lift is inherently different from highway contract routes; ANM's attempt to snow the Commission with this inappropriate comparison conflicts with the evidence on the record.

8. Rate category distribution keys have not been recommended by anyone.

The Postal Service applies the TRACS-based distribution keys in the development of subclass costs. No party presents or relies on comprehensive TRACS distribution keys below the subclass level. In fact, for nonprofit Standard (A) mail, TRACS does not even collect data at the basic or 3/5-digit presort level. Despite this fact, ANM, apparently quoting its witness Haldi, asserts that "If TRACS were applied at rate category level, it would contain substantial bias against basic presort mail." ANM Brief at 45, n. 26. This allegation is nothing more than unsubstantiated and reckless speculation. It must, accordingly, be dismissed.

9. ANM witness Haldi's "mismatch" theory is as inapplicable to TRACS as it is to the IOCS.

ANM's initial brief attempts to bootstrap TRACS into its "mismatch" theory regarding the Postal Service's data systems, which its witness Haldi claims is responsible for the increase in mail processing costs reported for nonprofit Standard (A) mail. ANM Brief at 39. ANM claims that, because TRACS data collectors refer to "postage evidencing on mailpieces . . . to determine the class of mail . . ., TRACS suffers the same drawback as IOCS when nonprofit evidencing is used on mail entered at commercial rates." *Id.* Presumably, ANM is alleging this as one of the bases for its increased purchased highway transportation costs. ANM describes this theory in greater detail in terms of what it considers to be a mismatch between the costs reported from the IOCS and the volumes reported by the Postal Service's RPW system; the Postal Service responded to the supposition with the rebuttal testimony of Dr. Leslie Schenk, USPS-RT-22, and in its initial brief. Postal Service Brief at III-129-43.

Unlike its discussion of Dr. Haldi's "mismatch" theory regarding mail processing costs, ANM makes no attempt to quantify the degree of its postulated "mismatch" between transportation costs and RPW volumes. To the extent that ANM wishes to fashion a "me too" link of transportation costs to mail processing costs for Standard (A) nonprofit mail, the portions of the Postal Service's initial brief that dispel Dr. Haldi's theory regarding IOCS apply with even more force to the attempted extension of that theory to TRACS. As explained in the Postal Service's brief, the mismatch could go in both directions, which witness Haldi ignores, and the impact, if any, of the mismatch is negligible. Postal Service Brief at III-142. With TRACS there is the additional issue of disparities in mileage between non-profit and regular which further cripple any use of witness Haldi's estimates.

10. Extensive explanations for highway transportation cost increases, that are clearly applicable to Periodicals Mail, have been provided on the record.

In its joint initial brief, ANM et. al.[26] argue that transportation cost increases for Periodicals Mail are unexplained on the record. ANM et. al. Brief at 18-19. Apparently, ANM et. al. failed to read the testimony of Postal Service rebuttal witness Young, who offered a long list of specific reasons for general cost increases in highway transportation. Among these are (1) inflation, (2) increased use of containerization, (3) changes in pallet regulations, and (4) increases in the number of facilities served. Tr. 35/18861-63. It is self-evident that Periodicals Mail is directly affected by each of these factors. Furthermore, the Postal Service has increased highway transportation capacity by adding trips, in order to boost "local mail service to meet EXFC goals." Tr. 35/18862. Periodicals mail traveling on those trips should benefit from this operational change as well. Of course, if Periodicals Mail does not receive additional transportation service as a result of this change, TRACS would not record Periodicals Mail on these trucks. In that case, no costs associated with these trucks would be directly allocated to Periodicals Mail.

[26] Alliance of Nonprofit Mailers, American Business Press, Coalition of Religious Press Associations, Dow Jones & Company, Magazine Publishers of America, National Newspaper Association, the McGraw Hill Companies, Inc. and Time Warner Inc.

11. The vague and vapid allegation of "uncertainty" in the Postal Service's costing methodology for purchased highway transportation costs resides only in the minds of those who do not wish to pay their fair share.

ANM et. al. assert that there is "uncertainty" about the Postal Service's costing methodology. ANM et. al. Brief at 19. There is none. As explained in the Postal Service's initial brief, the costing methodology used to allocate purchased transportation costs is a two-step procedure. Postal Service Brief at III-159-61. The first step is Dr. Bradley's variability analysis, an update of an accepted Commission analysis from ten years ago. Much of Dr. Bradley's work has now been scrutinized in two rate cases, Docket Nos. R87-1 and R97-1. In addition, related cross-sectional econometric work, which laid the groundwork for the Docket No. R87-1 breakthroughs in transportation variability methodology, were fully explored in Docket No. R84-1. In Docket No. R87-1, the Commission stated:

> The next time transportation costing is considered, we expect to see a cross-sectional data base comparable to the one witness Bradley presented. We hope it is complete and reliable.

PRC Op. Docket No. R87-1, para. 3567. The Postal Service is confident that it has far exceeded the Commission's expectations with Dr. Bradley's transportation variability study in this case. In the final analysis, there is no "uncertainty" with regard to the variability step. All parties interested in postal highway transportation variability analysis have had ample opportunity in these and other proceedings to develop their understanding and to air their disagreements.

With regard to the distribution step, as even Dr. Merewitz reluctantly admits, Tr. 22/11567-73, TRACS has been explored and explained thoroughly in this and in several other Commission proceedings. It does exactly what it was designed to do. As Postal Service witness Pickett stated so succinctly:

> It simply records what's being observed. To my mind it's the most straightforward way of keeping track of what mail receives the transportation services on the contract.

Tr. 35/18837. In short, TRACS provides conclusive evidence that ties transportation services to the mail that uses them. The only "uncertainty" in this case is the method by which ANM et. al. and FGFSA would engineer the unfair re-allocation of their highway transportation costs onto other postal products that did not use the transportation services provided.

12. Without additional evidence, the Commission should leave unchanged the treatment of latent capacity.

FGFSA resurrects the canard that unused or latent capacity is not volume variable and the costs associated with it should be treated as institutional. FGFSA Brief at 4. This matter was argued extensively in both Docket Nos. R80-1 and R84-1. The Commission rejected it then (PRC Op. Docket Nos. R80-1, paras. 0408-19; R84-1, paras. 3286-94) and it should reaffirm that finding by rejecting it in this case. No party has presented a coherent argument or empirical analysis to support any other conclusion. Latent capacity is a sleeping dog; the Commission should let it lie.

13. In its initial brief, FGFSA quotes Postal Service witnesses Young and Nieto grossly out of context.

In an attempt to support its argument that the costs of purchased highway transportation are not volume variable, FGFSA quotes a fragment from the testimony of Postal Service witness Young. FGFSA cites Mr. Young for the proposition that "the postal transportation system is 'not a system that will respond to a change in volume.'" FGFSA Brief at 3, *quoting*, Tr. 35/18871. A review of the record clearly shows that this citation takes Mr. Young's testimony out of context, and completely reverses the thrust of his testimony. In fact, what Mr. Young clearly states is, *in the very short term*, capacity may not be changed. He continues, immediately following the FGFSA quote, to provide an explanation of how the Postal Service can modify its contracts' response to mail volume over time. In numerous other parts of his testimony, Mr. Young articulately describes the sensitivity of transportation capacity to mail volume changes. *See*, for example, Tr. 35/18868-70 and 18904-05.

A similarly erroneous reference is made to Postal Service witness Nieto's testimony. FGFSA Brief at 3. In an attempt to shore up its position on the variability of highway transportation costs, FGFSA states:

> Witness Nieto, USPS-T-2, stated that, because surface transportation capacity is jointly determined for all classes of mail using that transportation, determining the causality "is not only infeasible, but would be highly speculative."

FGFSA Brief at 3. What Ms. Nieto actually said was:

> Because surface transportation capacity is jointly determined for all classes of mail using that transportation, determining the *causality of every contract trip and leg of highway transportation* is not only infeasible, but would be highly speculative. The cost of a cubic-foot mile is determined for the whole contract, not for each specific leg. All the route trips, stops, and capacity are jointly determined by all classes of mail which use the transportation, therefore the cost per cubic-foot mile of the contract is also determined by the joint requirements. Please refer to witness Bradley's response to FGFSA/USPS-T13-25a, 27d, and 30c.

> TRACS is designed to provide statistically reliable estimates of the use of purchased transportation by the classes and subclasses of mail. The purchased capacity of a truck is a resource purchased for all types of mail which use it, and empty space on a truck reflects the requirements of all the mail on that particular contract route. When there is empty space on a truck, the mail which caused the truck to be dispatched at that particular time (rather than holding the truck until it was full) bears the costs of the truck. Service standards and mail processing requirements (such as producing a steady flow of mail across the day) of the mail traveling on the truck contribute to the empty space on the vehicles. As discussed in my response to FGFSA/USPS-T16-13e, TRACS produces a snapshot in time of what classes of mail are found on the various types of contracts, and does not speculate on the causality of empty space on a truck which may be caused by a variety of different factors.

Tr. 7/3348-49 (emphasis added). Rather than affirming FGFSA's proposition, the cited passage is an explanation of the rationale for assigning costs of transportation services to those classes of mail that use the services. This passage explicitly connects TRACS to Dr. Bradley's variability analysis and foreshadows portions of the testimonies of Postal Service witnesses Young and Pickett. There is nothing in this passage or any other part of Ms. Nieto's testimony that can be fairly construed as supporting the proposition that the cost of purchased transportation should be treated as institutional.

After offering up these two spurious citations, FGFSA asserts that, at Tr. 22/11407-15, Dr. Merewitz explained why Dr. Bradley's analysis is inappropriate and unsubstantiated without the use of the mail volume variable. FGFSA Brief at 3. In fact, a review of the cited passage proves it to be little more than an incoherent diatribe. Part of this passage refers to an "analysis" of volumes that is so riddled with errors as to be utterly unreliable. *See* Postal Service Brief at III-175-76. Among other allegations, this is the passage that asserts that "Prof. Bradley has foisted on this Commission a very clever little trick." Tr. 22/11408. How Dr. Bradley's update of the Commission's own variability model can be characterized as trickery is beyond comprehension. Near the end of the cited passage, Dr. Merewitz even has the audacity to draw an analogy of Dr. Bradley to "an inebriate who has lost his keys" in the dark. Tr. 22/11415. Such indecorous comparisons are wholly inappropriate, and cannot change the fact that Dr. Merewitz has offered little more than a confused and disjointed screed that provides no new insights into the variability of purchased highway transportation costs. The Commission would be wise to give Dr. Merewitz's "analysis" no weight in its Recommended Decision.

E. Witness Thompson's Cost Model Does Not Replicate Postal Service Costs, Is Not Easy To Use, And Will Not Be Useful In The Future.

In its initial brief, the OCA states that witness Thompson "updates the Commission's cost model" and "uses it to replicate the Postal Service's Base Year (FY 1996); FY 1997; and the Test Year (FY 1998) data." OCA Brief at 218 (footnote omitted). Without the benefit of using the output of the Postal Service's cost model, however, witness Thompson could not have calculated the results shown in her testimony; therefore, no replication of the Postal Service's results occurred. Several instances where witness Thompson substituted Postal Service outputs into the OCA model were discussed in the Postal Service's initial brief: "volume variable less PESSA costs" (Tr. 20/10619), ratio to calculate higher level supervisor costs (Tr. 20/10620), and the Volume and Workyear Mix Adjustments (Tr. 20/10624). Postal

Service Brief at III-193-94. The OCA's further claim that it has provided "intervenors with a SAS program that easily converts Postal Service data files into a format compatible with the Commission's updated cost model" (OCA Brief at 219) is likewise suspect because witness Thompson admitted that she relied on the output of the Postal Service cost model when the SAS program did not provide the desired results. Tr. 20/10617.

The OCA's implication that the Thompson cost model can be readily used by "costing neophytes" is highly questionable. *See* OCA Brief at 219. Six examples of editing by witness Thompson, described in the Postal Service's initial brief, portray a cost model that is anything but easy-to-use. Postal Service Brief at III-195-96. The examples range from changing nearly half the lines in PESSA96P.FAC to experimenting with input files to achieve the results without understanding the cost implications. *Id.* at III-197. Moreover, much of witness Thompson's editing would have to be repeated in each new proceeding. Thus, the OCA's claim that "[i]f the Postal Service's costing methodology changes, then parties wanting to examine alternative cost proposals can follow the strategy presented in library references OCA -LR-4, OCA-LR-6 and OCA-LR-7" makes things sound much more straightforward than they really are. OCA Brief at 219.

In fact, rather than aiding intervenors, witness Thompson may have contributed to the confusion surrounding the differences between the Postal Service's cost model and methodology, and the Commission's cost model and methodology. NAA states in its initial brief, "Major Mailers Association witness Richard Bentley and OCA witness Thompson have presented estimates of the Postal Service's costs using the Commission's established cost attribution methodologies." NAA Brief at 41. Obviously, this is *not* what witness Thompson has done. Witness Thompson attempted to replicate the *Postal Service's* costs using the *Postal Service's* Docket No. R97-1 proposed costing methodologies. Thus, in spite of witness Thompson's efforts, "neophytes" are apparently still confused.

IV. THE PARTIES THAT CHALLENGE THE POSTAL SERVICE OFFER NO SOUND REASONS FOR THE COMMISSION NOT TO ADOPT THE PRICING FRAMEWORK PROPOSED BY THE POSTAL SERVICE

In this section of the brief, we refute the arguments raised by parties who challenge the framework advocated by the Postal Service for the allocation of institutional costs. The results of the application of that framework in this case, i.e., the institutional cost allocations proposed by Dr. O'Hara, were amply addressed in our initial brief. No parties have raised matters in that regard which warrant reply. Omission in this reply brief of discussion of any issues addressed in the briefs of other parties should not be construed as any indication that the Postal Service necessarily agrees with the views and positions expressed by those parties.

A. Neither UPS Nor NAA Are Able To Identify Any Portion Of Section 3622(b)(3) That Conflicts With The Postal Service's Proposed Pricing Framework

In their briefs, both UPS and NAA accurately describe the fundamentals of the Postal Service's proposed framework for pricing: apply markups, based on the other eight criteria of section 3622(b), to subclass volume variable costs, and use subclass incremental costs to ensure that proposed rates meet the rate floor requirement. See UPS Brief at 10-12, NAA Brief at 52-54. Both parties then claim that such a framework would violate section 3622(b)(3). *Id.* As discussed in detail in the Postal Service's initial brief (IV-13 - 19), such claims are incorrect.

Section 3622(b)(3) establishes required *results* -- rates that cover a minimum rate floor, and reflect a reasonable share of "all other costs." Section 3622(b)(3) neither specifies nor precludes any *process* by which such results may be achieved. Section 3622, in its entirety, mentions neither cost coverages nor markups. Under the Postal Service's proposed framework, the Commission would be able to confirm that each subclass was covering the cost floor by applying the incremental cost test. Furthermore, the Commission would have available all information necessary to evaluate the reasonableness of the contribution of each subclass, relative to all of the factors which the Commission has traditionally considered relevant, including the other eight criteria of section 3622(b).[1] Such a framework is in full accord with the actual language of section 3622(b)(3), and the interpretation of that language by the Supreme Court in *NAGCP IV*.

Neither NAA nor UPS point to any language of section 3622(b)(3) that actually conflicts with the proposed framework. They point instead to, for example, previous Commission opinions. Primarily, their citations relate to earlier Commission statements regarding what should constitute the cost floor. See, e.g., NAA Brief at 53, UPS Brief at 8. In this case, however, it would appear that there is no dispute that the rate floor should be set by reference to subclass incremental costs. With regard to the separate issue of the appropriate base for markups, however, both NAA

[1] Contribution in this context includes both contribution over volume variable costs, and contribution over incremental costs. Contribution over volume variable cost is necessary information, because it is required to evaluate the relative efficiency of various rate levels. Contribution over incremental costs provides much less relevant information for efficiency purposes, but may be considered more relevant for other purposes. Most importantly, under the proposed framework, complete information is available to consider what constitutes a reasonable contribution relative to either cost measurement.

and UPS also cite language from paragraph 3009 on page 103 from the Opinion in Docket No. R87-1. NAA Brief at 53-54, UPS Brief at 12, fn. 6.

The great reliance they put on that portion of the Commission's Opinion in Docket No. R87-1 warrants that it be examined in some detail and placed in context. To understand the intent of the paragraph in question, it is necessary to refer to the preceding paragraph, which starts on the bottom of page 102:

> [3008] It is clear, on the other hand, that the Commission's decision must demonstrate that each such class is meeting the attributable-cost standard. Section 3622(b)(3) lays down a
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> > ...requirement that <u>each class of mail or type of mail service</u> 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[.] [Emphasis added.]
>
> That a class satisfies this requirement cannot be demonstrated with any more completeness than that with which its attributable cost has been calculated. Since witness Baumol recommends selective application of the incremental cost test for essentially administrative reasons -- there being nothing <u>theoretically</u> objectionable about calculating an incremental cost for each subclass -- we must turn to the statute to see if the shortcut he suggests is feasible. The literal language suggests that it is not.

PRC Op., R87-1, at 102-03 (Emphasis in original).

It is important to understand the point that the Commission was trying to make in paragraph 3008 because, as we shall see, it also defines the point that the Commission was trying to make in paragraph 3009, which immediately follows it. This is clear from the very first sentence of paragraph 3009.

> [3009] The legislative history, as reviewed by the Supreme Court in <u>NAGCP IV</u>, suggests the same thing. One striking feature of that history is that, despite the various attempts of the draftsmen to find a suitable

> name for the process, they kept steadily before them the idea of establishing a rate floor for each class of mail. ... The term used in the House Managers' Statement, for instance, was "floor for each class of mail" ...; the House bill ... provided that
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> > ... at least those costs demonstrably related to the class of service in question will be borne by each such class and not by other classes of users of postal services or by the mails generally.
>
> The whole tenor of this development is that costs were to be examined for their causal nexus with classes; those reliably subject to causal attribution were to be attributed; and the resulting figure for each class was to be treated as its minimum acceptable revenue target. In brief, Congress expected the floor to be constructed for each class and the rate built upon it. The opposite procedure, in which a rate is arrived at by marking up marginal (not incremental or attributable) cost and only in suspicious cases checking for consistency with a cost floor not theretofore constructed, seems to us the opposite of what the Act contemplates. In a great many cases there is no necessary inconsistency between the results these two processes are capable of achieving; but we think it clear that Congress wanted the job done in a particular way, rather than simply wanting rates pretty certainly equal to or greater than incremental cost.

PRC Op., R87-1, at 103 (Citations omitted).

Properly read together, these two paragraphs make abundantly clear the entire thrust of the Commission's comments: section 3622(b)(3) requires that the costing tier establish a cost floor <u>for each subclass and service</u>. An approach which did not include the identification of a definitive cost floor for each subclass and service was not considered to be in accord "with what the Act contemplates." The Commission's remarks regarding the issue of marking up marginal (or volume variable) costs were made solely in the context of a proposal under which ratemakers "only in suspicious cases check[ed] for consistency with a cost floor not theretofore constructed." It was specifically such "selective application of the incremental cost test," resulting only in "rates pretty certainly equal to or greater than incremental cost," which the Commission found troubling, and apparently not in accord with the way "that Congress wanted the job done." The focus of the entire discussion was on the first portion of section 3622(b)(3), the cost floor requirement. The substance of the second portion of that subsection, the "reasonable assignment" provision, was simply not addressed (except in the limited context of a failure to comply with the cost floor requirement).[2]

In this case, of course, the framework proposed by the Postal Service does not involve selective application of the incremental cost test. The provision of a full set of incremental costs (in this case, by witness Takis) obviates any need for "only in suspicious cases checking for consistency with a cost floor not theretofore constructed." Application of the incremental cost test, as witness Panzar testified, is the procedure specifically and appropriately designed to insure that no subclass of mail is cross-subsidized by all other mailers. USPS-T-11 at 8-11.

Testing all recommended subclass rates against subclass incremental costs (and making adjustments to rates if necessary) thus meets the important statutory goal, as expressed in section 3622(b)(3), to avoid cross-subsidies. This procedure fulfills the objective identified in the above-quoted portions of the Commission's Opinion in Docket No. R87-1. Beyond that, as explained the Postal Service's initial brief at IV-16 - 19, the language of section 3622(b)(3) requires only that the pricing

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[2] Thus, for example, none of the legislative history cited in paragraph 3009 relates to anything beyond the first clause of section 3622(b)(3), the cost floor requirement.

process be conducted so as to yield rates which, relative to the other criteria of the Act, are reasonable.[3]

The Supreme Court in *NAGCP IV* found to be quite important the extent to which Congress both acknowledged that its expertise in ratemaking was limited, and emphasized its desire to leave enough flexibility in the law to allow "future generations" to incorporate improvements in economic theory. *NAGCP IV*, 462 US at 829-32. The testimony of Prof. Panzar, which strongly echoes that of Prof. Baumol in earlier cases, exemplifies exactly the type of consensus improvement in economic theory that Congress might have been contemplating. What may be Prof. Panzar's most critical insight in his testimony in this case is that the use of one cost concept based on a single statutory term -- "attributable cost" -- to attempt to perform the functions properly played in ratemaking by two separate economic cost concepts --

[3] In its brief at 11, fn.4, UPS misleadingly cites only two of the three portions of the transcript in which Dr. Christensen addressed the question of the minimum markup over incremental cost required by section 3622(b)(3). The complete text (Tr. 34/18268, 18282-84, and 18293) indicates clearly that it was not Dr. Christensen's view that a zero markup over incremental cost necessarily *would* satisfy the section, but rather a zero markup *could* satisfy that section if otherwise justified by full consideration of the other factors of the Act. In other words, the statute requires a "reasonable" amount of contribution, and, in an unlikely extreme situation (Tr. 34/18283), a contribution of zero may be considered reasonable based on all of the other ratemaking criteria. The insinuations of UPS to the contrary, Dr. Christensen's position is not inconsistent with the Act, and, in fact, corresponds closely with the statement of the Commission in the above-quoted portion from page 103 of its Opinion in Docket No. R87-1, that for each subclass, the figure estimated as all causally related costs (i.e., incremental costs) "was to be treated as its minimum acceptable revenue target." If UPS is suggesting that there is some higher "minimum acceptable revenue target," it certainly cannot be found within the confines of section 3622(b)(3), which offers no substantive guidance regarding appropriate markups, and which consequently should not be construed as a legal impediment to utilization of the coherent pricing framework proposed by the Postal Service.

marginal cost and incremental cost -- "is unnecessary and doomed to failure." USPS-T-11 at 5, 27-28.[4]

No fair reading of the Court's decision in *NAGCP IV* supports any conclusion other than that what Congress really wanted to establish in section 3622(b)(3) was the unmistakable requirement of a rate floor of all causally related costs. Indeed, as shown in the paragraphs quoted above, the Commission reached exactly that conclusion in Docket No. R87-1. Beyond that, there is simply no indication, in either the language of the Act or its legislative history, that Congress intended section 3622(b)(3) to tightly constrain the process by which reasonable rates would be set, in accordance with the other factors of the Act. The framework for pricing proposed by the Postal Service meets the applicable statutory requirements. UPS and NAA are in error to maintain otherwise.

B. Other Objections Raised By UPS And NAA To The Proposed Pricing Framework Are Similarly Flawed

As discussed, above, primarily because incremental costs have been provided for all subclasses and services by witness Takis, the comments made by the Commission in Docket No. R87-1 (and now cited by NAA and UPS) regarding

[4] UPS and NAA, on the other hand, wish to ignore the tension created by the well-recognized intent of Congress to include the enhancement of efficiency as one of several ratemaking policies (acknowledged, for example, in the UPS brief at 14), and Dr. Panzar's straightforward testimony that markups over incremental costs cannot suitably address economic efficiency concerns. Prof. Panzar explains how to avoid this dilemma in a way which allows recognition of all relevant ratemaking policies, which precludes appropriate recognition of no relevant ratemaking policies, and which complies with both the spirit and the literal language of the Act.

markups over volume variable costs are inapposite to the current case. There is another difference, however, which also merits discussion. Given the information available in Docket No. R87-1, in practical terms, the proposal to restrict the markup base to volume variable costs, rather than "attributable costs" as some proxy for incremental costs, essentially boiled down in that case to a decision whether or not to include "specific fixed" costs in the markup base.[5] With incremental costs as actually (and correctly) measured in this case, however, the difference between the incremental costs and volume variable costs for any subclass is no longer confined to any "specific fixed" costs that might exist for that subclass.[6] This change in circumstance alone would be sufficient to warrant a reevaluation of any comments that the Commission might have made in Docket No. R87-1 regarding the merits of using volume variable costs as the appropriate markup base, relative to the potential alternatives.

This situation is also quite relevant to NAA's claim that using volume variable costs as the basis for markup "would blur the concept of recovering institutional

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[5] See Docket No. R87-1, Direct Testimony of W. Ashley Lyons, USPS-T-17 at 11-12.

[6] Mr. Takis discusses this explicitly in his testimony, USPS-T-41 at 21-24. Beyond "specific fixed" costs, the other source of difference between volume variable costs and incremental costs is the difference between the total volume variable cost of the subclass (i.e., unit marginal cost times subclass volume) and the volume-related portion of incremental costs, calculated separately for each cost component by removing the entire volume of the subclass from the cost driver, and then summing across cost components. *Id.* This important distinction is also the basis for Dr. Christensen's statement that incremental costs and "attributable costs" (customarily defined as volume variable costs plus specific fixed costs) are distinct cost concepts. Tr. 34/18241.

costs." NAA Brief at 54, n.51. It is inevitable, however, that given the need in ratemaking for incremental costs (to avoid cross-subsidy) and the need for volume variable costs (to iterate to breakeven with the rollforward model, if nothing else), the concept of institutional cost will necessarily become blurred when defined as the residual of costs that are not causally related to a subclass. Prof. Panzar shows that rational ratemaking under a breakeven constraint requires two separate measures of causation (marginal and incremental), and it follows therefore (by operation of arithmetic) that there are two potential ways to calculate residual "institutional" costs.

Prof. Panzar, however, also explains why the residue of total accrued cost left after deducting the sum of subclass volume variable costs has relevance for pricing, while the residue left after deducting the arithmetic sum of subclass incremental costs does not. USPS-T-11 at 29. In fact, as witness Takis discusses, incremental costs are not even "summable" across subclasses, in the following sense: the incremental cost of, for example, the Periodicals class of mail, is not the sum of the incremental costs of each of the four subclasses of Periodicals mail. See USPS-T-41 at 34.[7]

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[7] This is another respect in which incremental costs differ from "attributable costs" (when the latter is defined as volume variable costs plus "specific fixed" costs). Their other defects notwithstanding, "attributable costs" are summable -- the "attributable costs" of the Periodicals class are indeed the sum of the "attributable costs" of each of the four subclasses. Nevertheless, when compared with total volume variable costs, total "attributable" cost is an irrelevant number for pricing for the same reasons that the number one gets by summing subclass incremental costs is also irrelevant for such purposes.

For example, consider the following scenario. Assume that for each subclass, volume is expected to change by x percent (e.g., 2 percent, 5 percent, 7 percent). If we know the ratio of total volume variable cost to total accrued cost, we know how much of a change in total accrued costs will be caused by this change in volume. (Accrued costs will change by the ratio of total volume variable to total accrued, The mere fact that the proposed new framework requires consideration of more types of cost information, and that as a result certain concepts may become less transparent to the casual observer, is no reason to prefer an alternative which may appear simpler, but which is, in fact, irrational.

Similarly off the mark are UPS' allegations that the proposed pricing framework would constitute a three-step process (UPS Brief at 12), in apparent contravention of the two-tier approach approved by the Supreme Court in *NAGCP IV*. In fact, as presented by witness Panzar, the proposed approach maintains the exact same boundaries between the costing and pricing tiers outlined by the Court. Costing is the first tier, in which accepted economic concepts and methodologies are employed to establish reliable causal relationships between costs and subclasses of mail. Information from costing is then used in the second tier, pricing, to develop reasonable rates that comply with the cost floor requirement and the other criteria of the Act.

While it is true that the methodologies used to establish causal relationships are applied to produce estimates of both marginal and incremental costs, such a procedure is in no way akin to the separate and additional application of unreliable cost accounting principles rejected by the Court. After the months of incredible effort expended during this proceeding in order to, among other things, get those causal

multiplied by x percent). Neither the ratio (to total accrued costs) of total "attributable costs," nor of the sum of subclass incremental costs, however, can be used in this or any similar fashion. As Prof. Panzar explained, it is only the sum of volume variable costs which allows meaningful identification of the total amount that needs to be recovered through the markup process. USPS-T-11 at 29.

cost relationships right, it would be supremely ironic to suggest that it is somehow too awkward, too confusing, or just too much trouble, to bring all aspects of what we have learned about costs to bear on the pricing process.

There is also a similar element of oversimplification in the UPS argument that marking up incremental costs for all subclasses is necessary to guard against an underestimate of incremental costs for any particular subclass that might cause its rates to be set below true incremental costs. UPS Brief at 14. This totally ignores the fact that an error in incremental costs of any given magnitude is not equally likely to cause rates for each subclass to fall below true incremental costs. In fact, any plausible undetected margin of error in witness Takis' estimates of incremental costs of, for example, Express and Priority Mail, would not cause them to fail to recover their true incremental costs at proposed rates, given the comfortable margins reported for those subclasses by Dr. O'Hara. USPS-T-30 at 27, 29. Marking up the incremental cost for such subclasses, while certainly in the interest of UPS, makes no sense as a protection against inadvertent cross-subsidy.

As Dr. Panzar testified, if potential underestimates of incremental costs is deemed to be a problem, the obvious solution to handle that would be at the subsidy testing stage, by adding whatever margin for error was deemed appropriate. Tr. 34/18460. But, as Dr. Panzar also testified, and contrary to what UPS asserts in its brief at 14, overstating incremental costs creates the exact same potential for inefficiency costs that motivated the creation of the statutory cost floor in the first place. Tr. 34/18459. And, ultimately, that is the most fundamental problem with the

UPS proposal. The statute creates a particular cost floor, and what UPS is advocating is tantamount to creating a higher cost floor, in a manner that is totally inconsistent with the clear intent to keep the costing and pricing tiers separate. If UPS has reason to believe that the incremental costs presented by the Postal Service are understated, it has full opportunity to propose any desired alternatives on the record. Marking up incremental costs purely as a prophylactic measure is grossly unwarranted and, if based on the faulty reasoning advanced by UPS that would actually create a higher cost floor than the one included in section 3622(b)(3), would violate the Act.

Also wrong are two arguments of NAA directed specifically at the testimony of Dr. Panzar. See NAA Brief at 54-56. First, NAA claims that his testimony lacks practical relevance because he made no attempt to address the non-economic factors which must be addressed to actually determine markup levels, and which sometimes conflict with economic factors. *Id.* at 55. In part, this argument is a red herring, as Dr. Panzar was presented as a witness to discuss theory, and not to apply that theory to the facts in this case. Prof. Panzar left specific discussion of the non-economic factors to other witnesses, such as Dr. O'Hara. He was, however, quite aware that those factors exist, as shown on one of the very transcript pages NAA cites:

> The quoted portion of my testimony was directed at explaining the economically appropriate *starting point* from which *any* mark-up methodology should be applied. This starting point should be marginal costs for any rate-setting procedure that is required to meet a break-even constraint. The markups themselves may be designed according to many criteria, one of which is economic efficiency (Ramsey pricing).

Tr. 9/4665 (emphasis in original).

NAA is simply in error to suggest that using Dr. Panzar's recommended "starting point" is inconsistent with the Act, when, as Dr. O'Hara has shown, both economic and non-economic factors can be subsequently applied to marginal costs to determine markups. As Prof. Panzar explicitly stated, in the above response and in his direct testimony, the policy objectives pursued are chosen by the ratemakers, and may include economic and/or non-economic factors, but "they can be pursued effectively only by taking cognizance of the marginal costs of expanding or contracting the relevant mail volumes." USPS-T-11 at 7. Nothing in Dr. Panzar's testimony in any way presupposes that economic efficiency is the only objective, or even the dominant objective, of postal ratemaking.

Second, NAA claims:

> Professor Panzar admits that prices that are economically efficient from the Postal Service's perspective might not be economically efficient from society's perspective. Tr. 9/4671 & 9/4680.

NAA Brief at 55. NAA's claim, however, mischaracterizes the record, as Dr. Panzar specifically denied at Tr. 9/4671, and again at Tr. 9/4672, the proposition which NAA now claims that he admitted.[8] Later, at Tr. 9/4679-80, without changing his earlier

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[8] To be strictly accurate, it should be noted that the discussion on the transcript pages that NAA has cited is actually couched in terms of a comparison of efficiency for the Postal Service versus efficiency for the entire postal and delivery industry, rather than a comparison of Postal Service efficiency versus efficiency "from society's perspective," as the NAA Brief states. This clarification is noted not to quibble with NAA's terminology, but to avoid confusion when we focus in the following discussion on exactly what it is that Prof. Panzar actually said, and how that conflicts with NAA's characterization of what he said.

answer in the least, Dr. Panzar clarified his position. First, it is possible for a firm to attempt to set rates to maximize its "profits or revenues," and that does not necessarily promote economic efficiency in the industry. Tr. 9/4680. However, postal rates which attempt to maximize producer and consumer surplus (i.e., Ramsey prices), rather than profits or revenues, are economically efficient from the perspective of both the Postal Service and the industry. (This point is not spelled out completely on Tr. 9/4680, although plainly this is what Dr. Panzar was driving at on lines 11-18; the point is made much more clearly and directly on Tr. 9/4672). Second, Dr. Panzar wanted to make sure that it was understood that the rates actually proposed by the Postal Service in this case are not the welfare-maximizing Ramsey prices developed by witness Bernstein. Tr. 9/4680. Therefore, a review of the cited transcript pages not only reveals an absence of support for NAA's claim, but, in fact, actually contradicts it -- prices that are efficient from the Postal Service's perspective are efficient from society's perspective as well.

Lastly, it cannot escape mention that NAA's position on markups in this case is hopelessly inconsistent. In the context of the Postal Service's proposed pricing framework, NAA argues that marking up anything other than the full measure of "attributable costs" which constitute the rate floor would violate the statute. NAA Brief at 52-54. Yet earlier in its brief, NAA enthusiastically urges the Commission to adopt the proposal of its witness Chown, who advocates that markups be applied to "weighted attributable costs."[9] NAA's inconsistency reveals that its true objection to the procedural framework for pricing proposed by the Postal Service has nothing to do with conformity with the statutory scheme, and everything to do with NAA's substantive and self-interested pricing objectives.

C. UPS Is The Primary Source Of Confusion On This Record Regarding "Long Run" And "Short Run" Costs

In its brief, UPS first reminds the Commission that it is "the long run cost consequences of providing a class of service that count," then proceeds to reassure that "the Commission should not be unduly concerned about the copious and confusing testimony on how to define the 'short run' and the 'long run.'" UPS Brief at 9. The testimony on this matter has indeed been extensive, but with the exception of that provided by UPS (with a little help from the OCA), it has been remarkably consistent. In the no-doubt-vain hope of putting this issue to rest once and for all, or at least setting the record straight in this case, an attempt will be made here to

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[9] NAA argues that the weighting scheme would only be used in assigning institutional costs, and would not affect the projected "attributable costs" of a subclass. NAA Brief at 15, n.18. In the same sense, however, using volume variable costs as the basis for markup would only affect the assignment of institutional costs, because using such a base in no way affects the level of the incremental costs of any subclass. As long as each subclass passes the incremental cost test, the effects of basing markups on volume variable costs are limited to the assignment of the same pool of "institutional" costs to which NAA refers, because those are the only discretionary costs left after the rate floors have been applied. Application of the incremental cost tests precludes assignment of any causally related costs to any subclass other than the one which causes them, contrary to the fears of UPS (UPS Brief at 12) regarding a "gray category" of costs.

All other aspects of witness Chown's proposed metric were adequately refuted in the Postal Service's initial brief, as well as those of AMMA, NNA, MOAA, and Val-Pak.

discuss the matter one more time.[10]

First, extensive citations to and quotations of the record on this matter are presented in the Postal Service's initial brief at III-3 - 5, III-44 - 47, and IV-70, and they will not all be repeated here. The points that follow, however, have been made by an impressive array of Postal Service and intervenor witnesses, and (other than those specifically relating to UPS witness Henderson) each could be supported by more than the single transcript cite provided here.

When economists speak of the long run, they are referring not to a period of calendar time, but to 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. 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.

How does the testimony of UPS witness Henderson comport with these rather

[10] One reason for pessimism regarding whether this issue will ever go away is that virtually all issues relating to length of run which have arisen in this case were exhaustively addressed by Prof. Baumol in his testimony (USPS-T-3) in Docket No. R87-1. For example, Prof. Baumol repeatedly stressed that the assumption that long-run costs are likely to be greater than short-run costs is wrong, because, in fact, the "actual" short-run costs that he was advocating be used (and upon which the Postal Service has constructed its costing framework) are in reality likely to be greater than ideally-minimized long-run costs. See Docket No. R87-1, USPS-T-3 at 12, 43-44, 50. Despite Prof. Baumol's warnings that the assumption that long-run costs are necessarily greater than short-run cost is a common fallacy (*id.* at 43), UPS continues to rely on exactly that assertion.

basic points? So far, so good. Dr. Henderson states:

> The short run is generally defined as any period shorter than the time that it would take to vary all of the firm's productive inputs. The long run, on the other hand, permits all productive inputs to be varied.

Tr. 25/13560. Dr. Henderson also agrees that, as a practical matter, it is not possible to estimate reliably the reoptimization that is a necessary component of any true long run analysis, as he has defined it (all inputs variable). Tr. 25/13600.[11] Therefore, there would appear to be a consensus that the cost estimates available for postal ratemaking will be some version of short-run costs, exactly as Prof. Panzar explained.

Given this consensus that any available cost information will of necessity be some version of short run costs, is the source of dispute exactly what length of run *within the realm of short run costs* is most relevant? The framework on which the Postal Service's costs have been estimated is once again described by Dr. Panzar, who explains that the relevant actual costs are those that would be incurred 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. Tr. 9/4636. As Prof. Bradley explains, 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 adjustments that may be made in a broader range of productive inputs over a period of substantial

[11] The unavailability of true long-run cost estimates, however, does not preclude Dr. Henderson from speculating as to how such estimates, if available, would relate to the versions of short-run cost estimates that are available. E.g., Tr. 25/13626. As Dr. Christensen demonstrates in his rebuttal testimony, however, Dr. Henderson's speculations in this regard do not withstand critical scrutiny. Tr. 34/18244-46.

duration. Tr. 11/5417-18.

Somewhat surprisingly, there seems to be no controversy here either. Dr. Henderson even cites Dr. Panzar's testimony that the version of short-run costs which are relevant are those corresponding to the period over which rates will be in effect. Tr. 25/13559. Moreover, Dr. Henderson's estimate of two to four years as the likely length of the rate cycle (Tr. 25/13560) does not conflict with the testimony of any other witness regarding the expected duration of the rates. The wheels seem to fall off the cart, however, when Dr. Henderson shifts gears abruptly:

> Accordingly, the relevant costs for pricing purposes are longer run, not short run, costs.

Tr. 25/13560. Rather amazingly, this is exactly where Dr. Henderson inserts his perfectly correct definitions of short run and long run costs, quoted above. While it is distinctly unclear what Dr. Henderson means by "longer run," it is perfectly clear that what he denies are short run costs are, by his very own definition, indeed some version of short run costs, because he could not possibly be assuming that <u>all</u> productive inputs of the Postal Service are fully variable over a two to four year period.[12]

One can only surmise that what Dr. Henderson really meant to say is that, within the realm of short run costs, an estimate that allows for a more prolonged ("longer run") period of adjustment is appropriate. He apparently wants to contrast this "longer run" with what he confusingly calls the short run (in conflict with his own

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[12] If he is making that assumption, as Dr. Christensen testifies, he is wrong. Tr. 34/18243-44.

definition of short run in footnote 12 in his direct testimony), which he apparently equates with an adjustment period of "a short time period, such as an hour, day, a month, or a season." Tr. 25/13559. In any event, regardless of the labels, it appears fair to say that there is solid agreement between Dr. Henderson and the postal economists that the relevant costs for postal ratemaking are those costs that could be, in response to a volume change on the margin or elimination of an entire service, adjusted over the time period in which the rates are expected to be in effect.[13]

With such a consensus on theory, where is the confusion? It would appear to manifest itself in the following portion of Dr. Henderson's direct testimony, which immediately follows the above-quoted passage in which he introduces the term "longer run":

> Most (if not all) of the specific fixed costs identified by the Postal Service are avoidable in the time span between rate cases. For example, advertising expenses are not volume variable, but they can be adjusted within such a time frame. The relevant costing concept for economically efficient pricing should capture such resource adjustments. Unfortunately, the Postal Service's proposed rates are based solely on costs that vary over a much shorter time period.

Tr. 25/13560.

In one sense or another, the first three sentences of this statement are essentially consistent (or at least can somehow be reconciled with) with the testimony of the postal witnesses. With respect to the first sentence, to make a distinction of

[13] Of course, exactly how those costs should be used (i.e., whether marginal costs or incremental costs are the proper basis for markups) remains a substantial source of disagreement, but, as Dr. Panzar stresses in his rebuttal testimony, that issue is not the same as the matter of what length of run is appropriate. Tr. 34/18461-62.

some importance which will be revisited later, it is all rather than most of the "specific fixed" costs which are treated by the Postal Service as avoidable over the relevant time span. But Dr. Henderson's statement certainly allows for this in the parenthetical. With respect to the second sentence, there is complete consistency. With respect to the third sentence, as Dr. Panzar testifies, there are two relevant costing concepts for economically efficient pricing (or, for that matter, any rational pricing regime subject to a breakeven constraint), marginal costs and incremental costs. USPS-T-11, *passim*. The resource adjustments Dr. Henderson is referring to in his third sentence, the avoidance of non-volume variable product specific costs, should be captured in incremental costs, but should not be captured in the costs used for pricing markups, marginal costs. USPS-RT-13 at 18-20 (Panzar)[14]. Once again, while this distinction is of great importance, it is not central to the length of run debate.

The crux of the matter is presented in the final sentence, in which Dr. Henderson alleges that "the Postal Service's proposed rates are based solely on costs that vary over a much shorter time period." If in this statement Dr. Henderson is referring to the volume variable costs, upon which the rates "are based" in the sense that only those costs are marked up, he is wrong. Or, more accurately, he is clearly wrong if he is suggesting that the postal costing witnesses in any sense intend to consider cost changes in response to a sustained change in volume over any time

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[14] As Prof. Panzar states, this is because advertising costs do not vary with volume, either in the short run *or* the long run. *Id.*

period shorter than the exact same time period that Dr. Henderson has himself endorsed, the time period over which the rates will be in effect.[15] He may be less clearly wrong if he is suggesting that the Postal Service witnesses failed in their intent but, as shown in other parts of this brief with respect to specific costing analyses, he would nonetheless be wrong in that context as well.[16]

Lastly, if Dr. Henderson is referring not just to volume variable costs, but also to the "specific fixed" costs such as advertising that he mentioned in the first two of the four sentences under examination, he is also wrong. First, the length of run used for incremental cost measurement, in which the Postal Service captures such product specific costs, is the exact same length of run used for the measurement of volume variable costs. Tr. 34/18461 (Panzar). Second, the apparent implication of Dr. Henderson's allegation in this context would be that there are product specific costs which the Postal Service has identified, but which have been excluded from incremental costs because they are not avoidable over that "much shorter time period" that Dr. Henderson claims the Postal Service is employing. As discussed in the Postal Service's initial brief at III-9 - 10, such is not the case. All product specific costs, including all product specific advertising costs of the type discussed by Dr. Henderson, have been included in the incremental costs presented by witness Takis.

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[15] That such was the intent of the Postal Service's costing witnesses is fully supported in the cites provided in the Postal Service's initial brief at III-45 - 46.

[16] If Dr. Henderson was intending to suggest as an empirical matter that any particular Postal Service witnesses failed to measure the version of marginal costs that they set out to measure, he certainly provided no citations or explanations to that effect.

Thus, the sentence on lines 7-8 of page 12 of Dr. Henderson's direct testimony (Tr. 25/13560) is simply wrong, no matter how it is interpreted. The proposed rates are based on costs that vary over exactly the time period that Dr. Henderson, consistent with the other economist witnesses in this case, has recommended.

The more important point to be made, however, and the rationale for including this rather extended discussion of the matter in this brief, is to emphasize to the Commission the very high degree of consensus among the economist witnesses, even when UPS witness Henderson is included, on length of run issues. Even Dr. Henderson agrees that, as a practical matter, the relevant estimates likely to be available for postal ratemaking are those based on actual cost adjustments which could be made over the time period during which the rates will be in effect.

Two caveats to this consensus view are in order. First, as repeatedly noted above, a consensus on length of run should not be confused with a consensus on the appropriate base for markups. Second, more directly relating to length of run, there is, at least at a theoretical level, continuing debate on the matter of product specific sunk costs.[17] UPS highlights this matter in its brief at 9-10, and the Postal Service

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[17] Sunk cost can be thought of as relating to length of run issues because, in the long run, not only are we all dead (Keynes), but (construing all inputs to be variable) one could argue that, by assumption, there are also no sunk costs. Therefore, an economist attempting to estimate the long run incremental costs of a product, rather than the actual incremental costs of the product which the Postal Service aspires to measure, could include elimination of the product specific sunk costs as one component of the estimation process. Yet, even adopting such an approach in any instances in which product specific sunk costs have been identified (and there are none in this case), one cannot necessarily assume that long run incremental costs would be greater than actual incremental costs. Once one leaves the world as we know it and enters into the totally hypothetical construct of the long run, there could

discussed it at III-8 - 10. Unless and until any party actually proposes to omit a product specific sunk cost from that product's incremental cost estimate, however, this issue need not concern the Commission.[18]

On this record, except insofar as there are empirical disagreements about

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be an infinite variety of reconfiguration and reoptimization issues which affect the long run estimates of the costs of the Postal Service with and without any particular line of service. Tr. 34/18245. It is impossible to predict how all of these possibilities might play out and affect the estimates. As Dr. Christensen testified, there is no *a priori* reason to believe that long run incremental costs are necessarily greater than actual incremental costs. *Id.*

As a final matter, it must once again be stressed how strictly limited the circumstances must be in order to even contemplate the existence of product specific sunk costs, which require at least two conditions. First, either all money for the input would have to have been paid out already, with no chance of getting any of it back, or the committed future payments would have to be so totally secure that there would be no provision, either in the contract specifically or in the law generally, to avoid making *any part* of the payments even in the event of the complete disappearance of any need for the input being purchased. Second, the input purchased under these draconian conditions would have to be so uniquely related to the product in question (i.e., nonfungible) that its use could not effectively be transferred to the production of any other output, either inside or outside the Postal Service. See generally the discussions by witness Panzar at Tr. 34/18471-75, 18487-95, 18503-04 (as well as Prof. Baumol's testimony on sunk costs in Docket No. R87-1 at 19-20 and 45-46 of USPS-T-3). It would seem extremely implausible for these types of conditions to be present in, for example, the context of contracts for advertising services.

[18] To use an analogy which may not be any more extreme than the 10-year totally-sunk Express Mail advertising contract cited in the UPS Brief at 9, the National Highway Traffic Safety Commission would presumably be reluctant to discount the analyses offered by traffic safety engineers just because those engineers may not be exactly sure how the results of traffic safety analyses might hypothetically change if car speeds started to approach the speed of light. Similarly, the Postal Rate Commission should be reluctant to discount the "actual cost" framework proposed by the Postal Service's economist witnesses (and supported by most intervenor economist witnesses) merely on the basis of hypotheticals concocted to presuppose that the Postal Service would "sink" costs into nonfungible resources applicable only to the production of one subclass, and then fail to include such costs in the incremental costs of the subclass merely as a function of the period over which the costs are sunk.

specific cost segments, there is no basis to dispute the proposition that the "actual cost" framework presented by Prof. Panzar properly captures, as either volume variable or incremental costs, all of the costs causally related to the provision of each subclass and service. Other than in the context of whether specific analyses have properly been conducted in accord with that framework, the Commission is faced with no material issues regarding the practical distinction between long run and short run costs.

D. Ramsey Pricing Is A Valuable Tool To Aid In The Ratemaking Process

The arguments of parties opposing any use of Ramsey pricing in postal ratemaking base their arguments largely on a misunderstanding of its intended role, and mischaracterizations of the record. Their arguments should be rejected. Ramsey pricing is presented not to substitute for reasoned and balanced application of all other criteria of the Act, but as a rational way to think about one very important type of factor -- economic efficiency.

1. NAA bases its opposition to Ramsey pricing on erroneous legal and technical arguments

NAA argues that the use of Ramsey pricing models is incompatible with the Act, and that the presentations of such models in this docket are inconsistent and flawed. NAA Brief at 56-59. Neither view is correct. The fundamental flaw in the legal arguments presented is shown by the fact that all that the Second Circuit rejected in the *DMA* case was the claim that the Commission was <u>required</u> to apply Ramsey pricing. *DMA*, 778 F2d at 104. The court made very clear that the

Commission was perfectly free to use Ramsey pricing if it chose to do so, and accord it whatever weight it believed to be appropriate. *Id.* In no way did the court find, as NAA at page 56 erroneously claims, "that Ramsey pricing is incompatible with the Postal Reorganization Act." Moreover, NAA's arguments fallaciously equate any use of Ramsey pricing with total exclusion of all other factors of the Act. NAA Brief at 57. As NAA is well aware, whether the Commission evaluates relative demand and concerns of economic efficiency with or without the aid of a formal Ramsey model, the Commission must and will balance such consideration with all other factors of the Act.

On technical grounds, NAA challenges the demand elasticities used in the Ramsey models of witnesses Bernstein and Sherman. NAA Brief at 57-59. As even UPS witness Henderson stated, however, the very fact that the demand elasticities used in a Ramsey model are those which must be relied upon for forecasting is a point which supports their use in a formal Ramsey model and is not, as NAA suggests at 57, any reason to avoid such use. Tr. 25/13669-70. With respect to the expected migration between Standard (A) Regular and Standard (A) ECR, raised in the NAA brief at 58, witnesses Thress and Bernstein have already explained why that situation has no bearing on witness Bernstein's Ramsey models. Tr. 13/6742-53, 10/5023-27.

Moreover, Mr. Bernstein also explained why, given the empirical robustness of the sum of own price and cross price postal elasticities, the effects of estimating and including a cross-price elasticity in the Ramsey model are likely to be small. Tr.

10/5023-24, 5027. Lastly, witness Bernstein provided an extensive response to a POIR explaining why a Ramsey model which included private sector alternatives (the omission of which NAA complains of at 58 and 59) would be expected to yield results quite similar to models which omit them. Tr.10/5068-74. As explained in the Postal Service initial brief at IV-21 - 27, the Ramsey models presented on this record are adequate to fulfill their intended function.

2. On the subject of Ramsey pricing, Hallmark has filed a document which is part testimony and part brief, and the Commission should reject both parts

Hallmark starts its 42-page brief (devoted virtually entirely to the topic of Ramsey pricing) with a section explaining why Ramsey pricing is an important issue in this case. Hallmark Brief at 3-7. The Postal Service does not disagree. But if Hallmark is so convinced of the importance of this matter, why did it not submit testimony on the topic, submit discovery on the topic, or, as best can be determined, even bother to designate the responses to discovery requests posed by other parties? See Tr. 10/4977-78, 26/13779.

Instead, Hallmark has chosen to file a document which consists largely of erroneous and misleading assertions of fact and economic theory, interspersed with enough legal argument and transcript cites to try to make it look like a brief. In the limited amount of time available to submit reply briefs, the Postal Service has not been able to devote the time and effort necessary to rebut every unsupported factual allegation that should have been presented in testimony over four months ago. (Even were it possible to do so, such is not the appropriate function of a reply brief.)

Accordingly, the Commission is urged to give no weight to the unsupported arguments made by Hallmark for the first time in its brief, and is cautioned that the brief abounds with them.

A major part of the problem with the Hallmark brief relates to its fervent insistence, without support in the record, that the proponents of the use of Ramsey pricing actually intend for it to totally dominate the ratemaking process to the virtual exclusion of all other considerations (page 5), do not recognize that the Commission exercises its judgment to balance economic and non-economic factors (page 6), and present demand pricing as a "super-criterion" of the Act (pages 14, 22). These and similar allegations (of which there are many) cannot be squared, however, with the relatively modest purposes identified by witnesses Bernstein, O'Hara, and Sherman for Ramsey pricing. The Commission has recognized economic efficiency as one of the many factors it must consider, and Ramsey pricing is a powerful tool to aid in consideration of that factor.[19] The broader limitations of Ramsey pricing in the context of the current postal ratemaking regime, however, are at this point in time

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[19] Hallmark (Brief at 38) quotes Aristotle to the effect that the well-schooled man "searches for that degree of precision in each kind of study which the nature of the subject at hand admits." Unlike many of the other factors which the Commission must also consider, economic efficiency is a subject which, by its nature, admits to a relatively high degree of precision. In the study of economic efficiency for purposes of postal ratemaking, Ramsey pricing is an appropriate tool. Following the advice of Aristotle, the degree of precision by which economic efficiency may be studied should not be influenced by the degree of precision allowed in the study of the other ratemaking factors by virtue of their particular natures. Using (in accord with Aristotle) different means to study different types of factors, however, does not preclude or inhibit the Commission's ultimate ability to balance and blend the results of those various "studies" into the rate levels it recommends.

universally acknowledged. Much of the Hallmark brief is devoted to attacks on a strawman of Hallmark's own making.

On a more technical note, another underpinning of the Hallmark brief which fails to withstand even cursory review is the repeated allegation that demand analysis (irrespective of whether or not employed in demand pricing) is incapable of recognizing the value to the recipient of a greeting card. See, e.g., Hallmark Brief at 9-12, 15-18. This unsupported claim is sheer nonsense. It is difficult to imagine that mailers use greeting cards for any reason other than that they hope and expect that it will have value (i.e., bring enjoyment) to the recipient. People do not buy and send cards if they think the recipients could care less (or, in economic terms, are indifferent) whether they get the card or not. The value that the card purchaser expects that it will have to the recipient is the measure of benefit that he or she uses to weigh against the costs -- the cost of the card, the cost of postage, and the opportunity costs associated the time that it takes to select and purchase the card, sign it (and maybe write a note), and mail it.

Hallmark actually suggests that purchases made by one person with the expectation that some or all of the good or service will be consumed by others are somehow impervious to cogent demand analysis, because of the "higher-order motives the purchaser may have." Brief at 15, n.26. The implications of this view are rather staggering. When parents do the grocery shopping for their family, could their grocery list be divided into two parts, classifying each food item depending on whether it is one that only they will eat, or one more likely to be consumed by their children, with the principles of demand analysis applying to one part of the list but not the other? An infinite number of similar examples could be hypothesized. Common sense, no less than economic theory, tells us that purchasers of any good or service take account of the value of that product to the person or persons whom they intend to receive the benefits of their purchase, whether that is themselves or some one else.[20]

Having erroneously postulated that value to a recipient is excluded entirely from conventional demand analysis, Hallmark proceeds to suggest that such value should be considered as an "externality." Hallmark Brief at 11, 17-18, 36. Once again, this manifests a fundamental misunderstanding of economics. An "externality" has been defined as follows:

> An externality is an unintended consequence of a course of action that incidentally has beneficial or detrimental effects upon third parties, from whom the generator of the externalities cannot collect adequate compensation if the externalities are beneficial, or to whom compensation for damages will not automatically be paid by the generator if they are detrimental.

Baumol and Sidak, *Toward Competition in Local Telephony*, 1994, at 29,n.7. Clearly, the value to the recipient of a greeting card is not an "unintended consequence" that "incidentally" benefits the recipient. Even if one wants to use what appears to be Hallmark's more generic definition of an externality -- an effect on others who are not

[20] Hallmark asserts that the contention that the value of mail to recipients is implicitly reflected in the sender's purchasing decision is "untenable." Hallmark Brief at 17. It is, however, Hallmark's unsupported views which, in fact, are "untenable." This basic misunderstanding of economic theory underscores the dubious nature of the entire brief.

parties to the transaction -- it makes no sense to suppose that B is not a party to the transaction of sending a card from A to B. The Hallmark brief in this regard is hopelessly garbled.

Moreover, with respect to the value of the "mail service," it is possible that consumers will buy a card, but wait to deliver it until the next time that they see the recipient in person, rather than incur the expense of mailing the card. It is that trade-off which is most relevant to the appropriate rate to set for the price of mailing the card. In other contexts, witness Bernstein makes this important distinction at Tr. 10/5043-45. Once again, however, it is the purchaser's perception of how the recipient's enjoyment of the card will or will not be affected by this potential delay which will drive the decision to mail or to wait, when that is an option.

None of this is to suggest that there is no merit to Hallmark's claim that greeting cards may be entitled to consideration under the ECSI factor based on the cultural value of the content of the mailpiece. Such considerations could constitute one of any number of factors that cause ratemakers to depart from Ramsey prices. As Ramsey pricing was never intended to consider such other criteria, the fact that it does not is neither surprising, nor any grounds to reject Ramsey pricing for the appropriate uses for which it was intended.[21]

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[21] The ECSI concept, however, serves to highlight a fundamental and major logical inconsistency running throughout the Hallmark brief. Hallmark repeatedly stresses the importance of its view that certain relevant values are not susceptible to quantification:

> If there is a felicific calculus capable of representing numerically the value of a birthday card received from a family member, it has not been

Another theme of the Hallmark brief which is simply wrongheaded is the perverse claim that demand pricing somehow involves a "rationing" of demand that other forms of pricing do not. Hallmark Brief at 20-26. The fact that the prices which are set for any product, by any means, act to "ration" the demand for that product is an economic fact of life. If we reject Ramsey pricing and ignore demand factors in setting rates, the rationing effect does not go away. Demand is "selectively suppressed" by the relative rate levels set, no matter what means are chosen to do so.[22] The implication that demand rationing will go away if we merely banish Ramsey pricing surely constitutes one of the more struthious attitudes exhibited in

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presented on this record.

Hallmark Brief at 17. Yet although these values undoubtedly have a non-economic dimension, Hallmark wants to rely on them as the basis to achieve a decidedly economic result -- lower rates for particular types of mail. The Commission can not grant discounts in terms of "cultural units." It must set postal rates in dollars and cents, whether Hallmark believes cultural values can be expressed in such units of measure or not. See Hallmark Brief at 38. If cultural values truly could not be quantified, then logic would dictates that they could play no role in the inherently quantitative task of setting postal rates. In fact, of course, quantitative value can be placed on cultural content, and when some rates are lowered as a result of ECSI considerations (and therefore, because of the breakeven standard, other rates are increased), economic analysis of the resulting trade-offs properly and necessarily plays a role in that process.

[22] To support its argument, Hallmark claims that Congress wanted postal rate schedules that would foster *more* postal communications, not "ration" the demand. Hallmark Brief at 21. In fact, although Ramsey pricing does <u>not</u> maximize postal volumes (Tr. 10/5110) -- it instead minimizes the aggregate burden on consumers -- witness Bernstein's comparison between Ramsey prices and the illustrative rates developed on the basis of the R94-1 markup indices clearly shows a substantial increase in volume when Ramsey prices are applied. USPS-T-31 at 54-56, 67. As he discusses at 56, the increase in total mail volume is one reflection of the benefits to mailers from Ramsey pricing. Ironically, Hallmark appears to be totally oblivious to these facts in its baseless arguments on demand rationing.

this docket.

Beyond difficulties with some of the more sweeping allegations made by Hallmark, many more specific claims are erroneous and unsupported as well. For example, Hallmark at 29 claims that Ramsey pricing depends on price responses measured in an "open, competitive" market. Hallmark provides no citation, and there is no support for this claim on the record.[23] On page 31, Hallmark claims that witness Bernstein's analysis of single-piece and workshared letters "appears to give no recognition to the fact that mailers of single-piece letters are generally not free to perform ... worksharing activities." In fact, witness Bernstein addresses exactly this type of issue not only in his POIR response (Tr. 10/5080-82), but in his direct testimony at 77-78.

In the context of postal ratemaking, Hallmark totally misconstrues the nature and objectives of the Ramsey analysis:

> Undifferentiated maximizing of total surplus (i.e., producer plus consumer surplus) is not a stated goal of the legislation; and where the "producer" is declared in the first sentence of the first section to be a fundamental service provided *by* the government *to* the people, it cannot reasonably be inferred as a Congressional purpose. Instead, the Act seeks to provide benefits to the people -- not a theoretical aggregate comprising the people plus the Postal Service itself.

Hallmark Brief at 25-26. In the context of postal ratemaking, however, the breakeven

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[23] Once again, however, it should be noted that Dr. O'Hara was specifically asked what effect the existence of the Private Express Statutes should have if they were presumed to influence the observed elasticity of First-Class Mail, and he readily acknowledged that this would provide a basis under section 3622(b)(5) to mitigate the cost coverage otherwise implied by the observed elasticity. Tr. 2/182. This would be done not to "correct" the Ramsey model, as Hallmark mistakenly suggests on page 31, but to insure full compliance with all of the criteria of the Act.

constraint insures that there is no producer surplus. Tr. 10/5118-19. As Mr. Bernstein emphasizes throughout his testimony (e.g., USPS-T-31 at 14-16, 67-71), all gains from Ramsey pricing are accrued by "the people," while the Postal Service is indifferent, in terms of "producer surplus," between any sets of rates that allow it to achieve breakeven. This is why, as addressed in the Postal Service initial brief at IV-3 - 5, Ramsey pricing is such a useful tool to allow ratemakers to seek to avoid impairment of "the overall value of such service to the people," as required by the last sentence of section 101(a) of the Act.

On pages 32-33, Hallmark claims that Ramsey pricing assumes that accurate measures of costs are available. So does every other pricing scheme ever proposed in postal ratemaking. Specifically, on page 32, Hallmark alleges that non-volume variable costs are assumed to be incurred efficiently, and cites Tr. 10/5114-16. On those pages, however, witness Bernstein explicitly and directly explained that no such "efficient provider" assumption is required for Ramsey pricing. If Ramsey pricing does not solve any potential problems of underlying efficiencies, as Hallmark alleges on page 34, neither will any other ratemaking scheme that remains subject to the breakeven constraint imposed by the statute in section 3621.

Most curiously, Hallmark at 33 appears to suggest that "under a Ramsey-pricing regime," the Postal Service has great "leeway" to ignore ECSI values, the preservation of fairness, or mitigation of rate shock, as if Ramsey pricing somehow makes the Commission disappear, or substantially diminishes its role in the pricing process. Obviously, however, use of Ramsey pricing for the purposes proposed in this proceeding in no way diminishes the central role of the Commission in the pricing process.[24]

With respect to the specific Ramsey models presented on this record, Hallmark also makes substantial errors. As Hallmark claims at 27, witness Bernstein and Prof. Sherman do use slightly different elasticities. The difference, however, is a manifestation of nothing more than varying approaches on how best to integrate the breakeven constraint with the Commission's test year rule under which these proceedings are conducted. Most importantly, whereas Hallmark asserts (with no supporting citation) on page 26 that the "difference in results is material," the record shows that Prof. Sherman testified that "[a]s it turns out, these differences are not great." Tr. 26/13714, 13716. On the matter of cross-price elasticities, raised in its brief at page 28, Hallmark ignores the testimony provided by witness Bernstein to explain why these matters are not the problem which Hallmark attempts to make them out to be. See Tr. 10/5023-24, 5027, 5068-74.

In summary, the misapprehensions of Hallmark regarding Ramsey pricing are

[24] Even when the Commission takes account of "non-economic" factors, however, it cannot ignore the role that demand factors must play in the achievement of breakeven. For example, the markups for the preferred subclasses are linked by RFRA to those of their commercial counterparts. If this clearly "non-economic" consideration leads to lower rates for preferred subclasses, it must likewise lead to higher rates for at least one other category of mail. The extent to which rates for other subclasses must be raised to offset exactly the revenue loss associated with conformity to RFRA requires estimation of the volume effects of rate changes, using demand elasticities. A Ramsey model using such demand elasticities can calculate the economically most efficient manner to take account of RFRA. Tr. 25/13800. The Commission, of course, is free to adjust rates differently from the Ramsey solution, but, in order to maintain breakeven, the resulting prices will depend on the same estimated elasticities of demand.

based on a fundamental misunderstanding of economic theory and the record in this case. Perhaps most importantly, thought, the greatest disservice that the Hallmark brief does is to woefully exaggerate the role proposed for Ramsey pricing by its advocates. It is a tool which the Commission can use to evaluate directly matters of economic efficiency. It in no way presupposes the weight that the Commission will give to economic efficiency factors, nor diminishes the Commission's ability to apply other criteria to achieve contrary results. If the Commission chooses to use the Ramsey models in a more qualitative rather than quantitative fashion, that is its prerogative, as the Second Circuit held in the *DMA* case. What is <u>not</u> within the Commission's discretion, however, as even Hallmark must acknowledge, would be to ignore altogether issues of economic efficiency and relative demand.

E. Conclusion: The Proposed Pricing Framework Makes Sense

When Congress enacted the Postal Reorganization Act, establishing both the Postal Service and the Commission, Congress was well aware of the tension it was creating between its desire to retain the postal system as a public service within the federal government, and its intention of allowing the postal system to be run on a much more "businesslike" basis. The committee reports of both the House and Senate addressed this potential conflict directly. See, e.g., S.Rep. No. 912, 91st Cong., 2d Sess. (June 3, 1970) at 2-3; H.Rep. No. 1104, 91st Cong., 2d Sess. (May 19, 1970) at 19-20. What Congress was hoping for was a structure that would allow the Postal Service and American public to enjoy the best of both worlds.

The pricing framework proposed by the Postal Service enhances the ability of the ratemaking process to support that intention. Marking up volume variable costs provides the best possible basis to keep consumption decisions as close as possible to the margin, where trade-offs are most properly conducted between the value to the purchaser and the scarce resources of society that are expended. Setting an incremental cost floor protects mailers and competitors from suffering the potential harm of cross-subsidy, while likewise protecting the interest of the Postal Service -- no rational business wants to give away goods or services for less than it costs to produce them. Ramsey pricing, while perhaps a less integral part of the framework, provides a direct and relatively simple way to integrate available information on the markets in which postal products compete. Moreover, Ramsey pricing also encourages recognition of the fact that ultimately all ratemaking factors will have to be blended into rates which must be expressed in dollars and cents, and that, given the breakeven constraint, offsetting rate adjustments, no matter how developed, have tangible effects on economic efficiency.

Yet the framework proposed in no way impinges on the Commission's ability to recognize that the Postal Service is a public service, and that the ratemaking factors extend well beyond the scope of pricing criteria that might be considered by a purely "businesslike" enterprise. The ability is there for the Commission to continue to give ample consideration to the full range of statutory factors, starting with fairness and equity. No presumption is applied as to how the Commission might choose to weight those factors as it goes about the difficult task of balancing the many competing considerations which must inform the exercise of reasoned pricing discretion. The proposed pricing framework allows rates to be set in accord with the Congressional intent to maintain the postal system as a public service, but it likewise allows that objective to be achieved in the most "businesslike" way practicable, with complete awareness of the trade-offs required between economic efficiency, fairness and equity, and the full range of other statutory considerations. The Postal Service urges the Commission to employ it in this case, and in future rate proceedings as well.

V. THE PROPOSED RATE DESIGNS OF THE POSTAL SERVICE ADHERE TO THE POLICIES OF THE ACT IN SUCH A MANNER AS TO RENDER ALTERATIVE PROPOSALS INFERIOR.

A. The Commission Should Recommend First-Class Mail Rates And Classifications Which Conform As Closely As Possible To Those Proposed By The Postal Service And Reject Non-Conforming Intervenor Proposals

On Brief, a number of intervenors concerned with First-Class Mail have urged the Commission to reject the First-Class Mail rate and classification proposals of the Postal Service and to adopt alternative rate and classification proposals which they have sponsored or endorsed. The testimonies of Postal Service witnesses Miller(USPS-T-23 and USPS-RT-17), Hatfield (USPS-T-25), Fronk (USPS-T-32), Daniel (USPS-ST-43), Ellard (USPS-RT-14), Steidtmann (USPS-RT-15), Sheehan (USPS-RT-16) and Murphy (USPS-RT-18) demonstrate why the Postal Service's proposals should be embraced by the Commission and why alternative intervenor proposals should be rejected.

The Postal Service's First-Class Mail rate and classification proposals and, to a great degree, the intervenors' proposals were addressed in § V.A. of our Brief. Not all of these intervenor proposals merit further discussion in our Reply Brief. A number of parties introduced new proposals in their Briefs. Below, the Postal Service responds to many of the principal arguments advanced by intervenors in opposition to the Postal Service's proposals and in support of their own alternatives.

1. ABA/EEI/NAPM's analysis should be rejected in it entirety.

a. The arguments of ABA/EEI/NAPM are based upon a misleading comparison.

The opening paragraphs of the ABA/EEI/NAPM Brief contain a misleading comparison of the proposed average increase for First-Class Mail to the proposed average increase for Standard (A) Regular Mail. Their Brief asserts that the proposed average increase for Standard (A) Regular Mail is only 1.9 percent, as compared to a proposed 3.1 percent increase for single-piece First-Class Mail and an average 4.5 percent increase for workshared First-Class Mail.

As discussed by Postal Service witness Moeller (USPS-T-36 at 2-3; Tr. 6/2737-8), the percentage change measurement for Standard (A) Mail uses a constant volume mix, so that after-rates migration of ECR Basic letters to the Regular subclass does not distort the figures. Thus, the appropriate figure to use in comparing to other mail classes, including First-Class Mail, is the proposed 4.1 percent increase for Regular Standard (A) Mail.

b. ABA/EEI/NAPM misrepresent the First-Class Mail passthroughs.

The opening paragraphs of the ABA/EEI/NAPM Brief also misrepresent the First-Class Mail passthroughs presented in the Postal Service's request, asserting that the First-Class Mail passthroughs never exceed 100 percent. As clearly stated in the testimony of Postal Service witness Fronk, the proposed discount for Automation Carrier Route letters represents a 150 percent passthrough of the cost differential between 5-Digit and Carrier Route letters. USPS-T-32, at 28.

c. Dr. Clifton's approach is devoid of analytical rigor and is anything but conservative.

In defense of Dr. Clifton's First-Class Mail cost analysis and rate design, ABA/EEI/NAPM criticize the Postal Service's First-Class Mail costing and pricing analysis. The Postal Service offered general criticisms of Dr. Clifton's work at pages V-39-50 of its Brief. As explained below, ABA/EEI/NAPM's defense of Dr. Clifton does nothing to convert his sow's ear into a silk purse.

d. The points of comparison should be clarified.

ABA/EEI/NAPM argue that the 7.1 percent increase originally 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, which is referenced by Dr. Clifton at Tr. 24/12477, 12479. They argue that:

> In contrast, given the actual mail processing cost declines, -13.8 percent, Dr. Clifton examined the source(s) of the dynamic and whether a continuation into the test year was likely. He considered, *inter alia*, the effects of mail mix changes and classification reform. Based on this thoroughly analytical process, Dr. Clifton developed a conservative -3.6 percent roll forward factor and demonstrated that the Postal Service's 7.1 roll forward factor was an arbitrary number, wholly divorced from actual results as well as data underlying Postal Service's filing.

ABA/EEI/NAPM Brief at 5-6. On that page at n. 8, they point out that, had Dr. Clifton not taken a "conservative" approach, his rollforward factor would have been a considerably larger negative number, based upon his projected 25 percent decline in TY 1998 unit mail processing costs for workshare First-Class Mail letters compared to Base Year 1996 and his emphasis on recent cost data. As is demonstrated below, Dr. Clifton has not followed a "thorough analytical process" and he has been anything but "conservative."

There is no dispute that First-Class mail processing labor unit costs declined from FY94 to FY96 and that the Postal Service projects an increase in these same costs for FY96 to FY98. But the ABA/EEI/NAPM Brief fails to clarify the magnitude of the aforementioned trends. Concerning the decrease in labor unit costs from FY94 to FY96, Dr. Clifton indicated that, once he realized he needed to include mail processing overhead labor costs, the actual decline in mail processing labor unit costs for First-Class presort was 12 percent, rather than 13.8 percent. Tr. 24/12654 and 12656, 12700-03.

With regard to the Postal Service's 7.1 percent increase projected for mail processing labor unit cost for FY96 to FY98, it should be remembered that the Postal Service acknowledged the need for a correction in a revised rollforward which would nearly cut this increase in half, due to the erroneous omission of the USPS Library Reference H-126, page II-4 First-Class Mail presort volume mix adjustment from the rollforward.[1] The Postal Service's March 6, 1998, response to POIR No. 14, Question 1, clarified that the 2.9 percent reduction in First-Class presort mail processing costs had not been made. Once corrected, the Postal Service's projected 7.1 percent increase in the First-Class presort mail processing unit labor

[1] In fact, Dr. Clifton's correctly suggested that Postal Service witness Patelunas had not included the 2.9 percent reduction specified by the mail volume mix adjustment in obtaining the overall 7.1 percent increase for First-Class presort. Tr. 24/12480, n. 7.

costs between FY96 and FY98 would instead be approximately a 4.2 percent increase.

e. Dr. Clifton has been neither analytical nor thorough.

Dr. Clifton did not follow a "thorough analytical process" in deciding that the 13.8 percent decline in First-Class presort mail processing unit labor costs between FY94 to FY96 was a good indicator for cost trends between the Base Year and Test Year. Dr. Clifton provided no evidence of any meaningful analysis. As indicated in our Initial Brief at V-42-44, Dr. Clifton simply asserted that much of the decline in unit labor costs between FY94 and FY96 resulted from the growth in prebarcoding by First-Class presort mailers. *See* Tr. 24/12481. Given this assertion, he computed an elasticity (Tr. 24/12515) which was meant to suggest that the growth in prebarcoding in the FY94 to FY96 had a very large downward impact on labor unit costs in this same period. An examination of the data shows that most all of the cost decline occurred between FY94 to FY95, while the growth in prebarcoding, which supposedly caused the decline in costs, occurred evenly over the FY94 to FY96 period. Dr. Clifton did not even examine the data on labor unit costs and the percentage of non-prebarcoded mail for the period prior to FY94, to study if growth in prebarcoding reduced the labor unit costs in the years prior to FY94. USPS Brief at 43. Most egregiously, he did not examine to what degree the cost decline in FY94 to FY96 was caused by the Postal Service's automation of letter mail processing. *Id.*

In addition, Dr. Clifton applied his "rollforward factors" to total mail processing unit costs (labor and piggyback costs). This is an unjustifiable approach, since trends in labor unit costs are unlikely to apply to total unit costs during a period of automation. *Id.* at 43-44. In short, Dr. Clifton liked the implications of the FY94 to FY96 cost trend, whatever caused it, and simply asserted it would happen again for FY96 to FY98 for those same reasons, whatever they may have been.

Dr. Clifton's rejection of the 2.9 percent volume mix adjustment also lacks an analytical basis. He rejected this adjustment as highly flawed, simply because it did not reflect the 13.8 percent decline between FY94 and FY96 or "make use of the good empirical data we have for FY94 to FY96 relating shifts in First-Class workshared volume mixes to changes in unit costs." Tr. 24/12481. That was his entire rationale for rejecting it. He made no other criticism of USPS LR-H-126. In fact, Dr. Clifton's calculations used all of the inputs from USPS LR-H-126 -- Dr. Tolley's and Mr. Thress' forecasted-before-rates volumes,[2] witness Hatfield's cost models (USPS-T-25),[3] and witness Alexandrovich's (USPS-T-5) Base Year costs[4]. Dr. Clifton accepted all the inputs and offered no criticism of the calculations in USPS LR-H-126, or witness Patelunas' (USPS-T-15) rollforward costs. He just could not bring himself to accept the results.

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[2] *See* Tr. 24/12515, 12707.

[3] *See* Tr. 24/12639.

[4] *See* Tr. 24/12725.

Incredibly, Dr. Clifton's rejection of the -2.9 percent mail mix adjustment and the Postal Service's original projection of a 7.1 percent increase for First-Class presort mail processing labor unit costs (which, if corrected, would be approximately 4.2 percent) now appears to have been contradicted by ABA/EEI/NAPM in the course of their attempt to rebut MOAA witness Andrew at pages 6-8 of their Brief. Dr. Clifton's elasticity of 0.4568 gave all the credit for labor unit cost declines to mail volume mix changes (growth in prebarcoding). Tr. 24/12481. His other statements (Tr. 24/12481) give most all of the credit to mail volume mix changes. Nevertheless, ABA/EEI/NAPM argue, indeed demonstrate, that mail volume mix changes alone could not have caused even half of the 13.8 percent drop in unit costs. In addition, ABA/EEI/NAPM argue that unit costs would likely increase, due to inflation, if the only source of savings was mail volume mix changes. ABA/EEI/NAPM Brief at 7, n. 11.

At Tr. 36/19770, an ABA/EEI/NAPM cross-examination exhibit implied how inflation could offset the effects of the volume mix savings and lead to a 4.3 percent increase in mail processing unit labor costs for workshared mail from the Base Year to the Test Year, similar to the revised 4.2 percent increase projected by the Postal Service for First-Class presort mail processing unit labor costs. Although some of the inputs used in this exhibit are unrealistic, this result still has value, since overstatement in both the rate of inflation and the cost difference between automated and nonautomated are offsetting.[5] One could interpret this exhibit as an implicit acceptance of the calculations performed in USPS LR-H-126 for the mail volume mix adjustment. It affirms the reasonableness of the Postal Service's mail volume mix adjustment of 2.9 percent. It also could be viewed as an endorsement of the Postal Service's projected Base Year to Test Year 4.2 percent increase in mail processing labor unit cost for workshared First-Class Mail.

f. Dr. Clifton's claims of conservatism are contrived.

The lack of "conservatism" in Dr. Clifton's approach is evident when one reviews the manner in which he arrived at his projected "25 percent" decline in TY 1998 unit mail processing labor costs referred to at n. 8 on page 6 of the ABA/EEI/NAPM Brief.[6]

As the first step in obtaining his 25 percent decline result, Dr. Clifton calculated his elasticity of unit costs with respect to nonautomation share, 0.4558 (Tr. 24/12515), which is predicated on the assumption that 100 percent of the

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[5] The inflation rate in the exhibit, 10 percent, appears to exceed actual or anticipated inflation rates, and the cost difference between auto and nonauto is exaggerated by the use of total mail processing costs, rather than just labor costs, as indicated by USPS LR-H-126, page II-5.

[6] This refers to Dr. Clifton's roll back of the 4.61-cent First-Class Mail 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 rolls this 4.61-cent cost estimate back to 3.21 cents. Based upon this revised mail processing unit cost, Dr. Clifton provided his own mail processing unit cost estimates for each First-Class presort rate category, as shown at the second column of Tr. 24/12484. *See also* Tr. 24/12519, 12718.

decline in unit costs was due to mail volume mix changes.[7] This elasticity embodied the labor unit cost decline of 13.8 percent over the FY94 to FY96 period. Dr. Clifton applied this elasticity to the FY96 to FY98 period and obtained a 25 percent labor unit cost decline for FY96 to FY98 of .6908 cents, a decline much larger than the 0.4-cent unit cost decline in FY94 to FY96. *See* Tr. 24/12518, 12479. He obtained this result, even though the decline in the nonautomation share (or the growth in prebarcoding) between FY94 to FY96 was of the same magnitude as projected for FY96 to FY98. He obtained his improbable result because the lower level of the nonautomation share in the period FY96 to FY98, as compared to FY94 to FY96, magnified the drop in the percentage change in unit cost. *See* Tr. 24/12661-63. The 25 percentage decrease in the base year labor unit costs of 0.6908 cents, plus the approximately 0.2-cent increase (Tr. 24 /12479) in labor unit costs included in the Postal Service original calculations, amounts to a 0.9 cent decline in labor costs relative to the Postal Service's calculations. To top it off, Dr. Clifton's method led to a decline in piggybacked costs in proportion to the decline in labor costs as well, so that Dr. Clifton obtained a 3.21-cent estimate of First-Class Mail non-Carrier Route Presort mail processing unit (labor and piggyback) costs (Tr. 24/12519), a decline of 1.4 cents.

In summary, Dr. Clifton applied his flawed premise that a 13.8 percent decline in labor unit costs resulted from the growth in prebarcoding in a questionable

[7] A view which ABA/EEI/NAPM apparently no longer endorses, as indicated earlier in this discussion.

manner to obtain a 25 percent labor unit cost decline. Then he further enlarged this decline by reducing, again without basis, the piggybacked costs in proportion with the labor unit cost reduction. At page 6, n. 8 of their Brief, ABA/EEI/NAPM point out that Dr. Clifton was being "conservative" in not using this 25 percent decline in TY 1998 unit mail processing costs for workshare FCLM compared to BY 1996. Dr. Clifton's decision not to use this result is a "no-brainer," since the result is indefensible. Dr. Clifton agreed that this result was not credible, but used it as a "straw man" to make his otherwise result-oriented -3.6 percent rollforward factor look "believable." Tr. 24/12718-9.

Using his unbelievable 25 percent decline in First-Class presort unit labor cost as a backdrop, Dr. Clifton decided "in the interest of financial conservatism" to rely entirely on the percentage decline in unit cost that occurred between FY95 to FY96, in making his rollforward adjustments. Tr. 24/12485. His initial estimate was a 2.8 percent decline in mail processing direct labor costs between FY95 and FY96. Accordingly, he assumed an annual decline of 2.8 percent in projecting from FY96 to FY98, or a -2.8 percent rollforward factor. *See* Tr. 24/12656, 12654, 12700-03, 12739. From this calculation, Tr. 24/12638-39, he provided the mail processing unit costs for each First-Class presort rate category shown at Tr. 24/12638. He uses these costs in his Table 14 (Tr. 24/12496) to develop his proposed rates at Tr. 24/12506.

But, just before his testimony was filed, he realized that he had not included mail processing overhead labor costs in his calculation of a decline of 2.8 percent in labor unit costs between FY95 to FY96. Tr. 24/12656. When he recalculated the decline, with overhead costs, he got a 1.1 percent decline in mail processing labor unit costs. *See* Tr. 24/12654, and 12700-03. Apparently this decline was too financially conservative for him, so he developed a new rollforward method for projecting future cost trends which considered the decline in costs between FY94 and FY95, as well as the decline between FY95 and FY96. *See* Tr. 24/12654 and 12701. This resulted in his "modest" -3.6 percent rollforward factor. Using this factor, he reduced mail processing labor unit costs by 3.6 percent from FY96 to FY97 and again from FY97 to FY98. Tr. 24/12483.[8]

Based on this, Dr. Clifton obtained a mail processing unit cost of 3.98 cents, from which he provided the mail processing unit costs for each First-Class presort rate category shown in the six columns of Table 9 at Tr. 24/12484. These were the final costs contained in his Table 14 on Tr. 24/12496.

It is abundantly clear that Dr. Clifton did not perform anything resembling a "thorough analysis." When the false backdrop of the 25 percent decline in First-Class workshare mail processing unit labor costs is taken down, ABA/EEI/NAPM's effort to portray Dr. Clifton's proposed -3.6 percent rollforward factor method as "conservative" is revealed to be a sham.

[8] *See also* page 1-2 of the attachment to Dr. Clifton's revised response to USPS/ABA&EEI&NAPM-T1-4 (revised on 2/12/98), which replaced the answer reported at Tr. 24/12638-9.

g. Dr. Clifton's claims of inflated Postal Service cost estimates have no basis.

At pages 16-17 of their Brief, ABA/EEI/NAPM argue that the Postal Service inflated its volume-variable cost estimates for workshare First-Class Mail letters by using a higher mail processing piggyback factor for workshare letters than for single-piece letters.

This argument is based upon Dr. Clifton's comparison of the piggyback factors for workshared and single-piece mail and his decision, without explanation, to declare them invalid. At lines 4-7 of Tr. 24/12480, he called the second term in line 9 of Tr. 24/12480 (the figure 1.604) the "assumed" piggyback factor. However, at Tr. 24/12740-42, he did not seem to be sure why it was "assumed." He claimed he did not personally know where the mail processing piggyback factor came from or whether it was calculated in USPS LR-H-77, but he assured us that his staff would know. Dr. Clifton never disputed the details of the calculations in USPS LR-H-77. He never addressed the base year and test year treatment of non-labor costs. He also never suggested that First-Class presort had been distributed more than its appropriate amount of non-labor (such as facility and equipment related) costs in the Postal Service's development of Base Year or Test Year costs. Here again, Dr. Clifton just did not like the Postal Service's results and criticized them for . . . , well, for just not being results he would have preferred.

h. ABA/EEI/NAPM's arguments relating to the Move Update requirements have been thoroughly refuted.

At pages 8-10 of their Brief, ABA/EEI/NAPM argue that the Postal Service's workshare First-Class Mail letter volume-variable cost estimates are inflated because they fail to account for the impact of the implementation of mandatory Move Update requirements for prebarcoded and presorted First-Class Mail. At pages V-45-47 of its Brief, the Postal Service explained why this claim is invalid.

In support of their argument, at page 10. n. 8 of their Brief, ABA/EEI/NAPM mischaracterize the testimony of Postal Service rebuttal witness Murphy, and then refute the mischaracterization.[9]

In our Brief at page V-47, we demonstrated why, even if there had been a decline in forwarding of workshared mail in the Test Year (which witness Murphy demonstrated has not occurred), Dr. Clifton's estimated 0.262-cent per piece Move Update savings would still be an overstatement.

Reliance by ABA/EEI/NAPM at page 9 of their Brief on a 57-cent estimate of per-piece forwarding costs is misguided. Postal Service witness Murphy made clear that the 57-cent cost for forwarding that he provided an NAPM member (Tr. 33/17693) was not intended to represent a system-wide average forwarding cost estimate, but was intended to address specific scenarios described by the mailer in a technical paper it presented. Tr. 33/17694. The only estimate of forwarding costs

[9] Mr. Murphy's testimony is correctly summarized at V-46-47 of the Postal Service Brief.

in the record of this proceeding is reflected in the Docket No. MC95-1 USPS Library Reference on which Dr. Clifton relies (USPS LR-MCR-76). It estimates the cost of forwarding to be 23.16 cents per piece. Tr. 24/12512 and Docket No. MC95-1 USPS Library Reference MCR-76, at 5-5 (Table 5.2). *See also* Tr. 33/17686-87.

i. The ABA/EEI/NAPM criticism of the benchmark misses the mark and should be benched.

Echoing the testimony of witness Clifton at pages 17-19 of their Brief, ABA/EEI/NAPM criticize the Postal Service's use of the bulk metered benchmark in establishing discounts for automated First-Class Mail letters. The Postal Service addressed these criticisms at pages V-47—48 of its Brief.

In discussing the arithmetic revision to the benchmark cost estimate, the ABA/EEI/NAPM Brief, beginning at page 17, distorts history and indulges in an unseemly, vitriolic diatribe concerning Postal Service direct testimony, a tactic which, to coin a phrase, "makes a mockery of the ratemaking process." Witness Fronk's originally filed testimony (USPS-T-32) included two footnotes, footnotes 4 and 5, which flagged the revision in the benchmark and specifically indicated which rate categories this revision affected. Those footnotes also indicated that the benchmark cost revision was not available at the time the First-Class rate proposals were developed and approved by the Board of Governors.

Witness Fronk explained how this revision would change the cost differentials and the implicit cost passthroughs for Automation Basic and 3-Digit letters. Tr. 4/1406-07. He further clarified the matter by filing Appendix A to his direct testimony, explaining the effect on changes in the First-Class Mail cost data.[10] Such documentation hardly qualifies as "ignoring its own [USPS] worksharing cost estimates," as ABA/EEI/NAPM assert at page 20 of their Brief.

On page 17, ABA/EEI/NAPM argue that "[t]he benchmark used to set workshare FCLM rates has long been the costs for single piece First-Class mail." They assert that it has neither been shown to be unreasonable nor successfully challenged. ABA, EEI and NAPM are encouraged to get together and review the Commission's opinion in Docket No. MC95-1, particularly pages V-136-37, specifically ¶4302.

At page 18, they argue that the Postal Service's Docket No. R97-1 benchmark cost was understated, because its calculation assumes that the metered mail will be trayed. However, this argument ignores record evidence on this very point. *See* USPS-T-32 at 20 and Tr. 4/1418. Next, ABA/EEI/NAPM claim that the benchmark cost was understated, because it failed to reflect collection costs. Putting aside whether a difference in collection costs is relevant, there is no record evidence of a difference in the collection costs for bulk metered mail and First-Class workshare mail. For there to be an allegation of understatement, there needs to at least be a showing that bulk metered mail incurs more collection costs than does First-Class workshare mail. *See* Tr. 19-A/8411. They also assert that the benchmark cost is understated because it is based upon the assumption that bulk

[10] The effect of this benchmark revision on rates was summarized in the Postal Service Brief at V-14—15 and 23—25.

metered benchmark mail has a delivery cost equal to that of First-Class nonautomation presort letters. However, as indicated at Tr. 19-A/8417-18, the delivery costs for bulk metered mail are likely to be very similar to that for First-Class nonautomation presort letters, because of similar characteristics, especially when one considers the percentage of pieces which are delivery point sequenced. Finally, on page 19, they criticize the benchmark cost because it does not include costs unrelated to mail processing and delivery. But, if those costs are unrelated to the basis for cost avoidance calculations, it is not clear that they have any relevance to the validity of the benchmark cost estimate. USPS-T-32, at 20-21.

2. NDMS criticisms notwithstanding, the nonstandard surcharge should be increased to the levels proposed by witness Fronk.

a. NDMS exaggerates the impact of the proposed increase.

At page 3 of their Brief criticizing the Postal Service's First-Class Mail nonstandard surcharge proposals, NDMS argue that the 45 percent increase (in the single-piece nonstandard surcharge) represents a ten-fold increase over the proposed system-wide average 4.5 percent rate increase. This is a misleading comparison. The appropriate comparison is between the 43-cent postage for mailing a nonstandard piece of single-piece First-Class Mail at present[11] and the proposed postage of 49 cents.[12] This represents a 14 percent increase, which is nowhere near 10 times the proposed 4.5 percent system-wide average increase.

[11] 32 cents plus an 11-cent surcharge.

[12] 33 cents plus a 16-cent surcharge.

b. Table 5 in the NDMS Brief proves nothing.

The nonstandard surcharge for First-Class Mail is intended to reflect the additional cost associated with the handling of one-ounce pieces which exceed standard dimensions. The NDMS Brief criticizes the justification for the surcharge which applies to nonpresorted one-ounce letters proposed by Postal Service witness Fronk (USPS-T-32) and the underlying cost estimates of witness Daniel (USPS-ST-43). As demonstrated in our Brief at V-61-65, witness Fronk's proposal is more than justified, in light of witness Daniel's refinements to earlier cost studies. Below, the Postal Service responds to several points made in the NDMS Brief and further demonstrates that their proposals to either eliminate or reduce the surcharge are without merit.

At page 14 of their Brief, NDMS argue that "[t]he Postal Service's own evidence, coupled with Dr. Haldi's testimony supports elimination of, or a significant reduction in, the current First-Class nonstandard [single-piece] nonstandard surcharge." Beginning at page 17, they engage in considerable discussion which culminates in a cost analysis in Table 5 on page 44. This Table purportedly demonstrates that the current 11-cent surcharge should be reduced to less than three cents. A cursory review reveals that its results are contrived. Table 5 at page 44 of the NDMS Brief contains a number of arbitrary and fatal assumptions. To illustrate, the Postal Service has generated a parallel Table 5 below which "read[s] the evidence in a light most favorable" to those opposed to the surcharge.

Accordingly, NDMS's arbitrary, but non-fatal, assumptions will be "liberally" assumed. *See* NDMS Brief at 43.

The calculations in NDMS Table 5 use witness Daniel's estimated 8.8 cents cost differential[13] between the average cost of handling letters and the cost of manually handling letters. However, their calculation assumes only 25 percent of currently defined nonstandard letter-shaped pieces will be processed manually. This is an arbitrary assumption. While it is certainly more conservative than witness Daniel's assumption that 100 percent are processed manually, NDMS provides no rational basis for the selection of its 25 percent estimate. Nevertheless, for our purposes here, the 25 percent assumption will be used below.[14]

The next arbitrary assumption in NDMS Table 5 is the use of the "manual letter proxy" instead of the difference in the processing cost of an average First-Class parcel and an average letter. Using the 8.8-cent differential in place of the 62.3-cent differential is extremely conservative[15] and was clearly chosen by NDMS to drive toward a favorable result. The "manual letter proxy" for parcels, however, is also used in the parallel Table 5 below.

The most peculiar assumptions in NDMS Table 5, however, are those regarding flat-shaped pieces subject to the nonstandard surcharge. Clearly,

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[13] To be referred to as "manual letter proxy."

[14] In the absence of quantifiable evidence of the actual percentage processed manually, it is unclear which estimate is more realistic.

[15] Obviously, even if all First-Class parcels could be sorted in a letter-case, the cost of such activity would be higher than the cost of manually sorting letters because, among other things, the case would have to be swept more often.

assuming that only 25 percent of flats subject to the surcharge cost more to process than the average letter is unreasonable. It is a given that flats are not as efficiently handled as automatable letters. The productivity for the FSM 1000[16] is 708 pieces per hour, as demonstrated by witness Seckar in USPS LR-H-134, Section 1, page 12. However, the productivities for letter barcode equipment range from 7,467 to 17,124 pieces per hour. *See* USPS-T-29, Appendix I at 43. Accordingly, all other things equal, it is counter-intuitive to conclude that a flat could cost less than a letter. Therefore, the 100 percent assumption (as opposed to the 25 percent assumption) to weight the cost difference is more reasonable and is used in the parallel Table 5 below.

The only assumption left is the difference between the cost of processing flats subject to the surcharge and the cost of processing an average First-Class Mail letter. The NDMS assumption that this difference is equal to the manual letter proxy is absurd. NDMS assumes that flats are cased as efficiently as letters. The claim at page 42 of the NDMS Brief that "[i]f nonstandard flats have additional costs due to their "flimsy" nature, it would be amply covered by a surcharge based on the manual letter cost proxy" is devoid of any rational basis. Witness Seckar presented detailed information on flats mail processing costs in USPS LR-H-134. Even though mail processing costs for First-Class single piece flats are not presented, Seckar did present information on the cost of processing various First-Class Presort flats. Page

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[16] At page 42 of their Brief, NDMS concede that "[t]he evidence is less clear with respect to processing flats on the FSM 881."

3 of Section 1 in that library reference, adopted by witness Seckar, contains the cost of processing nonmachinable First-Class Presort flats. At page 42 of its Brief, NDMS concedes that it is not clear that these "flimsy" flats can be processed on the FSM 881. Using the cost of *Presorted* flats to compute the cost differential is a reasonable, conservative compromise and is used in the parallel Table 5 below.

USPS Parallel Table 5

Letters 19.3% x 8.8 cents	=	$.0170 x 25% =	$.00425
Flats 73.1% x 14.6[17] cents	=	$.1067 x 100% =	$.10673
Parcels 7.6% x 8.8 cents	=	$.0067 x 100% =	$.00669
USPS WEIGHTED COST DIFFERENTIAL			$.11767

This very conservative cost differential of 11.8 cents computed above in USPS Parallel Table 5 is based upon a number of extreme assumptions designed to favor NDMS. The Parallel Table 5 refutes any suggestion that the surcharge should be eliminated or diminished. The NDMS Table 5 proves nothing.

3. The APPA Brief abandons the APPA witness.

Testifying on behalf of APPA, witness Threadgill did his best to persuade the Commission that a century's worth of postcard/letter price relationships and intrinsic

[17] Mail flow processing cost of Nonmachinable First-Class Presort = 12.226 which is multiplied by CRA Adjustment factor of 1.9683. This product is added to the Fixed CRA cost of 2.2123 to equal 26.3 cents. Cost are from page 3 of Section 1 of LR-H-134. The average letter cost of 11.7 is subtracted from the Presort flat cost of 26.28 to get the 14.6 cent differential.

qualitative differences[18] between post cards and letters compel the Commission to recommend a postcard rate that is close to one-half the rate for a letter. Nearly halfway through its Brief, at page 7, however, APPA abandons its witness and argues that the Commission should, in the interest of rate simplicity, recommend the same rate for postcards, Courtesy Envelope Mail letters, and the additional-ounce rate for letters. APPA Brief at 7.

APPA argues that one could use a stamp with one denomination for all three of these First-Class Mail rate elements, but makes no attempt to reconcile this proposal with witness Threadgill's testimony about the degree to which qualitative differences between postcards and letters require significant price differentials, rather than price equality. Moreover, even if APPA's new proposals to have the same rate for postcards, CEM, and the additional-ounce rate were not inconsistent with its own witness' testimony, APPA does not explain how its new proposals are consistent with the § 3622(b)(7) objective of having identifiable rate relationships.

At page 9 of its Brief, APPA proposes that the Commission take a "common-sense" approach and treat single-piece and worksharing First-Class Mail as two separate services. APPA argues that there would be no need to identify these two distinct services as "subclasses," and goes on to cite, with approval, Postal Service Docket No. MC95-1 testimony which advocated such a subclass distinction. The Postal Service respectfully submits that, notwithstanding any disappointment it may

[18] Regarding relative degrees of privacy, communication quantity, and differences in elasticity of demand.

have about the resolution of the First-Class Mail subclass issue in Docket No. MC95-1, the record in the instant proceeding is devoid of any basis for reaching a different result.

4. The basis for a separate rate for stamped cards has not been established.

Douglas Carlson and the OCA claim that automation compatibility explains the CRA cost difference between stamped and private cards, and justifies two separate classifications. Carlson Brief at 1; OCA Brief at 153. If Mr. Carlson and the OCA wish to establish a stamped card rate category to reflect automation compatibility cost savings, these savings must first be quantified. As the Postal Service Brief emphasized, the extent of any automation compatibility cost savings has not been established. Postal Service Brief at V-70-71. The Postal Service has explained how longstanding tally assignment problems with stamped cards make the resulting stamped card cost figure unreasonable to use to establish any cost difference between stamped and private cards. Postal Service Brief at V-72-75. To the extent that there is any actual cost difference, witness Patelunas speculated in Docket No. MC96-3 that reasons other than automation compatibility, such as better address hygiene and shorter distance sent for stamped cards, might be involved. Tr. 19F/10090.

Instead, Mr. Carlson and the OCA apparently want to base rates on the entire CRA cost difference between stamped and private cards, whatever the reasons. This treatment is equivalent to subclass status, as the Postal Service explained in its Brief. The prerequisites for subclass status for stamped cards have not been demonstrated. Postal Service Brief at V-71-72.

The OCA claims that "[b]y design (and under the control of the Postal Service), stamped cards meet the physical automation compatibility requirements of the DMM . . ." OCA Brief at 153.[19] In fact (and perhaps contrary to expectations), stamped cards are not designed in order to be automation compatible, but rather were designed for ease of customer use, long before the Postal Service automated its mail processing operations. Tr. 19A/8651, 8659. In this regard, while many private cards now have the barcode clear zone marked off so that the user will not write in it, stamped cards have no such marking. *See* Tr. 3/795.

Mr. Carlson admits that his proposal would exclude some lower cost cards from the lower cost category. "Exceptions will exist, but the exceptions will be tolerable." Carlson Brief at 1. The Postal Service submits that the automation compatibility characteristics and other characteristics of private and stamped cards have not been explored adequately to determine the extent of overlap in their costs, or the merits of dividing the Cards subclass into two classifications. *See* Tr. 3/780.

5. The OCA's advocacy in support of CEM is not persuasive

a. The OCA's substitute CEM proposal is contrived.

Record evidence in this proceeding demonstrates that, when given a choice between the current "one-stamp system"[20] and the "two-stamp system" implied by

[19]On that page the OCA also presents some uncited operational claims about stamped and private cards that have not been established on the record.
[20] Of paying one rate of postage on all their standard-size, single-piece, one-ounce First-Class Mail letters.

the adoption of the OCA proposal for a 3-cent Courtesy Envelope Mail discount, a substantial majority of the bill payment mailing public prefers the retention of the current "one-stamp" system. The record also demonstrates that there are significant administrative and enforcement costs which would wipe out any benefit conferred by the adoption of the OCA's CEM proposal. In its Brief, at V-76-97, the Postal Service explained why the Commission should not recommend the 3-cent CEM proposal advanced by witness Willette on the record in this proceeding.

Beginning at page 45 of its Brief, the OCA abandons witness Willette's 3-cent CEM proposal in favor of a 4-cent proposal which no party has had an opportunity to scrutinize on the record. In the face of record evidence demonstrating overwhelming consumer support for the retention of the current "one-stamp" postage system for basic First-Class Mail letters and rejection of its proposed 3-cent discount for Courtesy Envelope Mail, the OCA desperately resorts to a number of misguided and unfounded arguments which are rebutted below.

b. The OCA's claims of "newly emerged facts" are a pretext for distancing itself from its witness' proposal.

The OCA argues that the Commission should ignore its witness' proposal and, instead, recommend a 4-cent CEM discount, contrary to the testimony of its own witness "to pass through 3 cents of the cost avoidance" (Tr. 21/10685). The OCA cites "newly emerged facts" as the basis for its substitute proposal.

The first "newly emerged fact" is data from witness Ellard's survey concerning the likelihood of use of a CEM stamp. But there is nothing "new" here. His data practically mirror the Docket No. MC95-1 USPS Library Reference MCR-88 data referenced by witness Miller at Tr. 33/17459. The OCA was aware of these data when it filed its original Docket No. R97-1 CEM proposal in December, 1997. The claim that the Ellard study revealed something "new" on this point is bogus.

The second "newly emerged fact" is the OCA assertion that "the Postal Service is doing much better financially than anticipated, and will in all likelihood make a profit during the test year." As explained in Section I of this Reply Brief, there is no basis for the OCA's Test Year surplus projection. Therefore, nothing "new" has emerged.

It is noteworthy that the OCA has utterly failed to explain which mailers would pay for the revenue loss from its CEM proposal. The Postal Service observes that in a similar vein, when considering the Postal Service's proposed Docket No. MC95-1 reclassification of First-Class Mail, the Commission opined that

> a proposed reclassification cannot be responsibly recommended without anticipation of its probable implications for the ratemaking process. One such foreseeable consequence is a potentially severe upward pressure on the rates for the Retail subclass . . . .

PRC Op. MC95-1 at V-15, ¶5033. A similar principle applies to CEM. De-averaging for the purpose of aligning rates with the costs of low-cost single-piece mail has a significant implication for the alignment of rates with costs for the remainder of the single-piece mail stream, a matter which the Commission and the Governors cannot ignore.

The third "newly emerged fact" which supposedly supports the OCA's 4-cent substitute CEM proposal: "there is now solid evidence that consumers tend to overpay rather than underpay." OCA Brief at 46-47. The OCA cites Tr. 33/17359 for this proposition. These data indicate both underpayment and overpayment under the current "one-stamp" rate structure. Overpayment results generally from extra postage on postcards or letters when none is required and from affixing 32-cent stamps instead of 23-cents for additional ounces.[21] The OCA also cites the testimony of Postal Service rebuttal witness Sheehan (Tr. 33/17430, line 14) that it is probable that consumers who are slower to make changes will apply the full First-Class postage rate to CEM mail. The inference the OCA wants the Commission to draw is that witness Sheehan testified that a CEM environment would probably result in overpayment on CEM pieces with full postage, period. The OCA apparently was hoping that the Commission would not bother to read witness Sheehan's testimony cited at lines 21-22 of page 17430, where he also indicated that there would probably be underpayment on full-rated letters through misuse of CEM postage, as well.

What the data cited at Tr. 33/17359 show is that when consumers do not

[21] Is the OCA concerned about postcard and additional-ounce overpayment? Apparently only insofar as it generates a "slush fund" with which to subsidize CEM. If the OCA were concerned about such overpayment, one might expect it to encourage the Postal Service to take measures to educate the public or increase the availability of postcard or additional-ounce stamps. If the OCA were interested in a fair and equitable manner of addressing the postcard/additional-ounce overpayment issue, one might expect it to advocate some offset in the postcard and additional-ounce rate design. But such a recommendation is unlikely from a party which argues that "all other affirmative rate and service classification recommendations in this docket must be conditioned upon Postal Service acceptance of" a four-cent CEM discount, which can be extorted from the Governors by the Commission issuing "a separate recommended decision on CEM and then await[ing] the Governors' action before issuing a recommended decision on the Postal Service's overall request." OCA Brief at 96.

have to think about which rate of postage to affix to a one-ounce letter, they rarely underpay. When they have to determine or calculate proper postage, such as on an additional-ounce letter, they miscalculate and underpay at least seven percent of the time, a very significant percentage. The implications for CEM are quite clear. In a two-stamp environment, one can expect a significant increase in improper postage payment. There will be underpayment on full-rate pieces and overpayment on CEM pieces, to a degree which no one can estimate with precision.

The OCA argues that since "household mailers have been "overpaying" postage on CRM for years, it would be equitable to expand the CEM discount to four cents. Here, the argument goes that, because CRM has below-average cost characteristics in comparison to that portion of the single-piece mail stream with above-average cost characteristics, the long-standing policy of rate averaging results in "overpayment" of postage on CRM pieces. The OCA's analysis of the rate averaging equation is distorted by its insistence on viewing issues through a prism that bends everything toward CEM. The OCA cannot bring itself to acknowledge that there are two sides to the equation -- that the same mailing public generates high-cost single-piece letters on which, because of rate averaging, it "underpays" postage. See Tr. 33/17477. At page 48 of its Brief, the OCA exhorts the Commission to consider microeconomic theory in analyzing CEM. What the Commission should do, instead, is employ simple arithmetic and disregard the OCA's specious CRM "overpayment" argument.

The OCA's advocacy on behalf of CEM is so strident that it argues, as an additional reason to favor CEM, that implementation will result in considerable misapplication of postage in the Postal Service's favor. The OCA argues that, because a significant portion of the mailing public would not use CEM stamps and would affix full-rated stamps to CEM-qualified pieces, this would dampen any adverse revenue consequences implied by a 4-cent loss of revenue on each piece on which CEM postage is affixed. OCA Brief at 47. Putting aside the fact that the OCA has no real idea what effect the availability of CEM postage stamps would have on the magnitude of overpaid First-Class Mail volume or revenues, its assertion is fatally defective, because it ignores the equally unknown phenomenon of underpayment through misapplication of CEM postage stamps. It also ignores the significant costs associated with administering and enforcing CEM.

This argument also stands out as a candidate for the most perverse reason ever advanced in support of any classification proposal in the history of postal ratemaking. In essence, the OCA argues that the Postal Service should embrace CEM because it will generate significant overpayment of postage by people who will affix full-rate stamps on CEM pieces. Ch-ching! Vote for CEM, Governors, and take advantage of the overpayment!

What could be more cynical? In testimony, the OCA asserted that CEM was a good idea because it would provide $219 million in direct benefit to consumers. Tr. 21/10692. Now it argues that CEM would actually be a sweet deal for the Postal Service because so many consumers would not use CEM stamps and their overpayment on CEM pieces would be so much gravy for the Postal Service treasury. This is a reason to implement CEM?

The Commission should reject the OCA 4-cent CEM proposal out of hand. The OCA's rationale for abandoning its original proposal is contrived. Both proposals should be rejected.

c. The OCA's reference to antitrust law is misguided.

Scrambling to construct a foundation for CEM, the OCA turns to Federal antitrust law and argues that

> [c]onsumer choice is the law of the land, as expressed in the nation's antitrust laws. The Sherman Act prohibits price-fixing not just because it is economically inefficient but also to promote consumer choice. . . . Congress designed the Sherman Act as a 'consumer welfare prescription.' (Citation omitted.)

OCA Brief at 49. The OCA seems to ignore that the courts which interpret the antitrust statutes to promote consumer choices "within the framework of our private enterprise system"[22] also have affirmed the validity of other Congressional consumer welfare prescriptions, such as the Postal Reorganization Act and the Private Express Statutes. All would agree that the latter work to restrict consumer choices in the area of letter delivery service and price. No one could credibly argue that the former requires any specified level of de-averaging of prices within First-Class Mail to promote some magical level of consumer choice. And no one could credibly argue that either is subordinate to the Sherman Act.

With respect to single-piece First-Class Mail letters, the real issue is where to rationally draw the line when considering whether and when to de-average postal

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[22] *Reiter v. Sonotome Corp.*, 442 U.S. 330, 342 (1979).

rates. Looking at the various proposals of some of the parties in this proceeding, one could pursue Ultimate De-averaging and develop a single-piece rate schedule that bore some resemblance to the table below:

BARCODED	MACHINE PRINTED
Local	Local
P.O. Box	P.O. Box
Carrier Delivery	Carrier Delivery
Non Local	Non Local
P.O. Box	P.O. Box
Carrier Delivery	Carrier Delivery
METERED	HANDWRITTEN
Local	Local
P.O. Box	P.O. Box
Carrier Delivery	Carrier Delivery
Non Local	Non Local
P.O. Box	P.O. Box
Carrier Delivery	Carrier Delivery

The debate over where to draw lines is a difficult one, but is driven, in part, by practical limitations in the ability of the Postal Service to administer and enforce distinctions in the mailstream and customer tolerance for complexity. The Postal Service believes that its proposed First-Class Mail rate structure, with the addition of PRM and QBRM, represents a rational extension of de-averaguing.

d. The OCA prefers theoretical consumers and transactions to real consumers and real transactions.

At page 48, the OCA argues that consumers like lower prices; the proposed CEM price is lower than the basic First-Class Mail price; therefore, consumers must want CEM.[23] The OCA argues that the Postal Service has ignored the multi-

[23] Besides, the OCA has conducted "informal discussions with consumers" to support this conclusion. Tr. 21/10751.

dimensionality of CEM (focusing on convenience only, instead of convenience, price, and consumer's freedom to choose). The OCA presented no record testimony on these issues, but quotes economic literature in its Brief.

The Postal Service agrees that CEM is a multidimensional issue related to convenience, price, and consumer's freedom to choose. However, it also involves other issues, such as implementation costs, fairness and equity, and revenue consequences, all of which are addressed by the Postal Service and ducked by the OCA. It is uncontested on the record in this case that CEM is less preferred than the current one-stamp system for the general mailing public. There is record evidence that household mailers do not place as high as value on price as they do convenience, in bill payment transactions. *See* USPS LR H-200. *See also* Tr. 4/1577.

Moreover, paying an "average" price is no different than paying a higher price for roughly half of one's mail and a lower price for the remaining half of one's mail. Tr. 33/17476. Therefore, "lower prices" are not really a "benefit" of CEM because, one way or another, a higher price for other mail results.

In addressing the CEM issue, the Commission need not ascend an ivory tower and ponder microeconomic theory about what consumers might want in some alternate postal universe. The testimony of witness Ellard (USPS-RT-14) provides compelling record evidence of the real-world bill payment mailing public's reaction to CEM. Real consumers have seen the OCA's CEM proposal. They understand the choices it offers. They have thought about convenience. They have considered price.[24] They have measured its impact on their individual mailing practices. And, when given the freedom to choose, a substantial majority still prefer to avoid having to deal with CEM. They prefer the current one-stamp system. When informed that the implementation of CEM could have an impact on the rate that they pay for their remaining First-Class Mail, they oppose CEM by an overwhelming majority.

The OCA makes similarly flawed arguments concerning consumer reaction to PRM. At pages 51-53 of its Brief, the OCA compares CEM to PRM. But, since the OCA does not oppose PRM, this is not the most relevant comparison. The acid test for CEM is how households view it in comparison to the present "one-stamp" system. When confronted with a choice between CEM and the current "one-stamp" system, consumers clearly prefer the latter.

At page 53, the OCA argues that since PRM and QBRM "make mailing a reply card or letter seem free to the customer, some customers may choose reply mail even though they would not do so at full cost." These assumptions about customer reaction to PRM are invalid. The USPS LR-H-200 survey of consumer reaction to PRM made it explicitly clear that

> This product would allow businesses to include a prepaid reply envelope with the bill they send to your household with the postage already paid and there would be no need to place any additional stamps or postage to mail the payment back to the biller. However, a charge associated with using this product to cover the postage would either be directly added to your bill or built into the overall price of the product or service that your household receives from the business.

[24] And, as demonstrated in USPS Library Reference H-200, household postal consumers do not value price at the expense of convenience.

USPS-LR-H-200, at 74. Thus, the favorable consumer reaction to PRM is premised upon the clear understanding that there is no "free lunch."[25]

At page 61, the OCA points to the approximately 240 32-cent First-Class Mail stamps in existence as reflecting the level of complexity in consumer choice that postal customers manage everyday. The analogy to CEM is misleading. It confuses the selection of images of birds, flags, or cartoon characters by philatelists with the decisions of persons who buy stamps for use. It further confuses aesthetic considerations with the decision concerning the denomination of the stamp to be purchased. There is no evidence that persons who buy stamps for use place the same degree of emphasis on aesthetic concerns as philatelists. Nor is there any evidence that persons who buy stamps for use generally place as much emphasis on aesthetics as they do on the denomination of the stamp they are purchasing. The OCA's argument also assumes that all 240 or even a substantial number of these stamps are available at any particular post office or offered as options during a stamp sale transaction.

In a similar vein, at page 71 of its Brief, in n. 252, the OCA refers to the typical household consumer as facing 4200 rate and service possibilities whenever he or she presents a package at a post office window for mailing. The Postal Service is unaware of any record evidence pertaining to any transaction in which a customer brings a package to a post office and is told by a postal clerk to select

[25] This reaction should be compared to the public's reaction to the possibility that CEM could affect the rates they pay for other First-Class Mail. Tr. 35/19128.

from among 4200 rate options. As the OCA well knows, once the weight and destination of a parcel are known, the customer selects a service level and the clerk uses the Integrated Retail Terminal to indicate the appropriate rate. The complexity is transparent to the consumer and is managed by the clerk via the IRT.

At page 59 of its Brief, the OCA demonstrates its unwillingness to directly address witness Miller's testimony regarding the significant potential confusion among customers regarding a "two-stamp" system for mailing one-ounce First-Class Mail letters. Rather than address witness Miller's testimony, particularly his emphasis on the OCA's own Docket No. R90-1 market research confirming the great potential for customer confusion that CEM could generate within the context of First-Class Mail letter transactions,[26] the OCA tries to argue that if consumers can distinguish between letters and postcards and Express Mail and Parcel Post, then CEM will cause them no confusion. This is akin to arguing that people who can quickly tell the difference between apples and cantaloupes can just as quickly distinguish among particular varieties of apples. The OCA sidesteps the fact that the consumers in the OCA survey expressed concern about CEM-induced confusion, despite the existing differences between Express Mail and Parcel Post and letters and cards. The empirical evidence is there. The OCA cannot deny it. The OCA cannot disown it.

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[26] Tr. 33/17615-16.

e. Recommending PRM and rejecting CEM would not be unduly discriminatory.

At page 57 of its Brief, the OCA argues that the Postal Service's support of PRM is "a classic form of price discrimination -- pricing like services or products differently for one group than for another." The OCA argues that households mailing prebarcoded single-piece First-Class Mail cause the Postal Service to incur precisely the same costs as PRM; but that, under the Postal Service proposal in this docket, consumers who return CRM prebarcoded pieces would continue to pay the standard single-piece rate. The OCA claims that such a rate design is a violation of § 403(c). In support of its argument, the OCA cites several public utility cases for the proposition that "the cost element is at the heart of the concept of price discrimination."

First, the assertion that the Postal Service ignores cost is specious. The current "one-stamp" system is premised upon the notion that it is fair and not unduly discriminatory to charge the same rate for the various elements of the one-ounce single-piece First-Class Mail stream generated by households and businesses. They are priced the same, despite the fact that some components of this mailstream cost more than others. The Postal Service acknowledges that the costs for various elements of this mailstream may vary somewhat, but the rebuttal testimony of witness Miller demonstrated that those costs are converging. *See* Tr. 33/17516. Accordingly, there has been a significant erosion in the basis for the quest the OCA began a decade ago[27] in pursuit of recognition of cost differences between "clean" and "dirty" single-piece through a CEM rate.

The Postal Reorganization Act does not confine the analysis of undue preference or "unreasonable discrimination" under § 403(c) solely to the cost aspect of any classification proposal. There are a host of non-cost factors which assist in the determination of how reasonable it is for two types of mail within the same class to pay the same rate.[28] There is no requirement in § 403(c) that the Commission and the Governors devise a rate schedule which reflects maximum rate de-averaging.

The Postal Service is interested in extending the cost benefits of automation in the prices paid by single-piece mailers. It has done so historically and continues to do so by averaging the rates that these mailers pay for their various types of single-piece First-Class Mail which, to varying degrees, benefit from efficient postal automation processing. Regardless of the degree of automation to which different elements of that mailstream are exposed, the benefit is averaged among all pieces. Thus, a one-ounce BCS-ready prebarcoded reply envelope pays the same rate as a one-ounce OCR-ready typewriter-addressed envelope, which pays the same rate as a one-ounce hand-addressed envelope which must be processed through Remote Encoding before becoming automation-compatible. Could the Postal Service charge

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[27] A generation of postal letter mail processing technology ago.

[28] The Postal Service does not concede that CEM and PRM generate the same costs. The rebuttal testimony of witness Miller establishes that there are considerable costs associated with CEM that would not apply to PRM.

different rates for each of these letters? Nothing in the Act would prohibit such a scheme, although other practical realities intervene to discourage it.

By proposing PRM and QBRM, the Postal Service has sought to initiate the extension of the benefit of rate de-averaging to those elements of the single-piece First-Class Mail stream where it has determined that it can administer and enforce such rates without undue administrative and enforcement burden and customer confusion -- on mail pieces on which no postage is affixed, because it is paid for by the recipient. The postage-paid reply mail stream has a long history of administrative and enforcement ease and convenience among senders, recipients, and the Postal Service. This mailstream avoids the myriad of problems and concerns spelled out in the testimonies of Postal Service rebuttal witnesses Sheehan and Miller in this proceeding.

Postal management has day-to-day responsibility for making the postal system operate effectively in the real world. Accordingly, as compared to the OCA, its views are due a measure of deference. For instance, the OCA argues at page 65 of its Brief that, "if short-paid postage were a rampant problem, the Postal Service could alter its automated equipment to detect short-payments."[29] This is symptomatic of the OCA's unrealistic view of the world: "Problem? Well, just invent a solution yesterday and solve it!"

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[29] Or its unwillingness to read or comprehend the testimony in this case. *See* USPS-RT-17, Exhibit RT-17E; Tr. 33/17512-14.

Fortunately for the Postal Service, available evidence shows that short payment on one-ounce pieces is not a significant problem in a one-stamp environment, where the act of affixing the proper postage is almost automatic.[30] To the contrary, short payment is relatively common among additional-ounce pieces.[31] In the absence of a technological solution, the Postal Service must depend on letter carriers and box section clerks to inspect pieces and perform enforcement functions. Tr. 33/17373-74. This task which is made harder to accomplish in an increasingly Delivery Point Sequenced environment. Tr. 33/17470. The OCA's argument at page 65 of its Brief is distilled to the absurd notion that if state-of-the-art equipment currently cannot match piece weight to postage paid, then any concern expressed by the Postal Service regarding the high percentage of underpaid additional-ounce pieces is mere pretense.[32]

Trying to strike a balance between the desire to extend the benefits of de-averaging to single-piece First-Class mail users and the need to avoid the perils of CEM, the Postal Service proposed PRM and QBRM. If these latter classifications are adopted, single-piece mailers obtain two benefits. The first would be the continuation of rate averaging for the bulk of their outgoing mail on which postage has to be affixed. The second would be the benefit of de-averaging on that portion of their outgoing mail on which no postage need be affixed.

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[30] Tr. 33/17358-60.

[31] *Id.*

[32] Apparently, the unavailability of a sophisticated, high-tech solution means that the Postal Service does not have a nettlesome problem.

Those who would allege discrimination in the Postal Service's opposition to extending a discount to all prebarcoded single-piece First-Class Mail, contrary to its policy regarding bulk-entered and pre-verified prebarcoded First-Class Mail, ignore the fact that mandatory pre-mailing postage verification (and payment of fees above postage to cover such costs) makes it unnecessary to administer and enforce rate distinctions after bulk mail has been accepted for processing. This relieves downstream personnel of enforcement responsibility and avoids the problems which would be apparent if such bulk mail could be deposited like collection mail or left on postal facility loading docks without being verified.

> Averaging is an integral part of postal ratemaking. It is neither possible nor wise to try to establish separate rates for every piece of mail. . . . The result of developing schedules of râtes to apply to groups containing millions of pieces of mail . . . is that a significant amount of averaging takes place.

PRC Op. MC95-1 at III-25, ¶3063. The Postal Service submits that section 403(c) does not impose upon the Postal Service or the Commission a barrier to the establishment of rate differentials in circumstances where

(1) there would be no effective or practical means of enforcing them, or

(2) the cost of enforcement and administration would overwhelm or severely diminish the benefit that de-averaging was intended to confer.

As the United States Circuit Court for the District of Columbia has held:

> It would not be unfair to refrain from extending a discount to certain users where it is not feasible to offer it to them or where offering it would cause an upheaval in the efficient operation of the Postal Service.

Mail Order Association of America v. United States Postal Service, 2 F3d 408, at 424 (DC Cir 1993). The rebuttal testimonies of Postal Service witnesses Miller and

Sheehan bear ample witness to the confusion, disruption and upheaval that CEM would visit upon the Postal Service and the mailing public, in contrast to PRM and QBRM.

f. The Commission should resist the OCA's invitation to rely on material not in evidence.

At various points in its Brief, the OCA relies upon factual assertions which have no evidentiary status in this proceeding. The Commission would do well to avoid the OCA's invitation to walk into the same tar pit of reliance upon non-evidentiary material that, in the judgment of the District of Columbia Circuit Court of Appeals,[33] marred its Docket No. R90-1 recommended decision.

For instance, at page 52 of its Brief, the OCA encourages the Commission to reach conclusions about Prepaid Reply Mail based upon assertions which the Presiding Officer explicitly ruled (Tr. 33/17629) were not in evidence. Other than the testimony of the Postal Service concerning the telephone interviews of 10 businesses regarding PRM (USPS Library Reference H-226) and the testimony of Brooklyn Union Gas Company witness Bentley (Tr. 21/11074 *et seq.*), there is no record evidence which measures any potential unintended and harmful consequences for businesses and harm to consumers.[34] There is no evidence which quantifies the impact of any new operations, systems, or customer service costs, or administrative burdens, or changes in billing systems, or remittance

[33] See, *MOAA v. USPS*, 2 F3d 404, 420-422.
[34] OCA Brief at 52.

processing equipment, or training for customer service staff.[35] The only mailer which presented any record evidence concerning PRM raised no such issues. See Tr. 21/11074 *et seq.*[36]

Likewise, contrary to the implication at pages 53-54 of the OCA Brief, there is no record evidence that CEM would encourage the use or creation of automation-compatible mail. The OCA made this claim in Docket No. MC95-1. It was thoroughly refuted by the Postal Service then. Consequently, OCA witness Willette did not make the assertion on the record in Docket No. R97-1. Accordingly, there is no basis for the OCA's argument on this point.

g. CEM fails to meet the statutory classification criteria.

At pages V-94-97 of its Brief, the Postal Service explained why the OCA's CEM proposal failed to meet the statutory classification criteria in § 3623(c). Quite understandably, the OCA's Brief, at pages 55-56, rushes through its discussion of how these criteria apply to its CEM proposal. As explained below, the OCA's analysis still falls short.

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[35] *Id.*

[36] PRM, like current BRM, like proposed QBRM, like every other discounted First-Class Mail rate category, is voluntary. Those mailers which do not want to prebarcode or presort do not have to. They can opt out of assuming the burdens, just as they opt out of enjoying the benefits. Those mailers which do not want to enroll will not be required by the Postal Service to do so. Tr. 4/1535-36, 45.

At pages 51-52 of its Brief, the OCA argues that CEM is less complicated than PRM. Less complicated for whom? Nothing could be less complicated for the sender than mailing a letter without having to affix any postage. There is no need to manage two different sets of First-Class postage stamps or distinguish between 33-cent and 30-cent letters. PRM does not require the recipient to take on any more administrative burden than it volunteers to assume, by enrolling in PRM.

At page 55 of its Brief, with respect to § 3623(c)(1), the OCA argues that CEM is more fair and equitable than PRM to small business mailers who wish to offer their customers the advantage of reduced rates, because some small businesses might not be able to afford the fees associated with PRM and QBRM. There is no record evidence concerning differential impact of PRM, based upon business size. The OCA's analysis and comparison of CEM to PRM on this score is incomplete, since it fails to consider that small businesses would have the option of QBRM, just as they presently have the option of Prebarcoded Business Reply Mail. PRM neither worsens nor betters the position of small businesses. Thus, its addition to the range of options is neither unfair nor inequitable.

It is noteworthy that the OCA neglects to explain why CEM, by itself, meets this criterion. The Postal Service regards it as neither fair nor equitable to de-average stamped single-piece First-Class Mail rates in a one-sided manner, as the OCA would propose with the adoption of CEM. Tr. 33/17477.

Regarding § 3623(c)(2), the OCA argues that CEM is desirable because "[c]onsumers highly value the mail system as a way to pay bills and CEM more closely aligns rates with costs for household mailers." OCA Brief at 55. The Postal Service submits that the public has expressed itself very clearly in this proceeding concerning the consequences of de-averaging that could result from the implementation of CEM. However highly the public may value the postal system as a means of paying bills, they still prefer the current one-stamp system. Tr. 35/19125.

With respect to § 3623(c)(3), the OCA argues that CEM is "clean" mail for which the reliability of delivery is greater than for much of First-Class Mail. How much greater, the OCA does not and cannot say. What the OCA also avoids saying is that CEM would be identical to all of the "clean" non-CEM letters that would not qualify for the CEM discount by virtue of the absence of a CEM indicator. The only difference between these two types of mail would be that one would say "CEM" and the other would not. Both would be pre-printed, prebarcoded, with FIM, but the sender would affix different rates of postage, with no difference in the treatment of the pieces form the time of acceptance to delivery. There is no evidence that the CEM indicator would result in any different level of processing or delivery, with respect to accuracy, reliability, ease, economy or speed. The OCA's criterion 3 analysis is devoid of substance and lacks foundation.

As explained in the Postal Service's Brief at V-95-96, the CEM proposal fails to meet the § 3623(c)(5) criterion. Neither the public nor the Postal Service desires it. The OCA argues that CEM "is a realistic way to ensure that consumers will be paying cost-based First-Class rate for prebarcoded envelopes -- despite unrefuted record evidence that the public prefers the current policy of rate averaging for all of its standard, single-piece First-Class Mail letters. Tr. 35/19077. At page 91 of its Brief, the OCA argues that CEM offers a more practical and less expensive way for businesses to gain goodwill, despite the fact that USPS LR-H-200 demonstrates that convenience, not price, drives consumer bill payment mailing preferences. *See also*, Tr. 4/1577. The OCA argues that CEM would ensure that bill payments are sent to the right address. On this score, one cannot help but ask whether there is evidence of an existing problem with CRM addressing that CEM would cure? None, as far as the record in this case is concerned.

On the final criterion, §3623(c)(6), which calls upon the Commission to consider such other factors as it may deem appropriate, the OCA argues that the Commission should consider "that the Postal Service's past resistance to CEM means that consumers using prebarcoded courtesy reply envelopes have been overpaying the "correct" postage on their bill payments for a number of years. Likewise, the Commission should consider that if it joins the Postal Service and the bill payment mailing public in rejecting CEM, the public can continue, at the same time to underpay the "correct" postage on the other half of their stamped correspondence which will not be mailed in pre-printed, prebarcoded, CEM-indicator envelopes provided by the recipient.

h. The OCA should proofread its discovery requests.

At page 65 of its Brief, the OCA argues that the Postal Service failed to properly respond to a discovery request. As demonstrated below, this argument reveals how little attention the OCA pays to the questions it asks and the answers it receives.

In interrogatories T32-12 through 15 (Tr. 19D/9337-40), the OCA asked interrogatories about *household* overpayment and underpayment of postage on single-piece First-Class Mail. The Postal Service responded to each interrogatory by indicating that there are no data which isolate *household* overpayment or underpayment. See Tr. 19D/9337-40. The OCA later asked a separate interrogatory (OCA/USPS-29) about short paid mail in general, to which the Postal Service responded. Tr. 19C/9052-53. Later in the proceedings, at Tr. 21/10894-05, the Presiding Officer requested data from any studies concerning single-piece First-Class Mail short payment and overpayment, to which the Postal Service responded. See Tr. 33/17358-60.

At page 66 of its Brief, the OCA characterizes all of these questions as "substantially similar." The Postal Service interprets the OCA's choice of words as "substantially similar" to a confession that the OCA wished it had asked different questions initially. Asking for non-existent data breakdowns relating to *households* is not the same as asking for data for *all* First-Class Mail users. The Postal Service interpreted the questions literally. It responded accurately and completely. If the OCA asks for something that does not exist, it cannot be a violation of any rule for the Postal Service to inform the OCA that what it asked for does not exist. Thus, there is no basis for the claim that an "apparent discovery violation"[37] occurred -- unless it is a violation of the Commission's rules to ask for one thing in discovery and then later wish you had asked for something else.[38]

i. The OCA's attacks on witness Miller and the Postal Service are groundless.

At pages 82-86 of its Brief, the OCA engages in a series of *ad hominem*

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[37] OCA Brief at 66.

[38] A "violation" which is committed by each party, including the Postal Service, from time to time.

attacks on witness Miller and others in the Postal Service in a hapless effort to persuade the Commission to disregard his testimony on several issues. The OCA's accusations are without merit. They should be disregarded.

At page 82, the OCA argues that the Postal Service has violated the Commission's discovery rules by not providing requested documents at the time that they were requested, and by failing to submit responsive information when it subsequently became available. As explained below, these charges are baseless.

At page 83, the OCA points to an interrogatory (OCA/USPS-31) which asked the Postal Service to provide an estimate of the cost associated with educating and notifying households about its Docket No. MC95-1 12-cent CEM proposal. The Postal Service responded by indicating that it had not prepared such an estimate.

CEM education costs for the OCA's Docket No. MC95-1 12-cent CEM discount proposal were not an issue in the development of the Postal Service's Docket No. R97-1 request. They were not relevant to any issue or rate proposal before the Commission until December 30, 1997, when the OCA filed its 3-cent CEM discount proposal. At that point, the Postal Service began to analyze the OCA's 3-cent Docket No. R97-1 CEM discount proposal, determined that it would generate substantial education and notification costs, developed an estimate of those costs, and reported them in witness Miller's testimony on March 9, 1998. Had an estimate of the education costs associated with either the 12-cent or the 3-cent proposal been developed by the Postal Service before then, the Postal Service would have fulfilled its obligation to report the estimate at that earlier time.

If the OCA has a complaint, it might be that the Postal Service, when it filed witness Miller's rebuttal testimony on March 9, 1998, did not amend its response to OCA/USPS-31 concerning the Docket No. MC95-1 12-cent CEM proposal to indicate the development of information in witness Miller's testimony in response to the Docket No. R97-1 3-cent CEM proposal,[39] a task which some might reasonably conclude would have been superfluous.[40] There is no basis for claiming that the Postal Service withheld information. The information on the 3-cent proposal was developed in response to the OCA's CEM proposal in this case and disclosed shortly after its development.

Nevertheless, at page 83, the OCA argues that the response to OCA/USPS-31 is "at a minimum evasive, at a maximum false." The truth is that the response is neither. At page 82, the OCA claims that when it received Mr. Miller's rebuttal testimony, it considered filing a motion to strike. The Postal Service suspects that a careful reading of Presiding Officer's Ruling No. R97-1/41 (October 7, 1997) discouraged a round of wasteful OCA motion practice.

At page 84 of its Brief, the OCA asks: When did the information used for Exhibit B become available? Witness Miller indicated that his work on developing costs began in December of 1997 and that different pieces of information came to him through others in December and through February of 1998.

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[39] Which would be little more than "See USPS-RT-17 at Exhibit B."

[40] Putting aside the question of whether the same type of education program would be undertaken to educate the public about a 3-cent discount as would be undertaken to deal with a 12-cent discount.

Preliminary or final data?

At what level of detail?

Subject to what qualifications?

Subject to what degree of internal review and validation?

The cross-examination of witness Miller sheds precious little light on these questions. And these are critical questions to be answered in determining when an analyst has sufficient confidence that certain cost information he has either developed or obtained is ready to stand as the Postal Service's official cost estimate. Asking a witness "when did you first receive a piece of information?" gets one only part of the way there. Asking "when were you able to validate the numbers you were given, submit them for routine internal review, and satisfy yourself and others that they were the best available information and ready for disclosure?" completes the process. Without answers to those questions, there is no basis for impugning the integrity of any witness or other participant in these proceedings.

The same applies to the OCA's arguments at pages 84-85 of its Brief concerning the development of window service stamp transaction costs in Exhibit RT-17C. In OCA/USPS-T32-46(c), the OCA asked the Postal Service if it knew what the incremental cost of selling a new issue of the current 32-cent stamp was. As the OCA observes, the Postal Service responded on September 9, 1997, by indicating that it had not developed a cost estimate. The OCA did not take issue with that response when it was filed, or at any time during these proceedings.

At page 85 of its Brief, the OCA highlights the fact that witness Miller had preliminary window transaction cost figures close to end of January 1998, but did not file any numbers until early March 1998. So, what? Every postal or intervenor witness who has ever prepared testimony, or an interrogatory response is acutely aware of the significance of the difference between "preliminary" and "final" numbers. How does one get from preliminary to final? Re-evaluation, refinement, and review. When witness Miller completed these tasks, he had "final" numbers, suitable for release.

The OCA apparently takes the view that if the Postal Service does not have certain information responsive to a discovery request, it is then precluded from ever developing that information later. The OCA's complaint appears to boil down to a gripe that, when the Postal Service developed the information and provided it in witness Miller's rebuttal testimony, the Postal Service also should have flagged that the information was responsive to an earlier asked interrogatory. The Postal Service agrees that such an approach could be seen as reflecting perfect compliance with Commission rules. However, the Postal Service submits that if the information was provided reasonably soon after it was developed, in broad daylight, in the heart of the rebuttal testimony in which the OCA would have the most interest, There is no prejudice to the OCA in disclosing the information under these circumstances, as long as that is when the information was ready for disclosure. There is no basis for any suggestion that witness Miller withheld any "final" information from the OCA before releasing it.

If these complaints were not worth raising as an issue when the testimony was filed or when witness Miller appeared for cross-examination, it is hard to conclude now that the OCA has been harmed in any way.

The OCA notes that the Postal Service responded to OCA/USPS-T32-46(d) on September 9, 1997, by indicating that the number of consignment stamp sale transactions was unknown. The question was straightforward. It asked whether certain information existed. A search was executed. Based upon that search, it was concluded that no responsive information existed.

Nevertheless, witness Miller, in the development of his rebuttal testimony, tread over the same ground and uncovered information which was not only relevant to his rebuttal of the OCA CEM proposal, but responsive to T32-46(d). Had the OCA asked witness Miller to explain how it was that he was able to provide information which, in response to OCA/USPS-T32-46(d), the Postal Service earlier reported was unknown, he would have revealed that good faith efforts to locate the information in response to the interrogatory apparently had been in vain. The fact is that there are times when the search for information in response to discovery requests which are "off the beaten path" requires casting a net in the direction of a number of possible departments and making reasonable inquiries, with the expectation that one of the departments can turn up responsive information or report that none exists. If the net is cast in the direction of the proper departments and reaches the proper individuals, a definitive response can almost always be retrieved.

It should be noted that, for purposes of Docket No. R97-1, the Postal Service designated various departmental representatives to serves as points of contact for the retrieval of information in response to discovery requests. This arrangement served the Postal Service and the rate case extremely well, playing a significant role in the Postal Service's ability to respond to as many discovery requests in as timely a fashion as it did. However, like any other system, it will not work to perfection.

If, by any chance, the nature or substance of a request is misunderstood or miscommunicated, the information reported back to the person responsible for formulating the interrogatory response can lead that person to report something in the response which is later revealed to be inaccurate. Fortunately, this happens very infrequently, but it is inevitable when an organization as large as the Postal Service seeks to respond quickly to a myriad of requests during the discovery window in these proceedings.

It so happens that witness Miller, in developing his rebuttal testimony, independently tread over ground which had been covered by OCA/USPS-T32-46(d). He managed to find information which, it turns out, was in the hands of a postal contractor. Did that make the original interrogatory response "evasive or false," as claimed by the OCA? Absolutely not!

At page 85, the OCA argues that information responsive to OCA/USPS-T32-46(d) was available earlier than March 9, 1998. It is true that this information was retrieved not long before then, during the course of the development of witness Miller's rebuttal testimony. But the Postal Service submits that it was not known to persons who could have been in a position to amend the interrogatory response (assuming they were cognizant of a need to do so) at a time before March 9th which would have made any material difference. Nor is there any basis for claiming so. Though the rules regarding seasonal amendment of interrogatory responses do hold all parties up to a perfect standard, the fact is that no one in the Postal Service involved in the review of witness Miller's rebuttal testimony was focused on OCA/USPS-T32-46(d) at that time of preparation of testimony. Information was developed in conjunction with the preparation of his rebuttal testimony which happened to be responsive to that interrogatory and disclosed shortly after development and review, as part of that testimony. There is no basis for suggesting anything to the contrary.

At page 82 of its Brief, the OCA claims that it was prejudiced by these events when the testimony was filed and when witness Miller took the stand more than three weeks ago. Strangely, the OCA was silent before and during its cross-examination of witness Miller. The OCA had every opportunity to cross-examine witness Miller concerning his testimony and explore these issues. It elected not to do so. Its claims of prejudice ring hollow. The OCA also argues that it considered filing motions to strike, but did not, claiming that "a pending motion to strike would have made brief writing problematic." This claim is contradicted by the experience of the Postal Service and another party to this proceeding. What really makes Brief writing problematic is parties filling their Briefs with babble about procedural motions they "could-a" or "would-a" filed a month ago in response to some alleged grievance which resulted in no prejudice to them.

At pages 82-83, the OCA invites the Commission to conclude that "widespread abuse of its discovery rules has occurred" and that "disciplinary actions" and that "changes in the discovery rules" are in order. Nothing of the sort has occurred. Nothing of the sort is in order.

The OCA failed to study the issue of public education costs in developing its CEM proposal. In light of overwhelming evidence that the costs would significantly erode the perceived CEM benefits, the OCA desperately thrashes about in a vain effort to persuade the Commission to disregard the evidence. The OCA's smokescreen should be ignored.

j. Stamp booklets with differently denominated stamps are no answer.

At pages 66-68, the OCA argues that the answer to the inconvenience which would be generated by CEM would be to sell stamps in booklets with full-rated and CEM stamps. The OCA argues that this would enhance consumer choice, which is "an essential element of a capitalist economy." OCA Brief at 67.[41] Next, the OCA argues that the downfall of Communist economies can be traced to the fact that consumer choices were restricted. *Id.*[42] The OCA apparently raises these "points" to provide a foundation for its argument that the Commission should defer to witness Willette on the issue of convenience, as it relates to CEM. As the OCA reminds us, she testified, in reference to grocery store coupons, that saving money is "pretty

[41] With all due respect, the Postal Service submits that the Private Express Statutes are an essential element of the capitalist American economy.
[42] Apparently implying that the only salvation for the Communist United States Postal Service is differently-denominated First-Class Mail stamp booklets?

convenient" and also "outweighs any inconvenience." Witness Willette does not, however, explain how grocery store coupons offered to entice customers to choose among competing products or services provided by competing producers relate to the CEM in any fashion -- where the choice is between: (1) paying 33 cents for two related products of the same supplier or (2) paying slightly different prices that add up to the same total for the two products of the same supplier. If you end up at the end of the day where you would have ended up, why go through all the inconvenience, other than to experience the illusion that you were "saving" something on the lower-priced product, all the while ignoring the increase in the price of the other product?

As witness Ellard testified, there is no basis for reaching any conclusion about consistency of usage of two different denomination that would inform the determination of how to balance a differentially-rated stamp booklet to make available a rate structure the public prefers not to have implemented. Tr. 35/19183.

6. The Postal Service does not welcome Brooklyn Union's proposed revisions to Prepaid Reply Mail, but welcomes the opportunity to clarify one point.

In its Brief, Brooklyn Union Gas summarizes witness Bentley's suggestions for modification to the Postal Service's Prepaid Reply Mail proposal. The Postal Service responded to these suggestions at pages V-100-01 of its Brief. In doing so, the Postal Service made an inaccurate statement on page V-100. There, the Postal Service stated that a manifest system would be required under PRM. This is incorrect. As indicated in the response to POIR No. 3, Question 22, a manifest is a possibility. Another PRM alternative would involve using data on PRM returns from a third-party lockbox operation. *See* Tr. 4/1582-83.

7. The Commission should decline the invitation of CMPCRE to violate the due process rights of the parties.

To the extent that it relies on record evidence, the Brief of Coalition of Mailers who Provide Courtesy Reply Envelopes (CMPCRE) alludes to USPS LR-H-226 to make its case against Prepaid Reply Mail. This library reference presents the results of interviews with 10 businesses, three of which are currently BRM users and seven of which supply courtesy reply envelopes.

The conclusion of CMPCRE that these interviews concerning PRM are decidedly negative is not borne out by an examination of the interview transcripts in USPS-LR-H-264. For example, one interview subject concluded that the computer programming changes involved in explicitly billing customers for PRM postage "would be no big deal."[43] Two interview subjects discussed "intelligent" inserting machines that permit businesses to exclude courtesy reply envelopes from the outgoing bills of customers using automatic debit.[44] Another stated that PRM "would be a good customer serving [sic] selling point."[45] CMPCRE's characterizations are decidedly one-sided and only serve to reinforce how little can be concluded on the basis of a handful of interviews.

The Postal Service did not rely on USPS LR-H-226 in developing its PRM

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[43] USPS-LR-H-264, at 2-22.
[44] USPS-LR-H-264, at 6-5 and 8-5.
[45] *Id.* at 8-7.

rate proposal for a number of reasons. It involved only a few interviews and was not statistically projectible. There was difficulty in identifying the most appropriate individual to interview at each location and in scheduling that interview. There is reason to question whether the interviewees fully reflect organizational thinking. In addition, the interviews involved a description of PRM fundamentally different than what was proposed. Tr. 4/1548-9.

In spite of these study limitations, the CMPCRE Brief relies on these few interviews as part of the basis for its criticisms of PRM. It should be emphasized that only two intervenor witnesses in this proceeding have presented evidence concerning PRM. The first was OCA witness Willette. The OCA does not oppose PRM. The second was Brooklyn Union Gas (BUG), which generally endorses the PRM proposal.

The CMPCRE Brief makes a number of arguments for which there is no evidentiary basis. The Postal Service encourages the Commission to steer clear of CMPCRE's invitation to rely on factual assertions which have no evidentiary foundation.

For instance, CMPCRE argues

> [t]here is no practical way that businesses could establish accounting programs that would enable them to recoup, as the Service proposes, their prepaid mailing expense from bill-paying customers.

CMPCRE Brief at 2. However, there is simply nothing in the record to support this assertion. In the same paragraph, and again without an evidentiary foundation, CMPCRE goes on to spin a tale of administrative woe involving a business having to differentiate -- separately for each and every customer -- between those who use prepaid envelopes and those who do not (and for different months).[46]

Another instance of reliance upon assertions which lack evidentiary status appears further down on page 2 where the CMPCRE Brief argues that "[t]hese enormously complex PRM-accounting systems would have to be set up on top of existing systems that track remittance payments." However, there is no record evidence to refute witness Fronk's statement that:

> PRM systems are likely to involve remittance processing. Such systems are high quality in the sense they are automated, involve strict quality control procedures due to the fact they handle considerable amounts of money, and 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 a business that the Postal Service can later compare against the number of pieces the mailer actually paid for.

Tr. 4/1511.

Yet another instance of reliance on assertions which are not in evidence appears on page 5 of the CMPCRE Brief, where the coalition asserts that "[b]y changing the economics of bill-paying by remittance mail, PRM would thus accelerate business' efforts to divert mail to increasingly attractive electronic alternatives for bill payment." Again, there is no record basis for this assertion.

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[46] Under the Postal Service's proposal, while a business could choose to explicitly bill each customer for the cost of postage actually used by the customer, the business could also build the cost of the PRM postage into its product or service prices in much the same way as it covers the costs of business expenses such as toll-free phone calls for customer ordering or customer service. Tr. 4/1518. It is up to the business to determine if it wishes to recover the postage cost and, if so, how it wishes to do so.

Indeed, this assertion appears to rest on three assumptions. First, it assumes that mailers will be unable to recover the postage costs of incoming PRM from their customer base. Related to this, it assumes that the unrecovered PRM postage and administrative costs will tip the balance in favor of electronic alternatives. Second, it assumes mailers will suddenly be able to overcome existing barriers to electronic payment for many of their transactions, in spite of the fact some of these alternatives have been available for many years. Third, it assumes that mailers can somehow be forced to offer PRM, even if it is not in their economic interest to do so. This last assumption is a peculiar view of how markets operate and ignores the fact that PRM would be voluntary. Mailers may participate in it if they determine that it meets there needs and they meet Postal Service requirements. Tr. 4/1545.

In any event, these assumptions have not been presented in a manner which would permit adversarial testing on the record. Any reliance upon them by the Commission, either explicitly or implicitly, would be a clear violation of the due process rights of the parties of a quality identical to those which occurred, unfortunately, in the course of the Commission's development of its Docket No. R90-1 Public's Automation Rate proposal.

At pages 3-4, the CMPCRE Brief also describes how regulated utilities may not be able to offer PRM due to regulatory hurdles. The Postal Service notes that of the 10 businesses interviewed in USPS LR-H-226, three were utilities. Of these, one, a current BRM user, responded positively to the PRM concept, without reference to any regulatory hurdles.[47]

8. Niagara Telephone Company's Brief provides no basis for the Commission to recommend Mr. Peterson's proposal.

The initial brief of the Niagara Telephone Company ("NTC Brief") essentially argues that, because certain postal facilities maintain "local mail" receptacles, the customers who deposit mail in these slots are providing presort and delivery services on behalf of the Postal Service, and that these mailers should be rewarded by the imposition of a new subclass, with reduced rates, for their local mail. With two exceptions, the NTC Brief makes fundamentally similar arguments for the imposition of its subclass as appeared in the testimony of its witness Sidney R. Peterson; the Postal Service's position on Mr. Peterson's testimony was presented in its Brief, at V-97-100. Niagara's Brief does nothing to change the fact that Mr. Peterson's testimony is silent as to the degree to which its proposed subclass may be utilized by mailers, and therefore what costs its implementation might impose upon the Postal Service. Niagara's Brief does, however, bring up certain matters that have been heretofore unaddressed by the Postal Service; they are discussed in turn below.

a. Niagara is generally unacquainted with Postal Service operations.

The NTC Brief makes the point that "[i]n prior years the USPS recognized a price distinction between 'local' and 'out of town' mail." NTC Brief at 5. Niagara's

[47] The study also included an organization (its line of business was not specified) using prepaid metered reply envelopes for its 75,000 customers, though this organization declined to be interviewed. Tr. 4/1545.

cited record support for this proposition, Tr. 21/10651, 10653, is Attachment A to Mr. Peterson's testimony. This reference is somewhat surprising.

During discovery, the Postal Service asked Niagara specifically about Attachment A, seeking to inquire as to Mr. Peterson's knowledge of any changes in Postal Service operations since the "prior years" whose rates he relies upon to support his contention that similar rates should be implemented now. These discovery attempts were met with spirited protest that Mr. Peterson's knowledge of the Postal Service's operations were not relevant to the proceeding. Tr. 21/10664, 10644. The Presiding Officer agreed that information on how Postal Service operations may have changed since 1946 is not relevant to Niagara's proposals. Tr. 21/10644-45. Now, Niagara uses evidence of the rate structure from 1946, which was obviously based upon Postal Service operations as they stood in 1946, to argue for a similar rate structure now. Because this rate structure is, according to Niagara's own arguments, not based on Niagara's comprehension of postal operations, it is difficult to see how Niagara's reference to its 1946 rates is in any way relevant to this proceeding.

For all its protestations of nescience regarding the operations of the Postal Service, Niagara observes in its Brief that "[t]he only sorting [of local mail] which remains for the Post Office is limited to placing the mail in a recipient's post box or in a mail carrier's bag, operations which do not require a bar code." NTC Brief at 6-7. Niagara cites witness Peterson's testimony for this proposition, despite the fact that Mr. Peterson admittedly did not observe sorting operations. Tr. 21/10660, 10670. Witness Peterson sees no point in transporting mail from its local post office to any kind of "central processing . . . for delivery back to the receiving post office," Tr. 21/10652, and indicates that few of the barcodes placed on Niagara Telephone Company's mail are ever read. Tr. 21/10674.

Moreover, although Niagara argues that its testimony regarding the operations of the 150 post offices visited by its witness are "uncontradicted," NTC Brief at 7, it misses the point that it bears the burden of providing evidence, not merely a conclusion, that "on premises sortation of 'local only' mail by the receiving/delivering Post Office is pervasive and results in significant transportation savings for the USPS." *Id.* It has not done so. Nothing in the record indicates that the 150 post offices with which Mr. Peterson has made himself familiar are in any way representative of the remainder of the 30,000+ postal facilities throughout the United States.

In the same vein, witness Peterson, in response to questions from the Presiding Officer, described the geographic situation of the Post Office in Niagara, Wisconsin:

> See, we are at the end of the line, we're the second post office at the end. We're at Niagara and the next one is -- we'll actually it goes through Iron Mountain, which there's others there, but it goes to Florence and I asked our postal people, they're in boxes, they're all in trays. They don't send, even send those trays to Green Bay, they're marked Florence.
>
> So when the mail comes in the morning, it comes up from Green Bay to Northern Wisconsin, up right by the upper Michigan, it goes to Niagara, Wisconsin. It actually goes through Iron Mountain, because U.S. 141 goes into Michigan, back into Wisconsin into Florence. It goes to Florence, and they put those right on that truck and they go right up there, so they are never

even going to centralized mailing.

Tr. 21/10674. Nothing in the testimony presented by Niagara does anything to indicate the "pervasive" nature of this geographic situation. Thus, even if Niagara had shown that its proposed local mail might work for them, they cannot claim that it would make sense for any other mailers.

b. Niagara's proposed rate is not supported.

In the testimony of witness Peterson, Niagara proposed a rate for local mail that would be "the combined discount for the first-ounce received by first-class [sic] prebarcoded and presorted (5 digit) mail . . ." Tr. 21/10652. Niagara's brief, however, presents *two new* pricing proposals, neither of which is supported in any way by the record of this proceeding. At one point, Niagara calls for a rate "which includes a combination of an entered [sic] at destination discount plus a presorted rate which is equal to 50% of the USPS's proposed First Class rates for the same weight article." NTC Brief at 1-2. Later, Niagara claims that is seeking a rate "which includes a combination of an entered [sic] at destination discount plus a presorted rate which is equal to *33%* of the USPS's proposed First Class rates for the same weight article." NTC Brief at 10 (emphasis added).

These rates, which are inconsistent even with each other, are supported by no references to the procedural record. For good reason! These rate proposals appear for the first time in Niagara's Brief. How did Niagara arrive at these particular proposed rates? How is the Commission to know that they will be compensatory (in compliance with 39 U.S.C. § 3622(b), one of the statutory factors that Niagara discusses in its Brief, at 9)? What contribution to institutional costs will these rates afford? What effect will these proposed rates have on inducing (or not inducing) mailers to use "local mail"?

The Postal Service and the Commission might have learned more about these issues had Niagara presented these proposals as part of its testimony. Perhaps the next time the Postal Rate Commission considers a Request for a Recommended Decision for changes in rates and fees, Niagara will intervene and present a proposal for "local mail" that includes the rate proposal discussed in its brief. For the time being, however, and on the record of *this* proceeding, these issues must go unresolved, and the Commission is left unable to rely on Niagara's last minute rate proposals.

B. The Commission Should Recommend The Postal Service's Proposed Priority Mail Rates.

Only two parties have challenged the Postal Service's proposed Priority Mail rates in their initial briefs, NDMS and UPS. The NDMS Brief essentially presents a recapitulation of the testimony of NDMS witness Haldi on the subject of Priority Mail rates and rate design. The Postal Service's response to Dr. Haldi's testimony has been presented in the initial brief of the Postal Service, and little need be added to that exposition. *See* Postal Service Initial Brief at V-102-115. Suffice it to say that although NDMS is undoubtedly concerned about the continued competitiveness of Priority Mail, and therefore would like to see average rate increases for Priority Mail kept in the moderate range proposed by the Postal Service, NDMS just as undoubtedly is concerned that the higher-weight Priority Mail rates that NDMS predominantly pays be kept as low as possible, even if the consequence is relatively higher increases in the low-weight cells paid by the vast majority of Priority Mail users. The Postal Service is confident that the Commission will be mindful of this in evaluating the Haldi testimony and the NDMS brief.[1]

The initial brief of UPS, not unexpectedly, reveals a contrary bias. It can

[1] The Commission should also take note of the fact that NDMS, in recommending new 12 and 13 ounce rates for First-Class Mail, ignores the impact that the potential diversion of over 134 million low-weight Priority Mail pieces to First-Class may have on the Postal Service's PMPC contract. *See* Tr. 4/1953. For example, under the contract with Emery, the Postal Service must pay or receive varying per-piece adjustments depending on whether Priority Mail volumes handled by the PMPCs are less than, equal to, or greater than expected. See LR-H-235 at Section A. Unless this impact is considered, the proposal cannot be said to be based on a complete analysis.

safely be said that UPS is also keenly interested in the competitiveness of Priority Mail in the communications marketplace. But its interest is that of a direct competitor taking advantage of the fact that its rival, the Postal Service, is subject to regulatory oversight that UPS itself does not face. Thus it can come as no surprise to the Commission or anyone else that UPS, in its testimony and its brief, argues for exorbitant increases in Priority Mail rates, and additional increases on Priority Mail parcels. *See* UPS Brief at 34, 36-37. The Postal Service's initial brief demonstrates why these outlandish proposals must be rejected. *See* Postal Service Brief at IV-65-71, V-113-116.

In a separate, sealed brief, UPS also devotes several paragraphs to an argument that the contract under which the Postal Service is experimenting with the use of PMPCs for processing and transportation of a subset of Priority Mail compels a parcel surcharge of at least 10 cents. UPS Supplemental Brief at 1-3. The essence of the UPS argument is that the terms of the Postal Service's contract with Emery Worldwide in some instances require different payment rates depending on the shape of the mail handled, a point alluded to in the cross-examination of witness Sharkey. *See* Tr. 4/2145. When these costs are considered, the argument goes, the 10 cent parcel surcharge recommended by UPS witness Luciani is reasonable. *Id.*

There are several reasons why the Postal Service does not favor a parcel surcharge in the Priority Mail classification. First, such a surcharge clearly would upset the relative simplicity that the Commission and the Postal Service have maintained by establishing unzoned rates through five pounds, and which would be further fostered by the current proposal to eliminate the Priority Mail presort category. As the Commission has recognized with respect to the unzoned rates, not every cost difference must be reflected in the Priority Mail rate design. In Docket No. R94-1, the Commission specifically rejected a proposal to zone all Priority Mail rates on the grounds that the proposal "would complicate the rate structure for 95 percent of the Priority Mail market." PRC Op., R94-1, at V-40-41. The same concern is fully applicable to the proposed surcharge advocated by witness Luciani. Moreover, given the high cost coverage in Priority Mail, no credible argument has been made, or can be made, that Priority Mail parcels are charged rates that do not cover their costs. Thus, no compelling reason exists to complicate the Priority Mail rate structure further.

Furthermore, the consequences of complicating the rate structure as UPS proposes have not been fully explored on the record. In suggesting that a ten cent Priority Mail parcel surcharge is appropriate, UPS has conveniently ignored that such a surcharge cannot be implemented in isolation. The Postal Service's rate design is based on the average cost of providing Priority Mail service for each zone-weight rate cell. If prices are deaveraged by shape, and the rate for Priority Mail parcels is increased, all other things being equal, the rate for Priority Mail flats must be decreased. In his testimony, Mr. Luciani does not make this offsetting reduction, and when asked about it, stated that he has "not formed a recommendation regarding how the revenues from the surcharge should be treated." Tr. 26/14409. In the absence of any analysis demonstrating how the Priority Mail parcel surcharge will affect the rates for Priority Mail flats, or how it would affect overall Priority Mail volume, costs, and revenue, the Commission should defer consideration of the Priority Mail surcharge proposal.

In addition, the cost basis for the Priority Mail surcharge proposal is questionable. The primary basis for the proposed surcharge is witness Sellick's analysis of parcel/flats cost differentials. While it is true that Mr. Sellick's analysis does track a similar analysis performed by the Postal Service in support of a Standard (A) parcel surcharge, there are reasons to believe that application of the method to Priority Mail may be inappropriate. First, the weight distributions of the two types of mail are grossly dissimilar. Whereas Standard (A) parcels must weigh no more than a pound, Priority Mail parcels may range up to 70 pounds. Secondly, while there may be a mix of parcels and flats in any given Standard (A) rate cell, it is highly likely that the zoned Priority Mail rate cells are dominated by parcel shaped pieces, and thus already reflect the costs of parcels. Hence, the underlying justification for a parcel surcharge would not appear to exist for parcel-dominated Priority Mail rate cells.[2]

[2] On brief, UPS also cites the PMPC contract for the proposition that its proposed surcharge is conservative. Although PMPC costs are relevant, caution must be used in their application, as the PMPC costs upon which UPS relies cannot be said to be representative of the majority of Priority Mail. The current PMPC network handles less than a third of total Priority Mail volume. Further, there is no certainty that the PMPCs will be expanded to handle a majority of Priority Mail volume, and it is possible that they may be reduced in scope in the future, depending on the outcome of the initial phases. The possibility also exists that in the future the contractual terms to which UPS alludes may also change. Such a fluid situation does not provide an stable basis for rate determinations at this time.

Due to the concerns expressed above, the Postal Service opposes the Priority Mail parcel surcharge proposed by UPS, and urges the Commission to reject it.

C. The Commission Should Recommend The Postal Service's Proposed Express Mail Rates

Two parties, UPS and intervenor David B. Popkin, address Express Mail issues in their initial briefs. The positions espoused by UPS have been anticipated and addressed in the Postal Service's initial brief, and no more need be said in response. Mr. Popkin's brief, however, merits a brief reply. Mr. Popkin contends that the Commission should deny any rate increase to Express Mail "until the Postal Service is able to design their service to be capable of delivering what is guaranteed." Popkin Brief at 11. Mr. Popkin's supposition that Express Mail service is falsely advertised is unsupported by any record evidence. The section of his brief, in fact, is devoid of any reference to the testimony, exhibits, workpapers, library references or oral cross-examination of any witness; nor does it mention the extensive discovery conducted by Mr. Popkin to which the Postal Service responded.

Thus, there is no reasonable way for the Postal Service or the Commission to evaluate Mr. Popkin's concerns that an unknown percentage of remote Express Mail destinations may be logistically impossible to reach within 2 days, or that some destinations may not receive Express Mail because "there is no normal delivery, such as on Sundays and holidays." Id. It is also unclear what bearing Mr. Popkin's concerns regarding unsubstantiated isolated defects in Express Mail service are supposed to have on the ratemaking process. Mr. Popkin has failed to substantiate any claim that Express Mail Service has declined nationwide, or that its value of service since the last omnibus rate case has changed in such a way that it would bear on the Postal Service's proposed cost coverage or rates. Thus, while the Postal Service is continually attempting to deliver excellence in its Express Mail service, and will continue to respond appropriately to concerns raised by individual mailers, such concerns simply do not warrant any deviation from the general rate increases which the Postal Service proposes in this case.

D. The Postal Service's Proposed Standard Mail (A) Rate Design Is Balanced, Fair, And Sound, And Enjoys Widespread Support From Standard (A) Mailers.

This case constitutes a significant departure from past rate cases, in that relatively few challenges to the Standard Mail (A) (formerly third-class) rate design have been advanced by participants. Challenges and alternatives to the proposed rate design have been few and very narrowly focused upon the following subject matter areas: (i) competitors' opposition to the ECR pound rate, (ii) competitor opposition to the density discounts and shape passthroughs in ECR, (iii) parcel mailers' opposition to the proposed residual shape surcharge, and (iv) adjustments proposed by mailers to the rate design, including increases in passthroughs for certain destination entry and automation categories and a new "bottom up" rate design for ECR letter and nonletter categories.

The bulk of the Postal Service's proposed rate design proposals, however, remains uncontroverted after having been thoroughly tested on the record. Intervenors have expressed praise and extended endorsements for various proposals. E.g., MASA Initial Brief at 2-5. Indeed, some aspects have even received support from competitor interests. *E.g.,* NAA Brief at 39-40. On all of these positions and proposals, the Postal Service would invite the Commission's attention to the full discussion of Standard Mail (A) issues found in its Initial Brief. Postal Service Brief at V-119-83. Not all of these intervenor proposals merit discussion in this Reply Brief. Below, the Postal Service responds to the principal arguments made by some of these intervenors on brief. In doing so, the Postal Service puts to rest the notion that any of the alternative intervenor proposals and challenges merit recommendation by the Commission.

1. The proposed pound rate for ECR is appropriate, is not anticompetitive, and is supported by substantial record evidence.

The proposed ECR pound rate has received support from Standard (A) mailers, including SMC, AISOP, and MOAA. SMC Brief at 44; MOAA Brief at 23-37; AISOP Brief at 12. Val-Pak also expresses opposition to intervenor testimony opposing the proposed ECR pound rate. Val-Pak Brief at 74-75. Only NAA and AAPS oppose the reduction to the pound rate on brief. AAPS Brief at 3-6; NAA Brief at 5. The opponents raise essentially no new arguments on brief that were not already addressed in the Postal Service's Initial Brief. Rather than revisit the issues responding to the NAA Memorandum of Law, filed March 26, 1998, opposing the Postal Service's proposed ECR pound rate, the Postal Service refers the Commission to its Initial Brief at V-145-58, as well as to the initial briefs of SMC, AISOP, and MOAA, for a discussion of the convincing record support favoring adoption of the proposed rate, as well as to the arguments made on brief thoroughly discrediting the opposition. In this brief, the Postal Service simply undertakes to dispel the notion that the proposed pound rate in ECR is contrary to the Postal Service's mission or is motivated by intent to harm alternative media and delivery.

Claims advanced by NAA and AAPS that the Postal Service has strayed from its public mission and is "taking sides" against the alternative media and newspaper industries are self-serving and empty. NAA Brief at 1-2; AAPS Brief at 2. Not one shred of evidence, including NAA/R97-1 LR-2, shows that the proposed ECR pound rate is motivated by a desire to gain market share or harm alternative media or delivery. Witness Moeller offers multiple, cost-justified, and common-sense reasons for the reduction, only one of which has anything to do with competition. USPS-T-36 at 24-26; Tr. 6/2791. The profitability of alternative delivery did not even inform witness Moeller's rate design. *See* Tr. 6/3002. The Postal Service's intent to offer a sensible rate design for advertising communications does not constitute an aggressive attempt to harm alternative providers. If anything, the Postal Service's proposal should be understood to offer a more cost-justified service for heavier weight advertising media. USPS-T-36 at 24-26.

Conspicuously absent from the arguments that the Postal Service's pound rate proposal is not justified and is designed to capture market share is any discussion of the private firms' prices against which the Postal Service is alleged to be competing unfairly. *See* Tr. 23/12037. Furthermore, while NAA complains that the proposed reduction in the ECR pound rate is not justified, nowhere has it shown on this record that the Postal Service's prices for pound-rated pieces would not be fully compensatory or would not make substantial contribution. *See* NAA Brief at 5. Even at the Postal Service's proposed rates, pound-rated Saturation mail will still make substantially greater unit contribution than lighter weight pieces. Tr. 34/18316. Also absent is any testimony proving the market share which the Postal Service will allegedly gain by virtue of a reduction in the pound rate. The only witnesses to offer industry testimony in opposition to the proposed pound rate, AAPS witnesses

Bradstreet and Green, offered no evidence showing that the proposed Saturation rates would undercut any of their prices.

In sum, the Postal Service's proposed reduction in the pound rate is reasonable, supported by substantial record evidence, and is not intended to harm competition.

2. NAA's criticisms of the mail processing cost differentials in the ECR subclass are misleading and based upon disproven assumptions.

At page 28 of its Initial Brief, NAA urges the Commission to reject the Postal Service's mail processing cost differentials, which were developed by witnesses McGrane (USPS-ST-44) and Daniel (USPS-T-29). As explained in the Postal Service's Initial Brief, the Postal Service has presented a refinement to the measurement of cost differentials in the ECR subclass by estimating separate mail processing costs for non walk-sequenced (Basic tier) and walk-sequenced (High-Density/Saturation combined) letters and nonletters. Exhibit USPS-44A; Exhibit USPS-29D. These mail processing cost differentials, in combination with delivery cost differentials, now inform witness Moeller's proposed discounts for ECR density tiers. USPS-T-36 at 29.

On brief, NAA points to "new preparation and entry requirements for commercial ECR letters and non-letters" as a basis for challenging the reliability in the Postal Service's mail processing cost differentials. NAA Brief at 28-29. NAA claims that mail preparation changes implemented in connection with classification reform operate to "overstate the cost difference between walk-sequenced and non walk-sequenced commercial ECR mail." NAA Brief at 28. According to NAA, the BY mail processing cost differentials "reflect out-dated operating conditions and entry requirements." NAA Brief at 28. In support of its argument, NAA cites witness Donlan's testimony, as well as the absence of Postal Service rebuttal testimony. NAA Brief at 29.

As an initial matter, NAA should take no comfort in the fact that the Postal Service did not file rebuttal testimony to witness Donlan's testimony. Like any other participant, the Postal Service's decision-making regarding the filing of rebuttal testimony requires consideration of multiple, competing considerations, including the consumption of resources devoted to the task, the relative importance of the matters to be addressed in rebuttal, and the believability of the testimony to which rebuttal is to be offered. The decision not to submit rebuttal testimony against NAA witness Donlan's testimony does not in any way constitute an implicit concession or tacit acquiescence in witness Donlan's testimony, or an acknowledgement that it is to be given any credence whatsoever. To the contrary, the testimony was so flawed as not even to merit the time and resources necessary to rebut it. The Postal Service simply determined that the argument could easily be discredited on brief, and has successfully done so. *See* Postal Service Brief at V-135-43.

Turning to NAA's arguments on brief, NAA's contentions suffer from internal inconsistency and fall short on substance. First, NAA's contention that the Postal Service's cost differentials underlying its discounts are "inadequate and unreliable," NAA Brief at 29, is fundamentally at odds with the essence of witness Donlan's testimony. As NAA points out on brief, witness Donlan shows that the data underlying the differentials "show an inconsistency between the pre-reclassification and post-reclassification periods." NAA Brief at 29 n.27. If, as NAA suggests, the data underlying the differentials are inadequate to support the mail processing cost differentials, NAA Brief at 29 n.27, then how can reliance upon witness Donlan's findings, which are based upon a disaggregation of the very same data into pre- and post-reclassification periods, be given any more credence? Clearly, NAA's arguments undermine the cornerstone of its own witness' analysis.

NAA's arguments on brief also stray in material respects from its witness' testimony. For the first time on brief, NAA challenges the adequacy of *both* the letter and nonletter mail processing cost differentials due to the introduction of classification reform in the BY. NAA Brief at 28 ("new preparation and entry requirements for commercial ECR letters and nonletters went into effect on July 1, 1996 . . . ."). This attempt by NAA to muddy the waters by mixing letter and nonletters into the equation appears to be nothing more than a feeble attempt to avoid exposing the fundamental weaknesses and flawed assumptions in witness Donlan's testimony, which was exclusively confined to the reclassification effects on *nonletters*. Tr. 27/14676-78. Yet when even when NAA's criticisms are evaluated separately for ECR letters and nonletters, they do not withstand scrutiny and must be rejected.

a. Mail processing cost differentials for ECR nonletters are not overstated.

With regard to nonletters, NAA's claim that classification reform served to narrow mail processing cost differentials for ECR tiers rests on the disproven assumption that classification reform had a substantial impact in the preparation requirements and handling of nonletter *carrier route mail*. Indeed, NAA never showed on this record how *any* change implemented in connection with classification reform should have affected the mail processing cost differentials between non walk-sequenced and walk-sequenced nonletter carrier route mail. To the contrary, witness Donlan failed to offer an explanation as to how classification reform affected mail processing differentials for nonletters. Tr. 27/14686, 27/14688. NAA witness Donlan did not so much as offer a theory regarding how the mail processing cost differentials for ECR were affected by any change implemented in connection with classification reform. *Id.* Simply put, NAA's contention that classification reform has caused the Postal Service to "overstate" the ECR nonletter mail processing cost differentials is not based on one shred of fact. There is simply no basis to believe that there is a cause and effect relationship between classification reform and changes in mail processing cost differentials between the ECR nonletter tiers in the pre- and post-classification reform environments.

NAA's contention that classification reform affected nonletter mail processing cost differentials was, moreover, disproven on this record by witness McGrane. As thoroughly explained in the Postal Service's Initial Brief, witness McGrane showed that classification reform had little impact upon ECR nonletters. Postal Service Brief at V-137-38. When asked about the comparison made of pre- and post-reclassification nonletter mail processing cost differentials provided in NAA-XE-1 at Tr. 15/7765, later reproduced in witness Donlan's testimony, Tr. 27/14678, witness McGrane unequivocally dispelled any suggestion that the mail processing cost differentials should have narrowed as a consequence of classification reform. In particular, he stated, "in terms of post-reclassification, the world is not all that different for ECR mail." Tr. 15/7771. Witness Pajunas' testimony in Docket No. MC95-1 confirms that relatively little change in the preparation of carrier route flats was sought in classification reform. Docket No. MC95-1, USPS-T-2 at 108. Consequently, there is no nexus between the ECR nonletter mail processing differentials and classification reform initiatives.

Witness Donlan's criticisms regarding the nonletter mail processing cost differentials are in any event inconsequential because, as explained in the Postal Service's Initial Brief, the 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. Postal Service Brief at V-139; *see also* USPS-T-36 at 29, 49; Tr. 34/18338. Because the density passthroughs are so low, the delivery cost differential *alone* is sufficient to maintain the Saturation discount of 2.3 cents. Tr. 34/18337-38. Thus, as a practical matter, even if witness Donlan's criticisms were to be believed, the passthroughs for nonletters are sufficiently low to negate entirely the effect of any change in nonletter mail processing costs engendered by classification reform.

b. Mail processing cost differentials for ECR letters are not overstated.

To the extent NAA claims that the mail processing cost differentials for *letters* are overstated, its argument is completely unpersuasive. Indeed, as explained below, the record demonstrates the superiority of the Postal Service's use of BY 96 data for measurement of the mail processing cost differentials for letters.

First, it is important to point out that NAA claims for the first time on brief that the mail processing cost differentials for ECR letters are overstated. NAA Brief at 28. NAA witness Donlan made absolutely no claim that *mail processing* cost differentials for ECR letters were in any way overstated by virtue of classification reform. Witness Donlan's criticisms regarding the *mail processing* cost differentials were confined to the pre- and post-reclassification mail processing cost differentials for *nonletters*. Tr. 27/14676-80. Witness Donlan's testimony is inexplicably silent on the adequacy of the mail processing cost differentials for ECR letters. *See* 34/18338 lines 21-22.

Witness Crowder observes that post-reclassification ECR mail processing cost differentials for letters increased in the post-reclassification environment. Tr. 34/18338. This should come as no surprise, because, unlike nonletters, implementation of classification reform in the BY did result in changes for non walk-sequenced letters. Tr. 34/18339. In particular, the introduction of a new rate category in ECR, the Automation carrier route letter category, became available pursuant to classification reform. 61 Fed. Reg. 10068 (final DMM rules implementing classification reform). As witness Crowder explains, the introduction of this category in the BY may have played a role in widening the mail processing cost differential for letters. Tr. 34/18339.

NAA, however, can take little comfort in the fact that classification reform may have been of consequence to *letter* mail preparation within ECR. Indeed, given that the Automation ECR letter category was introduced at the end of the BY, witnesses McGrane's and Daniel's development of letter mail processing cost differentials based on the entire BY is *superior* to the alternatives. This is because data for the entire FY are more reliable than any subset thereof. *See* Tr. 34/18349, Tr. 34/18345. Cost estimates based on a full year's data are, moreover, relatively unaffected by the combination of Automation ECR and Basic nonautomated ECR letters within the non walk-sequenced tier, since the Automation ECR category was introduced 10 1/2 months into the BY. Tr. 27/14686; Exhibit USPS-44A. Use of a post-reclassification BY cost would be less reliable, Tr. 34/18340, and contrary to accepted practice, Tr. 15/7763. Use of pre-reclassification data for the BY would also be suboptimal, since the entire year's worth of data permits identification of related dropship characteristics used in normalizing unit mail processing costs. Tr. 34/18340. In short, the Postal Service's use of the entire year's worth of data to determine the mail processing cost differentials for ECR letters is superior to the other available alternatives.

Furthermore, several factors mitigate any alleged influence the introduction of the Automation ECR category may have had on BY mail processing cost differentials for ECR letters. First, the Automation ECR letter category was introduced a mere 70 days before the expiration of the BY. Tr. 27/14686; 34/18333. Secondly, the proportion of Automation ECR volume relative to Basic nonautomated ECR, even in the "post reclassification" environment, is quite small. The billing determinants for the "post reclassification" period in quarters 1 and 2 of FY 97 show that Automated ECR letters constitute approximately 1/4 of all Basic tier letters. Moeller WP at 2. These two factors serve to make the proportion of Automation ECR in the non walk-sequenced tier to be quite small in the BY. In any event, to the extent the mail processing costs for the non walk-sequenced letter tier were allegedly influenced by the presence of the small proportion of Automation ECR letters in the last 70 days of the BY, the record shows that the *additional* mail processing cost for Automated ECR letters above nonautomated Basic letters is quite small, amounting to a mere 0.4 cent. Exhibit USPS-29A at 1. In combination, these three factors show that the influence that the introduction of the Automation ECR category may have had on the mail processing costs for the non walk-sequenced tier in the BY is likely to be trivial. As such, there is no reason in this docket to engage in an exercise to isolate the Automation ECR Basic letter mail processing cost within the non walk-sequenced tier in the BY.

To the extent NAA's criticism is intended to suggest that the presence of Automation ECR letters contributes to an inherent bias in study methodology of the mail processing costs of the non walk-sequenced tier, its concerns are misplaced. The IOCS tallies that form the basis of witness McGrane's disaggregation of the mail processing costs into walk-sequenced and non walk-sequenced tiers can be further disaggregated because Automation ECR letters bear a special endorsement that is distinct from nonautomation Basic. DMM § M012.2.0; M810.1.4 (pieces claimed at an automation carrier route rate bear the endorsement "AUTOCR"). Consequently, in the future, the mail processing costs for non walk-sequenced letters can be further subdivided into two groupings for purposes of analysis: Automation ECR Basic and nonautomation ECR Basic. The latter can then serve as the benchmark for the mail processing cost differentials necessary determine ECR density discounts, if that approach is determined to further the interest of precision in calculating the mail processing cost differentials. Alternatively, with the modeling techniques presented by witness Daniel, additional costs associated with Automation ECR letters are routinely identified, Exhibit USPS-29A at 1, and can be combined with the billing determinants data on the relative proportion of Automation ECR letters to total non walk-sequenced tier letters to isolate and remove, if appropriate, an estimate of the proportion of mail processing costs in the non walk-sequenced tier that can be traced to Automation ECR letters.

Finally, even if NAA's contention that ECR letter mail processing cost differentials are influenced by classification reform changes is given any weight, the rate design for letters essentially negates the effect of classification reform changes on the results. This is because witness Moeller passes through zero percent of the shape differential in the Basic ECR tier. USPS-T-36 at 27-28. As such, he uses the *nonletter* Basic rate as the starting point for determining the High-Density and Saturation letter rates. Moeller WP1 at 18, 23. This implies that, if anything, the effective rates for High-Density and Saturation letters are *higher* than they would be absent the policy decision to set a zero passthrough for shape in the Basic tier so as to promote the automation program. This, in turn, mitigates any influence on the resulting rates that any alleged distortion in cost differentials may have. Furthermore, the implicit passthrough for the density tiers is less than 100 percent, USPS-T-36 at 48 (revised October 3, 1997), and this serves as an additional means of mitigating any influence on letter costs that can be traced to classification reform changes.

3. The Commission must reject NAA's criticisms of the Postal Service's delivery cost differentials and its arbitrary and illogical alternative rate design.

NAA offers two criticisms of the delivery cost savings used to calculate the delivery cost differentials in ECR. The first concerns the propriety of the in-office casing productivities used in the development of delivery cost differentials for nonautomated ECR categories. NAA Brief at 31-32. The second pertains to the extent to which savings accruing to ECR letters that are processed on automation to delivery sequence should be reflected in the delivery cost differentials for nonautomated ECR tiers. NAA Brief at 32-34. Both criticisms lack evidentiary support. Furthermore, the alternative rate design NAA advocates is seriously flawed and must be rejected.

a. NAA's challenge to the productivities underlying the delivery costs lacks record support.

NAA opposes the density discounts in the ECR subclass by challenging the productivities used to calculate the in-office casing costs which underlie the ECR density discounts. NAA Brief at 31-32. NAA's contention rests on assumptions not established and tested on this record. Its criticisms are, moreover, mitigated by other countervailing rate design considerations.

The essence of NAA's argument is that the in-office casing productivities underlying the in-office costs do not account for an alleged incremental improvement in productivity due to the requirement, introduced at the end of the BY, that Basic tier letters and nonletters be presented in line-of-travel sortation. NAA Brief at 31. NAA then deduces that witness Hume's delivery cost differentials are overstated, presumably because Basic tier in-office delivery costs for letters and nonletters would be expected to decrease with the introduction of line-of-travel sortation. NAA Brief at 31. As with its other arguments, NAA is quick to jump to conclusions that serve its interests, but comes up short on substance. Its claim obviously rests on the assumption that Basic ECR in-office delivery costs should have decreased as a consequence of the implementation of line-of-travel sequencing requirements for the Basic tier. NAA cites to absolutely nothing on this record to prove the point, *see* NAA Brief at 31-32; consequently, its criticism is not based upon any fact established on this record.

NAA also errs in suggesting that productivities for either "walk sequenced" or "sector/segment" mail from witness Shipe's Docket No. R90-1 study on casing productivities (Docket No. R90-1, Exhibit USPS-10A) should have been used to calculate the differentials. NAA Brief at 31-32 & n.31. NAA errs to the extent it implies that "walk sequence" productivities serve as a proxy for line-of-travel sortation. *See* NAA Brief at 31 n.31. As the Postal Service explained in its advance notice of proposed rulemaking in connection with Docket No. MC95-1, line-of-travel sortation is "not exact walk-sequence arrangement of the mailpieces . . . ." 60 Fed. Reg. 34063.[1] Furthermore, to the extent NAA suggests that sector/segment sequence sortation is a suitable proxy for line-of-travel, NAA Brief at 31-32, its allegation rests on the assumption that the productivity of Basic ECR letters, which are predominantly presented in packages containing less than 125 pieces per route, is equivalent to the productivity measured by witness Shipe for sector/segment letters. This propriety of this assumption was not established or tested on the record. In any event, the study measured productivities for "full coverage mailings" and "mailings consisting of [a minimum] 125 pieces" to help determine the effect of coverage on productivity. Docket No. R90-1, Exhibit USPS-10A at 1. Therefore, the productivity for sector/segment sequence sortation in witness Shipe's study not only measures the productivity gains from *sequencing methods*, but also from *coverage*, *i.e.*, density of delivery for each particular carrier route. *See* Docket No. R90-1, Exhibit USPS-10B at 4. Witness Shipe's study further shows that productivity decreases as volume declines, regardless of sequence method. *Id.* Nothing on this record shows that Basic letters and nonletters exhibit the same *coverage* or *sequencing method* as sector/segment sequenced letters in witness Shipe's study.

[1] Rather, line-of-travel requires that mailpieces be sorted into "the sequence in which the ZIP + 4s are delivered by the carrier. The mailpieces are [then] sorted into ascending or descending numerical sequence within the number range associated with the ZIP + 4." 60 Fed. Reg. 34063.

Consequently, NAA's argument lacks an evidentiary foundation.

NAA also ignores the fact that the density passthroughs proposed in this docket, as well as the absence of a shape passthrough at the nonletter tier, essentially negate its concerns. The Postal Service's proposed passthroughs for ECR nonletters are well below 100 percent, which has the effect of minimizing or eliminating any alleged influence line-of-travel sortation may have on the Basic category in-office costs. USPS-T-36 at 29, 49; Tr. 34/18338. For letters, a lower-than 100 percent implicit passthrough, USPS-T-36 at 49 (revised October 3, 1997), as well as witness Moeller's use of the *nonletter* rate as the starting point for subtracting discounts for letters, Moeller WP1 at 18, 23, both operate to mitigate any influence the introduction of line-of-travel sortation requirements may have on delivery cost differentials for letters.

b. NAA draws unsubstantiated conclusions regarding the recognition of DPS savings in the delivery cost differentials.

On brief, NAA urges that the Commission reject the delivery cost differentials based on the claim that the delivery costs for letters are overstated due to the Postal Service's practice of processing Basic tier ECR nonautomated letters to delivery sequence on automation. NAA Brief at 32-34. In support of its allegation, NAA offers its own conclusion that "the percentage of ECR basic letters that are DPS processed *likely exceeds* the percentage of High-Density and Saturation letters that are DPS processed." NAA Brief at 34 n.34 (emphasis added). NAA offers no record source for this proposition. Indeed, it cannot do so. As the Postal Service demonstrated in its Initial Brief, the record lacks quantitative support for the proposition that Basic ECR letters received automated delivery sequence sortation in greater proportion relative to the other ECR categories. Postal Service Brief at V-142; Tr. 34/18404. Witness Moden further confirms that all three ECR categories, *i.e.,* Basic, High-Density, and Saturation, are barcoded and processed on automation to delivery sequence. Tr. 11/5844. Witness Crowder offers additional proof that the record shows that High-Density and Saturation letters were processed on automated equipment in the base year. *See* Tr. 34/18340. As such, the absence of quantitative information on the relative proportion of automated sequencing of the Basic versus High-Density/Saturation letters makes it impossible for NAA to establish its claim that nonautomation Basic letters are entitled to a greater share of the delivery cost savings owing to delivery point sequence sortation.[2] To reject the delivery cost differentials in the absence of such quantitative proof would be simply arbitrary. *Cf.* Tr. 34/18345.

Even if NAA's contention is to be given any credence, it is mooted by the below 100 percent implicit density passthrough for ECR letters, USPS-T-36 at 48 (revised October 3, 1997), as well as witness Moeller's use of the *nonletter* rate as the starting point for determining discounts for letters, Moeller WP1 at 18, 23. Both factors operate to mitigate any influence that the alleged disproportionate DPS sortation among ECR letter tiers may have had on delivery cost differentials for letters

[2] The delivery cost savings for DPS sortation of ECR subclass mail are *already* included in the in-office costs for ECR letters. Tr. 34/18342.

in the BY.

c. NAA's alternative rate design proposal is flawed and inconsistent with the Commission's previously stated objectives.

NAA's alternative rate design is flawed. To remedy the alleged overstatement of Basic tier letter costs engendered by line-of-travel sortation and automated delivery sequence sortation of nonautomated Basic letters, NAA proposes that the Commission "recommend no change in the current [ECR density] discounts at this time." NAA Brief at 35. As discussed in the Postal Service's Initial Brief, witness Donlan was a chief proponent of this approach in his testimony, but even he retreated from it. Postal Service Brief at V-142-43 (citing Tr. 27/14694). Inexplicably, NAA now sees fit to resuscitate its failed alternative rate design on brief. NAA Brief at 35.

NAA's proposed remedy reveals a fundamental flaw in its logic. In essence, NAA would have the Commission believe it would be better to use existing density discounts recommended in Docket No. MC95-1, which were founded upon delivery cost differentials from BY 93 data, as well as passthroughs informed by the nonmodel cost factor presented in that docket, *see* PRC Op. MC95-1 ¶ 4304. The discount levels which NAA advocates were, however, *derived using the very same in office casing productivities* that NAA challenges in this case! *Compare* Exhibit USPS-18B at 4, 6 *with* Docket No. MC95-1, Exhibit USPS-T-7B at 1, 6. Thus, to the extent NAA claims that witness Hume's cost estimates use "outdated" productivities, NAA's alternative rate design suffers from the very same criticism. Resort to Docket No. MC95-1 discounts does nothing to cure this alleged infirmity in the discounts. Furthermore, as discussed below, NAA's alternative suffers from two other fatal flaws.

NAA's recommendation to return to the previously recommended discount levels from Docket No. MC95-1 would require the Commission to ignore the updated in-office cost information for the ECR subclass that underlies witness Hume's delivery costs. This is fundamentally at odds with the Commission's interest in using the most current information available in evaluating the Postal Service's costs. PRC Op. MC95-1 ¶¶ 4101-03; PRC Op. R94-1 ¶¶ 1031-34. Simply put, NAA's suggestion contravenes the Commission's goal of encouraging the submission, receipt, and use of updated cost information. PRC Op. R94-1 ¶ 1034.

In addition, as demonstrated in the Postal Service's Initial Brief, adoption of the previous discounts results in rate anomalies. Postal Service Brief at V-142. 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. In sum, resort to the old differentials in this docket is inconsistent with sound ratemaking principles. NAA's alternative rate design must accordingly be rejected.

4. NAA's proposal to increase the shape passthroughs in the ECR High-Density and walk-sequence tiers lacks record support and is contrary to its stated interests.

In its initial brief, NAA endorses the Postal Service's proposal to reduce the shape passthrough in the Basic tier to zero percent. NAA Brief at 39-40. NAA states that the proposed shape passthrough constitutes "an acceptable accommodation" in this case, since it results in an appropriate rate relationship between ECR Basic and Regular Automation 5-digit, and thereby serves the "laudable [goal] of promoting the automation program . . . ." NAA Brief at 39-40. NAA, however, adopts a different tact in evaluating the shape passthroughs between letters and nonletters at the High-Density and Saturation tiers. NAA Brief at 40-41. NAA urges the Commission to "passthrough the cost differences between letters and flats at the ECR High-Density and Saturation tiers to the maximum extent possible, moving towards a full 100 passthrough of the cost differences between letters and flats." NAA Brief at 41.

NAA's proposal is obviously not borne out of a genuine interest in seeking the recognition of cost differences in rates. Rather, its proposed increases in the shape passthroughs for the High-Density and Saturation tiers are nothing more than a pretext for achieving its longstanding objective of shrinking the Saturation discount for nonletters. This result occurs by operation of the presort tree. Within the presort tree, the shape passthroughs at each presort tier, combined with the *letter* presort passthroughs, drive the nonletter presort passthroughs. USPS-T-36 at 16, 29; Tr. 6/2782. Thus, by widening the shape passthrough, the effective nonletter Saturation rate rises.[3]

[3] Indeed, manipulation of witness Moeller's electronic workpaper files shows that setting the presort passthrough for the High-Density tier in ECR to zero causes the High-Density rate for nonletters to exceed the rate for Basic. *See* USPS LR-H-202 (disk 1, file "wp_comm", worksheet "crpass", worktable C).

NAA's shape passthrough proposal is also fundamentally at odds with its challenge to the proposed pound rate for ECR. NAA Brief at 5. NAA's proposal would pass through the cost differences between letters, all of which, by definition, weigh below the breakpoint weight, and *all* nonletters, including those below *and above* the breakpoint weight. Yet passing through 100 percent of the letter/nonletter differential would not simply account for cost differences due to shape; rather, since the pieces underlying the cost estimates are exhibit different weight characteristics, the differential would include weight-related differences, if any. Much to NAA's chagrin, to the extent the shape passthrough accounts for differences in weight between letters and nonletters, the pound rate should be reduced even further than proposed by the Postal Service in this docket. *Cf.* Postal Service Brief at V-160 n.12. Clearly, NAA would not intend that result, given its staunch opposition to the pound rate in this docket. NAA Brief at 5.

NAA also fails to acknowledge that for the High-Density and Saturation tiers, witness Moeller proposes sharp *increases* in the shape differential between letters and nonletters to reflect the measured cost differences better. 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. USPS-T-36 at 27-28.

5. The Criticisms Put Forth By the Parties Concerning the Residual Shape Surcharge Do Not Detract from the Reasonable, Conservative Nature of the Proposed Surcharge.

a. The claim that the Postal Service is indifferent to whether parcels cover their cost is false and is based on a misunderstanding of the rate design.

Parties have attempted to make much of witness Moeller's testimony that "what percentage 10 cents is of the 'difference between revenues and costs' is not relevant to the rate design." *See, e.g.*, NDMS Brief at 75. Witness Moeller was merely stating that the rate design does not have such a percentage as an input. Instead, the rate design attempts to assign a rate differential that takes into consideration the cost difference between shapes. This use of a cost difference is consistent with the methodology employed for the other shape differential (letter/nonletter) in Standard Mail (A). In determining the letter/nonletter differential, no consideration is given in the rate design to the "difference between revenues and costs." Rather, the rate design formula includes a passthrough of the cost difference between letters and nonletters. USPS-T-36, WP1, page 11. The critics would have you believe that Moeller committed some egregious rate design *faux pas*, when they are the ones advocating a break with past shape-based methodologies.

b. Contrary to NDMS' assertion, the Postal Service's proposed surcharge does indeed address the "below-cost rate problem" identified by the Commission.

NDMS conclude that since witness Moeller bases the proposed surcharge on the cost difference between flats and parcels, the surcharge does not address the "below-cost rate problem." NDMS Initial Brief at 75. Such a conclusion is absurd.

Absence of a proposed surcharge would be a failure to address the problem. NDMS themselves note that revenues are below costs for parcels. *Id.* at 78. A surcharge addresses that problem.

c. NDMS wrongly suggests a current trend will cause parcels to one day cover their costs.

NDMS cite figures from a number of years which purport to show a "disappearing" of the "below cost-rate problem." NDMS Brief at 78-79.[4] While the existence of a trend is questionable (there are only three years of data cited, and FY93 costs of 51.9 cents would not fit the cost trend), there is nothing to suggest that such a trend will continue. The Commission should disregard this claim and recommend the surcharge.

d. NDMS incorrectly interpret the Commission's previous acknowledgment that the Postal Service was undertaking a review of "parcel costs and market characteristics" as stating that a review of market characteristics is required in order to establish a surcharge.

In Docket No. MC95-1, the Postal Service objected to the imposition of a surcharge on the basis that a comprehensive review of the parcel product line would be undertaken in preparation of a parcel classification reform case. PRC Op., MC95-1, at V-222-224. Part of that review would include market characteristics. Certainly, while any proposal that would include a new subclass for a group of parcels would require an analysis of the market, establishment of a simple surcharge (or rate category) does not require that the group have distinct market characteristics. Even if

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[4] Thankfully they don't project this "trend" into the future and claim that parcels will make an exorbitant contribution some day.

it *were* required that distinct market characteristics be identified, there could hardly be a more obvious, distinct grouping within Standard (A) Regular than parcels.[5] The Commission should not let this alleged deficiency in the Postal Service's proposal stand in the way of recommending a prudent surcharge for this predominantly non-advertising component of Standard Mail (A). As stated in our initial brief, the proposed surcharge meets the classification criteria of the Act. Postal Service Brief at V-160.

e. NDMS's criticism of the volume and revenue estimates is not germane to consideration of the surcharge, especially since no alternative estimates are suggested.

NDMS argue that the volume and revenue estimates from the surcharge appear to be grossly inflated. NDMS Brief at 79. Witness Moeller explained the derivation of the figures[6] and responded to interrogatories regarding the volume forecast.[7] No party has presented any alternative method for calculating the volume and revenue implications.[8] The rate design formula is not that sensitive to alternative estimates of the forecasted volume. Tr. 6/2734-6. As stated by Commissioner Haley in his dissenting opinion in Docket No. MC95-1, "the forecast need not be of extreme accuracy since the overall financial effects will not be large."

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[5]Also, if market characteristics are desired, they are available in Docket No. MC97-2, USPS LR-PCR-38. The CD-ROM version includes greater detail.

[6] USPS-T-36 Workpapers 1-3, Contents, page 1.

[7] AMMA/USPS-T36-2,3, Tr. 6/2733-36.

[8]Perhaps NDMS offers no lower estimates because such estimates might have the effect of pushing up the basic rates in Standard Mail (A) from which all of the other rates are determined.

Dissenting Opinion of Commissioner George W. Haley Regarding Third-Class Parcel Rates at 2.

f. NDMS is simply wrong in their assertion that there is no evidence that shape is a dominant cost influence.

NDMS' assertion that there is no evidence that shape drives cost is contrary to the record in this case, as well as other cases, and defies intuition. The record in this case shows conclusively that parcels cost more than flats. Witness Crum has provided extensive testimony regarding the costs of parcels and other nonletters, including the finding in ECR, where the weight per piece is the same for flats and parcels, that parcels cost 40 cents more than flats. Exhibit USPS-28K, Table 3A. This is consistent with his finding in Docket No. MC97-2.[9]

g. NDMS misinterpret the implication of the "or prepared as a parcel" phrase in the definition of the residual shape surcharge.

The inclusion of the phrase "or prepared as a parcel" in the definition of pieces which would be subject to the surcharge was an intentional effort to clarify exactly which pieces would be subject to the surcharge and to ease administration of the surcharge. Tr. 7/3161. Unfortunately, NDMS have seized upon this language in an attempt to criticize the proposal as treating "identical mailpieces differently." NDMS Brief at 84. While the physical characteristics of some surcharged pieces may be the same as some that are not surcharged, that does not mean that the costs will be the same. Pieces that are prepared as parcels will be processed like parcels, so it

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[9]In fact, the measurement of cost difference is even greater in this case than in the Parcel Classification Reform filing.

makes sense to surcharge these pieces. As witness Moeller stated, these pieces can avoid the surcharge if they are prepared as flats, however many mailers may choose to not prepare the pieces as flats since there are higher preparation costs, and the potential loss of presort discounts. Tr. 7/3161-3. NDMS' criticism that the surcharge treats physically identical mailpieces differently is groundless since the pieces are *not* identical by virtue of their differing preparation, and the criticism should not cause the Commission concern if it decides to recommend the residual shape surcharge.

h. Contrary to NDMS' assertion, the Postal Service's definition of a parcel is clear.

NDMS state in their brief that there is an "overlap" in the dimensions that describe a letter, a flat, and a parcels. NDMS Brief at 89. There is, however, no confusion or overlap for IOCS costing purposes. Those definitions are clear. *See* Tr. 5/2202-2205. If any item fully falls within the definition of a letter, then it is a letter in IOCS. If an item exceeds any one of the letter-size maximums, but still falls within the range of flats, then it is a flat in IOCS. If a piece does not fall fully within the definition of a letter or a flat, then it is a parcel (of some type) in IOCS. Despite all the attempted muddying of the waters, the shape definitions are quite clear for costing purposes.

i. NDMS' criticism that the "proposed Standard A parcel rates lack simple, clear definition parameters" is belied by the refined DMCS language proposed in this case.

While NDMS cite the DMCS language regarding the residual shape surcharge in their contention that identical pieces are being treated differently, they conveniently ignore the fact that the language very definitively states which pieces will be subject to the surcharge and removes ambiguity that was inherent in the definition provided in Docket No. MC97-1. The supplemental phrase "or prepared as a parcel" clearly defines which pieces are subject to the surcharge and provides the mailer the option of avoiding the surcharge on those pieces that could be prepared as flats.[10] The Commission should disregard the NDMS contention that the proposal "still lacks adequate definition parameters." NDMS Brief at 86.

j. The notion that the Postal Service has not considered machinability of parcels is incorrect.

NDMS contend that the proposal fails to distinguish between machinable and nonmachinable parcels and that the Postal Service has not considered machinability. NDMS Brief at 90. NDMS are correct that the proposal does not *create* any financial incentive for mailing parcels which are machinable — those incentives are already in place. As witness Moeller has repeatedly noted, and witness Haldi has confirmed, machinable parcels enjoy easier, less-costly mail preparation, and can qualify for the 3/5-digit presort discount simply by presorting to BMC. Tr. 23/12267; Tr. 6/2751; Tr. 7/3162-3. Witness Moeller also clarified that the calculated costs of parcels does reflect whatever level of machinability Standard A parcels exhibit.[11] To the extent machinability reduces costs, the cost differential on which the surcharge is based is narrowed. Tr. 6/2819. However, as noted by witness Crum, machinable parcels may

[10]NDMS somehow try to translate this option into an added cost. NDMS Brief at 88. If a mailer expends effort to separate pieces in order to avoid the surcharge, presumably that would result in a net benefit for the mailer.

[11]Over 72 percent of Standard A Regular parcels are machinable, so to the extent that machinability influences the measured costs, it is considered. Tr. 5/2251.

have other characteristics that result in higher cost in non-sortation activities. Tr. 5/2369-2371. The results from the Docket No. MC97-2 parcel characteristics study (LR-PCR-50), which responded to the machinability issue, support witness Crum's comments.

k. The Postal Service has provided sound reasons for the absence of a proposed barcode discount for Standard Mail (A), and the level of the proposed residual shape surcharge recognizes that absence.

PSA speculates that a possible explanation for the lack of a proposed barcode discount for Standard A parcels is that the Postal Service believes it is already losing money on these pieces. PSA Brief at 8. Speculation is not necessary, however, as the record contains several points regarding the absence of a proposed barcode discount. Tr. 6/2750-51, the Postal Service wishes to establish a simple, easy-to-administer surcharge, consistent with the classification criteria of the Act. Implementation of a surcharge in conjunction with an offsetting discount is counter to simplicity. If the Postal Service were to have proposed a barcode discount, it may well have reconsidered the level of the proposed surcharge since 72 percent or more of Standard A parcels would have been eligible. NDMS Brief at 91. Also, NDMS has mischaracterized the testimony of witnesses Crum and Moeller regarding the processing of Standard Mail (A) parcels. Witness Crum noted that although 72 percent of Standard Regular parcels are machinable, that does not mean they will be processed on the BMC Parcel Sorting Machines. He notes that parcels dropshipped beyond the destination BMC or presorted to 5-digits will likely not be processed on the machines and the barcode would be of no value. Also, some sorting of Standard

(A) parcels, although they meet the definition of machinable, are not processed on the BMC machines. In order to avoid a rate anomaly[12] or a change in the definition of machinability, the barcode discount would likely have to be offered to all of these parcels even though there would be no value to the barcode. NDMS also misuses a response by witness Moeller. NDMS claims that "witness Moeller even recognized that cost savings to the Postal Service from a prebarcoded Standard A parcel 'are likely to be similar to those for a prebarcoded Standard (B) parcel,' since Standard A parcels will also be processed on parcel sorters with barcode readers." NDMS Brief at 91. What witness Moeller actually said was: "*If* a prebarcoded Standard (A) parcel is processed on a parcel sorter with a barcode reader, the cost savings due to the presence of the barcode on that piece are likely to be similar to those for a prebarcoded Standard (B) parcel that is processed on a parcel sorter with a barcode reader." Tr. 6/2748 (emphasis added). He did not say anything regarding the relative likelihood of prebarcoded Standard (A) and (B) parcels to be processed on a sorter with a barcode reader, as is implied by NDMS's paraphrasing of his response.

I. The Commission should avoid recommending distinct dropship discounts by shape in this proceeding.

NDMS recommend that if a residual shape surcharge is recommended, then

[12] BMC presorted parcels have the same rate as 5-digit presort parcels. If the barcode discount was extended only to BMC presort, the rate paid by a BMC presorted piece would be lower than a 5-digit piece. To avoid this anomaly, the barcode discount would have to be extended to the 5-digit piece, even though the barcode would be of no value.

separate destination entry discounts should be established by shape. NDMS Brief at 111. NDMS cite the Docket No. R90-1 Recommended Decision that included separate presort discounts for letters and nonletters when shape-based rates were established. What NDMS do *not* say is that the current destination entry discounts apply to both letters and nonletters. It is unclear whether witness Haldi would recommend a smaller destination entry discount for letters than for nonletters. In any event, the Postal Service urges the Commission to consider the layers of added complexity that would come with destination entry discounts by shape and reject NDMS' proposal.

m. NDMS make conclusions regarding witness Crum's cost adjustments that are not supported by the record and are inaccurate.

NDMS provide a critique of witness Crum's adjustment in his calculation of costs by shape.[13] They contend that his "calculations *inflate* the actual Standard A parcel/flat cost differential by understating the degree to which additional dropshipment and presortation of flats (compared to parcels) skews the data reported in Exhibit USPS-28K, Table 3." NDMS Brief at 100 (emphasis added). NDMS offer no alternative calculation of the adjustment and merely assumes that witness Crum's method of adjustment leads to a wider differential. If, in fact, they would have made the calculation, NDMS would have seen that such a change as they suggest would expand the parcel/flat cost difference, not shrink it. *See* Exhibit USPS-28K, Table 7, lines 2-3, 5-6. Therefore, the criticism of witness Crum's cost adjustment

[13]The adjustment is to correct for differing levels of worksharing by shape.

methodology has no merit whatsoever as an argument against the proposed surcharge.

n. Special circumstances warrant the level of the proposed surcharge despite the percentage increase it implies for some pieces.

NDMS falsely claim that the Postal Service did not consider rate shock on Standard A parcel mailers. NDMS Brief at 103. Clearly, the Postal Service did consider the effect of the rate increase.[14] USPS-T-36 at 13. Witness Moeller explained why the 10 percent guideline did not apply to pieces subject to the surcharge. Tr. 6/2842. The 10-percent figure was to apply to existing rate categories. Creation of a new classification to accomplish de-averaging often requires a greater increase. For example, Classification Reform was intended to be contribution neutral, yet some cells increased 17 percent.[15] The proposed surcharge recognizes a long-standing inequity in the rates for Standard Mail (A) and is certainly viewed by some as long overdue. As stated in the Postal Service's Initial Brief, even with the surcharge, Standard (A) parcels are still a bargain. Postal Service Initial Brief at V-173.

o. The "below cost rate problem" does not have as its only solution a surcharge which results in costs exactly equal to revenues.

Some intervenors seem to have interpreted the Commission's admonishment that "the below cost-rate problem cannot be allowed to stand for an unreasonable and

[14]Perhaps NDMS believes the Postal Service did not consider it enough.

[15]Basic automation flats increased from 23.7 to 27.7 cents.

unwarranted period of time," PRC Op., MC95-1, at ¶ 5569, to mean that revenues from parcels should equal costs, but not exceed them. *See* PSA Brief at 32. Obviously, a surcharge addresses the problem even if the result is that some parcels *actually make a contribution to institutional costs.* For that matter, the problem is addressed, though possibly not solved, by a surcharge which continues to result in revenues below costs. The fact that parcels do not cover costs puts a spotlight on the need for some sort of surcharge, but the rationale for a rate determinant is not contingent upon whether a certain grouping of mail is covering its costs. As NDMS witness Haldi acknowledges, the implementation of shape based rates in Docket No. R90-1 was not because nonletters were not covering their costs. Tr. 23/12198. It was to recognize the cost difference between the two shapes. The Commission should not be hesitant to recommend a surcharge that might go beyond asking parcels to simply cover their costs.

p. Contrary to the assertion of RIAA, *et al.,* the Postal Service has not conceded that there was an "elemental mistake" in the cost analysis supporting the surcharge.

RIAA *et al.* contend that the Postal Service concedes an "elemental mistake" in its cost analysis in that revenues are not considered. RIAA *et al.* Brief at 1. Aside from the fact that a cost study is presumably expected to study *costs*, Exhibit K of witness Crum's direct testimony which provides cost *and* revenue data. Exhibit USPS-28K, Tables 1 and 2. In addition, the Postal Service provided rebuttal testimony by witness McGrane which demonstrates that, even using RIAA, *et al.*'s criteria for a surcharge, the proposed 10-cent surcharge is warranted. Tr. 35/18957-

61. Other criticisms lodged in the RIAA, *et al.* brief were discussed at length in the Postal Service's Initial Brief. See Initial Brief of the United States Postal Service at V-163-170.

q. PSA makes an eloquent statement regarding the propriety of comparing implicit cost coverages within a subclass, and then proceeds to use implicit coverages within the subclass as an argument against the surcharge.

PSA correctly advises against comparing implicit coverages, but then cites implicit coverages regarding letters and nonletters in an argument against the surcharge. PSA Brief at 34. PSA suggests that the there is a huge disparity in the implicit coverages for letters and nonletters that warrants more attention than does the difference in implicit coverage between flats and parcels. *Id.* No citation is provided for the PSA calculation of implicit coverage for Regular nonletters, but it appears to have been miscalculated. Using witness Jellison's table, the calculation of coverage for nonletters would be 125 percent,[16] not 109.4 percent as stated in the brief. Tr. 24/12971. So, the disparity between letters and nonletters is not as great as PSA contends. In any event, though, noting the disparity between implicit coverage for letters and nonletters actually *bolsters* the argument for a surcharge. To the extent nonletters have too low of a coverage vis-à-vis letters, the residual shape surcharge would *help remedy* that situation. Tr. 6/2885. Also, regardless of relative disparity in implicit coverages between letters and nonletters, as opposed to flats and

[16](Regular Flats Revenue + Regular Parcels Revenue) ÷
[(Regular Flats Cost/Pc. x Volume) + (Regular Parcels Cost/Pc. x Volume)]
(2,481,505 + 403,812) ÷ [(.182 x 10,205,710) + (.513 x 868,434)] = 1.25

parcels, there is no reason why the rate averaging in each instance cannot be addressed simultaneously. *Id.*

r. On balance, despite the attempts at obfuscation by the intervenors, the Postal Service has presented solid, convincing evidence of shape-related cost differentials.

Despite all of the fuss raised by critics of the proposed surcharge, the most important fact remains: Parcels are substantially more costly than flats. Witness Crum's measure of the cost differential was conservative, so one could easily imagine that had there been aggressive review of the study by *proponents* of the surcharge equal to the criticism of its opponents, the record would have only widened the reported cost difference. Certainly, as with any ongoing rate issue, further study always lead to a refinement in the understanding of costs, but as Commissioner Haley stated in his dissenting opinion in Docket No. MC95-1 regarding the parcel surcharge, "the future is better faced by taking small steps in the right direction than by stopping progress for lack of perfection."

6. The Commission should not recommend miscellaneous, alternative proposals advanced by mailers.

A few members of the mailing community, including AMMA, MASA, and MOAA, favor an increase in the destination entry passthrough from the Postal Service's proposed 80 percent to 100 percent. AMMA Brief at 11-12; MOAA Brief at 22; MASA Brief at 7-8. The proposal to raise destination entry passthroughs could, however, result in inconsistencies with the Postal Service's twin objectives of avoiding larger increases for nondestination entry mail, and limiting rate increases, to the extent possible, to 10 percent. USPS-T-36 at 20; Tr. 6/2913. As discussed in the Postal Service's Initial Brief, the record contains alternative passthroughs that would address many of the intervenors' concerns, without violating other rate design objectives. *See* Postal Service Brief at V-179.

MASA also proposes that certain automation discount passthroughs be adjusted upwards so as to preserve the existing discount levels. MASA Brief at 9-10. As explained in the Postal Service's Initial Brief, however, the rate design strives to balance various, sometimes competing, objectives. Postal Service Brief at V-120-21. In the case of automation discounts, witness Moeller attempts to maintain the discounts at 80 to 90 percent of their current value, USPS-T-36 at 17-18, while recognizing the new cost information on worksharing that has served to narrow the cost differentials underlying the automation discounts. In this manner, witness Moeller best accommodates automation mailers by moving their worksharing incentives in the same direction as the costs suggest, without causing undue rate disruption and upsetting mailers' investment in automation equipment and practices. Tr. 7/3146.

On brief, Val-Pak/Carol Wright advances Dr. Haldi's bottom-up rate design. Val-Pak Brief at 15-22. For the reasons set forth in the Postal Service's Initial Brief, the Postal Service submits that this proposed change in rate design not be adopted at this time. Postal Service Brief at V-143-44. In view of the unlikelihood of the Commission's adoption of this rate design in this docket, the Postal Service directs the Commission's attention to the passage in Val-Pak/Carol Wright's Brief wherein it endorses the Postal Service's rate design as the next best alternative to Dr. Haldi's proposed rates. Val-Pak Brief at 13-14.

E. Standard Mail (B)

1. Parcel Post

None of the criticisms made by various parties in their briefs regarding the Parcel Post rates proposed in this docket detract from the solid evidence supporting those proposals and they should be recommended by the Commission. Those points which are worthy of reply are discussed below.

a. UPS's argument that dropship cost savings should not be fully passed through to Parcel Post mailers is ill founded and should be rejected.

In its Brief, UPS argues as follows: "In Docket Nos. R90-1 and R94-1, the Commission passed through 77% of estimated DBMC non-transportation avoided costs. The circumstances counseling against a 100% passthrough of the DBMC discount have not changed. In fact, although the DBMC discount was initially adopted in Docket No. R90-1, the basis for it was not re-examined in Docket No. R94-1. There is still no hard cost data on the costs actually avoided by DBMC entry." UPS Brief at 46.[1] UPS has purposely chosen to ignore both history as well as the extensive record in the present docket regarding the DBMC discount.

UPS seems to be suggesting that the fact that the DBMC avoided costs were not studied in Docket No. R94-1 is a reason to ignore the cost information provided by witness Crum in this docket. It is not clear why the passthrough is held as

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[1] The Postal Service does not necessarily accept the witness Luciani's characterization that the Commission used a passthrough of 77 percent; rather it made adjustments to the cost avoidance estimates for mail that already was bypassing postal operations.

sacrosanct; once the costs are re-examined, it would seem appropriate to re-examine the passthrough as well. While it is true that there was no basis on the record of Docket No. R94-1 to re-examine the DBMC cost avoidance and the appropriate passthrough thereof, the Postal Service has more than adequately remedied that situation in this docket with the very complete and thorough analysis of DBMC cost avoidance provided by witness Crum. Given this new cost information, a new passthrough is also appropriate, particularly in the context of an entirely new approach to Parcel Post rate design. For the reasons stated in our Initial Brief at V–205-11, the passthroughs proposed by witness Mayes are appropriate to the circumstances at hand and should be recommended by the Commission.

b. Witness Mayes properly handled revenue leakage due to rate-capping.

In its brief, UPS complains that witness Mayes's rate-capping solution to the crossover anomalies between intra-BMC and DBMC rates unfairly recovers the lost DBMC revenues from *all* Parcel Post mailers. UPS argues that "it is more equitable to recover the lost revenues from the DBMC mailers who would benefit from the capped rates ...." UPS Brief at 50. As shown in her workpapers, many rates also had to be capped to maintain the constraint that no rate increase more than 30 percent. The revenue leakage from maintaining such constraints was recovered from *all* rates. UPS does not seem to be disturbed by recovery of that revenue from all parcels. Nor does it suggest that the Inter-BMC revenue leakage must be recovered solely from other Inter-BMC pieces. This inconsistent approach to the revenue recovery issue is undoubtedly due to a bias against DBMC. Although such a bias is consistent with UPS's interest in stifling DBMC volume growth, UPS is grasping at straws; its inconsistent approaches to the issue of revenue leakage recovery should be rejected in favor of the consistent and equitable method used by witness Mayes.

c. UPS is wrong about the relevance of DBMC parcels' incurrence of mail preparation costs.

UPS argues that "There is no question that DBMC parcels incur mail preparation costs at the DBMC". UPS Brief at 40. While the Postal Service does not necessarily dispute that there may be some mail preparation costs at the DBMC, it is not a relevant issue. Witness Crum excludes all BMC costs in his analysis. Therefore, all mail preparation costs at the DBMC are already excluded from the pool of mail processing costs that DBMC avoids. Clearly, since those costs are already excluded from the costs avoided, UPS's criticism is of no moment.

d. The ASF cost calculation provided by witness McGrane should be used or else witness Luciani's criticism should be ignored.

When witness Crum originally estimated the pool of outgoing mail processing costs avoided by DBMC parcels, he included ASF costs. There was therefore no need to break out ASF costs. Witness Luciani testified that ASF costs should be excluded from the pool of avoided costs and he mis-estimated them, as shown by witness McGrane. Tr. 35/18952-57. In order to avoid release of facility-specific volume data, the finance numbers/facility names are masked in his data. Tr. 35/18964-65.

UPS now complains that witness McGrane's calculations cannot be verified. UPS Brief at 42. The Postal Service believes his calculations are reliable and ought to be used by the Commission, if it accepts witness Luciani's argument that some ASF costs should be excluded. If the Commission now accepts UPS's argument that it cannot rely on witness McGrane's work, then it should use witness Crum's original approach, since witness McGrane clearly demonstrated that witness Luciani's approach was erroneous.

e. UPS is wrong to argue that current average quantities per container are more appropriate than the assumptions underlying witness Crum's study.

UPS argues that "Mr. Crum merely *assumed* the average quantities per container" for DCSF parcels. UPS Brief at 43 (emphasis in original). UPS claims that the current averages should be used, despite the fact that witness Crum provided convincing reasons for his assumption. Tr.5/2290-91. In any event, it should be remembered that current averages are not the important point of reference. The preparation requirements governing eligibility for the discount will be formulated to reflect the assumptions underlying the cost savings estimated by witness Crum, rather than be based on current averages.

f. The Commission should maintain the existing and proposed approach to the assignation of nontransportation weight-related handling costs in Parcel Post.

It its brief at page 10, the Florida Gift Fruit Shippers Association states that "even though there are no identified weight related handling costs, it may be appropriate to recognize that size, or cube, may have an effect on costs, but the recovery must be on the curvilinear basis to produce an equitable result." The Postal Service agrees with the Florida Gift Fruit Shippers that cube-related costs should be recognized with appropriate rates. Hence, the Postal Service's proposal to reinstitute the balloon charge for parcels of large cube and low weight. See USPS T-37 at pages 13-14.

It is curious that the Florida Gift Fruit Shippers cited witness Mayes as saying that if costs are cube-related, it would be appropriate to use the curvilinear method which is used to allocate transportation costs. FGFSA Brief at 9. The point is, however, that the costs in question are weight-related, not cube-related. The 2-cent add-on is, by design and intent, assessed on the basis of weight because it is explicitly intended to recover weight-related costs. *See, e.g.,* PRC Op., R84-1, at ¶ 5517-18. Tr. 8/4220-21. FGFSA suggests that the 2-cent per-pound add-on for weight-related nontransportation costs be assessed differentially based on the amount of handling incurred. Such an effort might be commendable had FGFSA provided a more complete method by which to perform such an adjustment. Under the existing and proposed rate design methodologies, as witness Mayes described in her testimony at page 4, the 2-cent per-pound add-on is multiplied by the total weight, with the resulting dollar figure removed from the nontransportation costs. If, as suggested by FGFSA, the amount is not 2 cents for every pound, but some lower figure for heavier pieces, then as the mail mix changes, the amount of costs recovered by means of the add-on would be different. Given the existing mix of mail, it is not clear what the dollar figure removed from the nontransportation cost base would be, but it would certainly not be the amount removed by witness Mayes.

The same question plagues the proposal put forth by UPS that the per-pound add-on should not be 2 cents for all types of parcels, but should vary with the amount of mail preparation. UPS Brief at 51. Following the advice of UPS would result in disruption of the rate design that would not be associated with analysis of the underlying cost structure. Currently 2 cents per pound are assigned regardless of the amount of worksharing. As the survey of parcel mailers presented as Library Reference H-163 indicates, a significant portion of the mail is already being entered as DSCF, OBMC, DBMC or BMC presort. That means that a lot of the mail should not have been charged the 2 cents, but rather, some lower amount. Again, the Commission is left with no guidance as to the size of the pool of costs associated with the per-pound add-on that should be removed from the nontransportation costs before the remaining costs are allocated on a per-piece basis.

g. The Commission should reject the proposal by the FGFSA that the contribution per piece remain the same regardless of the amount of postal costs associated with providing service to the particular piece.

FGFSA suggests that there is "no justification for a piece of mail destined to Zone 8 having a larger contribution to institutional cost than a piece of mail destined to Zone 4." FGFSA Brief at 13. Nor, according to FGFSA, should heavier parcels pay a higher contribution per piece than lighter parcels. The question of whether contribution from disparate pieces should be the same on a per-piece basis or should be the same as a percent of the postal costs associated with providing service to the different pieces of mail is not a new one. The Commission has faced this issue in every examination of rate design. In response to FGFSA's argument that there is no justification for a piece of Parcel Post that costs more to handle by virtue of the fact that it is heavy or because it uses more postal transportation to have to pay more in contribution than pieces costing less to handle, the Postal Service asks for record evidence supporting the logic and business sense of deriving the same contribution per piece from a piece that costs 50 cents to handle and deliver as from a piece that costs $50 to handle and deliver. The Commission would be hard-pressed to find cohesive arguments in this case to support such a bizarre concept.

h. Intervenor criticisms of the testimony of witness Hatfield do not impugn its soundness.

i. FGFSA appears to fundamentally misunderstand Postal Service transportation and zones.

In its brief, FGFSA criticizes two aspects of witness Hatfield's methodology for assigning transportation costs to zones in Parcel Post. FGFSA is specifically troubled by two results of witness Hatfield's analysis: (1) intra-BMC Parcel Post unit transportation costs do not increase with zone and (2) unit transportation costs for intra-BMC Parcel Post in zones four and five are lower than the DBMC unit transportation costs. According to FGFSA these results are "nothing short of ridiculous!" FGFSA Brief at 14.

Clearly, FGFSA has failed to follow the advances that Mr. Hatfield has made in determining distance-based transportation costs for Parcel Post. Mr. Hatfield has examined the use of great-circle distance (GCD) as a proxy for actual transportation distance for each different type of transportation and for each rate category of Parcel Post. His analysis shows that, for certain segments of Parcel Post transportation, GCD is not related to actual transportation distance and should not be used as a proxy. USPS-T-16 at 4-12.

FGFSA argues that "it is not conceivable that transportation costs for Intra-BMC do not increase from Zone 1/2 to Zone 5." FGFSA Brief at 14. FGFSA provides no factual support for this argument, and it merely reflects the fact that FGFSA fails to comprehend the relationship between GCD and actual transportation distance. Witness Hatfield explained the rationale for treating intra-BMC Parcel Post transportation costs as non-distance related in his testimony, USPS-T-16 at 10-11, and in responses to both oral and written cross examination. Tr. 8/3896-97, 3908-09, 3930, 3991-95. In each of these instances, witness Hatfield has clearly explained that GCD is a poor proxy for actual transportation distance in intra-BMC Parcel Post, and therefore, does not provide a means to differentiate transportation costs by distance.

Mr. Hatfield has demonstrated how transportation costs of a zone 2 intra-BMC parcel may be greater than for a zone 5 intra-BMC parcel. Using Figure II-3, which appears on page 10 of USPS-T-16, he described exactly such a situation to FGFSA counsel during oral cross examination. Tr. 8/3993-94. Incredibly, the FGFSA initial brief ignores the fact that Mr. Hatfield has repeatedly and clearly explained his methodology regarding intra-BMC Parcel Post and that he has provided examples to illustrate and justify it.

FGFSA is also puzzled by the fact that witness Hatfield's analysis results in zone 4 and 5 intra-BMC unit transportation costs that are lower than zone 4 and 5 DBMC unit transportation costs. Its brief contends that "[t]his new methodology will hasten the decline of the most successful venture the Postal Service has used - namely - the

DBMC rate." What FGFSA has failed to recognize is that Mr. Hatfield's treatment of DBMC intermediate transportation costs as distance related is consistent with previous dockets. USPS-T-16 at 8-12. The improvements that Mr. Hatfield has proposed in his testimony actually have little impact on DBMC transportation costs.

Although the FGFSA initial brief recommends that witness Hatfield's "new methodology ... must be completely disregarded by the Commission", FGFSA Brief at 14, the only aspect of his testimony that they actually criticize is the treatment of intra-BMC intermediate transportation costs. The treatment of these costs as non-distance related results in constant intra-BMC unit transportation costs across zones and the DBMC crossover in zones 4 and 5. Mr. Hatfield has repeatedly provided evidence to support the appropriateness of his analysis of intra-BMC intermediate transportation costs. FGFSA has failed to rebut this evidence. Without any evidence to support its claims that Mr. Hatfield's analysis is inappropriate, the Commission must reject those claims.

ii. UPS demonstrates a lack of understanding of the development of DSCF local transportation costs, as well as a lack of understanding of their own witness' arguments.

In his testimony, witness Luciani argues that witness Hatfield has understated the unit transportation costs associated with DSCF Parcel Post by 12.3 percent. Tr. 26/14302. The Postal Service's initial brief discusses the fallacies in witness Luciani's analysis on this matter, and we will not revisit them here. See Postal Service Brief at V-199-201.

The UPS Brief demonstrates a lack of understanding of the development of DSCF transportation costs, as well as a misapprehension of their own witness's arguments on the subject. For instance, UPS contends that witness Hatfield's DSCF cost estimate is based on the assumption that all parcels are transported from the DSCF to the DDU. UPS Brief at 44. Exactly the opposite is true. Tr. 8/3957. Mr. Hatfield's DSCF cost estimate implicitly assumes that 12.3 percent of DSCF Parcel Post avoids the local leg of transportation. *Id.* UPS goes on to argue that "[s]ince 12.3 percent of DSCF parcels do not travel from a DSCF to a DDU, the transportation costs incurred by those DSCF parcels which do travel from the DSCF to the DDU are actually 12.3 percent higher than those estimated by Mr. Hatfield." UPS Brief at 44. Although true, this statement directly contradicts the testimony of witness Luciani.

It is true that the unit transportation cost for the subset of DSCF Parcel Post that *always* receives a local leg of transportation will be greater than the cost for the average piece of DSCF. This is because the average piece of DSCF does not incur the local leg 12.3 percent of the time. Tr. 8/3957. Since the object of developing unit transportation cost estimates for DSCF Parcel Post is to reflect the average piece of DSCF (and not some subset thereof), Mr. Hatfield's unit transportation cost estimate is correct. The arguments presented in the UPS Brief not only contradict witness Luciani, but they also support Mr. Hatfield's unit transportation cost estimate for DSCF Parcel Post.

iii. The Postal Service's treatment of intra-BMC intermediate transportation costs is correct.

UPS argues that Mr. Hatfield's development of intra-BMC intermediate transportation costs is incorrect. UPS Brief at 49. Like FGFSA, UPS is troubled by the result that unit transportation costs for zone 4 and 5 DBMC Parcel Post are higher than for zone 4 and 5 intra-BMC Parcel Post. UPS's solution to resolving this apparent anomaly is to doctor the cost data provided by Mr. Hatfield in order to achieve the rates proposed by witness Luciani's. Postal Service Brief at V-189. The Postal Service acknowledges that Mr. Hatfield's results do raise a rate design issue; however, the issue is properly handled in rate design, not by manipulating cost data. Postal Service Brief at V-188 through V-190.

iv. UPS's litany of uncertainties in Parcel Post cost avoidance estimates has been rebutted.

UPS list a number of "uncertainties" described by witness Luciani as its primary support for lowering the passthroughs on Parcel Post worksharing discounts. UPS Brief at 47. UPS fails to acknowledge, however, that these uncertainties have all been addressed.

One of the uncertainties listed by witness Luciani is "inexplicable changes from prior cases." Tr. 26/14312. Many of the changes that Mr. Luciani describes as inexplicable are, in reality, fully explicable and clearly documented in the Postal Service's case. Postal Service Brief at V-209.

A specific "uncertainty" that concerns witness Luciani is intra-SCF transportation below the DDU level. Mr. Luciani criticizes the percentage of local transportation incurred below the DDU level in Mr. Hatfield's testimony because it is not specific to Parcel Post and does not include postal owned vehicle costs. Tr. 26/14315. What

Mr. Luciani has failed to recognize is that Mr. Hatfield's method of calculating the costs of local transportation below the DDU level is a proven method. The methodology was developed by witness Acheson in Docket No. R90-1 for third-class destination entry discounts and was accepted by the Commission. Docket No. R90-1, USPS-T-12. In addition, the same method was used and accepted in Docket Nos. MC95-1 (USPS-T-9) and MC96-2 (USPS LR-PRR-7). Mr. Hatfield addressed witness Luciani's concerns in response to written cross examination. Tr. 8/3921-23, 3964.

Finally, witness Luciani argues that Mr. Hatfield has not incorporated certain flowpaths that Mr. Acheson used in his Docket No. R90-1 study of avoided transportation costs for third-class mail. Tr. 26/14316. Mr. Luciani contends that Mr. Hatfield's failure to include these flowpaths has biased his DBMC transportation cost estimates downward, and therefore, a lower passthrough is required to compensate for the overstated DBMC cost avoidance. This argument is based on a number of incorrect assumptions and is not supported by any quantitative evidence. Postal Service Brief at V-209 through V-211. In addition, Mr. Hatfield addressed this argument through his responses to written cross examination. Tr. 8/3916-18.

F. The National Newspaper Association's Arguments Do Not Require Changes to the Postal Service's Proposals for Periodicals.

The National Newspaper Association (NNA) raises three issues concerning the rate design for Periodicals. After discussing in general its concerns about the service for Periodicals, NNA renews a proposal it made in Docket No. MC95-1 that mail entered as "exceptional dispatch" mail, in order to improve service, receive the destination delivery unit (DDU) rate, even though such mail is "entered" for administrative purposes outside the destination delivery unit. NNA Brief at 23-28. NNA also endorses the Postal Service's proposal to create a 3-digit presort rate category. NNA Brief at 28-30. Finally, NNA repeats its Docket Nos. R90-1 and MC95-1 proposals to expand the high density discount to the lesser of 125 pieces or 25 percent of the route, instead of just 125 pieces. NNA Brief at 30-33.

1. The Postal Service is acting to improve service.

The Postal Service is working to improve service for Periodicals. As described by witness Degen in his rebuttal testimony, several equipment deployments are expected to improve service. First, all 812 of the model 881 Flat Sorting Machines (FSMs) will be retrofitted with an Optical Character Reader (OCR). Second, deployment of 240 FSM 1000s should be completed by July 1998. These FSM 1000s can process some larger tabloid-size flats as well as flats that are enclosed in non-certified shrinkwrap. Third, barcode readers should be added to the FSM 1000s by February 1999. Tr. 36/19355-56.

On the mail preparation front the Postal Service has reinstated the SCF sack as an optional preparation for Periodicals flats. This SCF sack will become a required sack level with the implementation of this rate case. 63 Fed. Reg. 153-56 (Jan. 5, 1998). A recently proposed rule in the Federal Register, 63 Fed. Reg. 8154 (Feb. 18, 1998), would eliminate the mailer's option to prepare mixed pallets of flat packages. This would help retain more mail on SCF pallets as opposed to ADC pallets. Tr. 36/19356-57. The MTAC/USPS group is also working on initiatives related to presort optimization. Tr. 36/19358.

2. NNA witness Speights' concerns about the destination delivery unit discount can be addressed through plant-verified drop shipment (PVDS) procedures.

With regard to exceptional dispatch, the Postal Service provides adequate opportunity for Periodicals mailers to both meet their service needs and obtain the DDU rate. Although the Postal Service may approve exceptional dispatch as a convenience to customers, exceptional dispatch is not as advantageous to the Postal Service as PVDS and additional entry. As such, exceptional dispatch does not merit the destination delivery unit discounts. For example, exceptional dispatch mail tends to be entered in the middle of the night, and thus avoids normal verification. Tr. 10/4955; tr. 27/14882. Moreover, the Postal Service seeks to meet customer service needs, including witness Speights, in order to avoid the need for exceptional dispatch.

As explained in the Postal Service's initial brief, exceptional dispatch mail does not qualify for DDU rates. Postal Service Brief at V-230-32. The publisher must meet the requirements in DMM § E250.2.0 to claim destination entry rates, which provide two options depending upon customer needs:

(a) plant verified drop shipment (PVDS) under DMM § P750; or

(b) an additional entry authorization at each post office serving a DDU under DMM § D230.

Under DMM § P750.2.0, a mailer does not need to have a detached mail unit (DMU) at their plant to qualify for PVDS. A postmaster may allow PVDS mail to be verified at the origin business mail entry unit (BMEU) when there is no DMU at the mailer's location.

To obtain additional entry, a publisher must file Form 3510 at the office of original entry and pay the additional entry fee (proposed to be reduced from $85.00 to $50.00). A postage statement must be prepared and presented with each mailing. To obtain the DDU rate, the additional entry must be at the same post office where the DDU is located. DMM § E250.3.

Witness Speights was asked about using additional entry or PVDS to enter her mail at the New Hebron post office. Tr. 27/14944. Regarding setting up additional entry, the problem faced by witness Speights appears to be the timing of the mail deposit at the New Hebron post office which is "long after the Post Office is closed." *Id.* Regarding PVDS, Ms. Speights states that "I don't have a commercial printing plant. I have no experience in plant verified drop shipping and am not familiar with the requirements. I am unaware of any mailers in my area who use this practice. It has not been suggested by my postmaster." Tr. 27/14944-45.

Witness Speights' publication would not need a commercial plant or a detached mail unit (DMU) to use PVDS. If all the other requirements are met, which would not appear to be a problem, the origin verification can take place on Wednesdays at 2:00 p.m. when she presents her mail at the Prentiss Post Office. After the postal verification is performed, she would simply transport the PVDS pieces with Form(s) 8125 to each post office at which she wishes to obtain DDU rates. It appears that witness Speights makes this weekly trip, but is not receiving the DDU rate, because she is using exceptional dispatch. Tr. 27/14896, 14944. With PVDS the only additional work would be filling out Form 8125 for each destination entry post office and verification of 41 mail pieces at the Prentiss Post Office. Tr. 27/14895. All other mailers that find themselves in a similar situation could also use PVDS to obtain these work sharing discounts.

Witness Heath (NNA-T-1) finds the PVDS rules complicated. Regarding the DDU rates, he states, "But under current DMM rules, newspaper mailers must undergo the complex procedure for Plant-Verified Drop Shipment and/or additional entry applications and procedures in order to receive these rates. Tr. 27/14758. When asked to specify the "complex procedure", a major thrust of his response relates to "postmasters do not suggest it" because "Postmasters do not seem to understand the rules, themselves, and are in a poor condition to explain them to the mailers (who are, after all, in the publishing business, not the mailing business.)." Tr. 27/14860.

PVDS has been available since 1991 and the Postal Service has made an effort to communicate the PVDS mailing requirements to the mailing community and postal employees. It is entirely possible that employees at some of the smaller offices may not be familiar with this mailing option, or assumed that this option was only available to large publishing plants, just as witness Speights assumed. Tr. 27/14944. The Postal Service is considering an informational campaign through the Mailer's Companion and Postal Bulletin to make mailers and its own employees aware of the PVDS option as an alternative to exceptional dispatch. The Postal Service believes this is a more appropriate avenue to address the needs of the affected customers.

3. The high density category should not be changed.

The Postal Service believes that the high density discount should be limited to a minimum of 125 pieces, and it has responded to NNA's concerns in its initial brief. Postal Service Brief at V-232-34. The Postal Service requests the Commission not to change the current DMCS language for the high density discount, so that the Postal Service can ensure that this discount is available only when the cost savings found in Docket No. R90-1 are clearly established. The Postal Service also believes that the 25-percent rule would be harder to administer than a simple 125-piece rule, since the 25-percent calculation would change whenever the number of addresses on a carrier route change.

VI. CRITICISMS OF THE POSTAL SERVICE'S SPECIAL SERVICES PROPOSALS ARE UNFOUNDED, AND ALTERNATIVE PROPOSALS MUST BE REJECTED.

The Postal Service presented the basis for many of its special service proposals in its initial brief. Postal Service Brief, Section VI. The less controversial special services are addressed in the testimonies of witnesses Needham (USPS-T-39) and Plunkett (USPS-T-40). The Postal Service responds to arguments raised on brief by the intervenors and the OCA below.[1/]

A. The Special Service Fee For Qualified Business Reply Mail Should Reflect The Costs Of Counting, Rating, And Billing Only.

Brooklyn Union Gas Co. argues that if Prepaid Reply Mail (PRM) is not implemented, then the Commission should recommend that the current two-cent per piece fee for BRM qualifying for BRMAS processing should apply to Qualified Business Reply Mail (QBRM). MPA argues that if the Commission does not recommend PRM, the QBRM fee should reflect prebarcoding cost savings. Both proposals should be rejected.

Brooklyn Union argues that if PRM is not implemented, then the Postal Service's cost estimate for counting, rating, and billing for Qualified BRM would be overstated, because there would be no migration of BRMAS BRM to PRM.

[1/] With respect to the annual permit fees, certified mail, Group C post office box service, insured mail, registered mail, return receipts, return receipts for merchandise, and special handling, David Popkin argues that the increases are greater than the average increase proposed in this proceeding, at a time of financial success for the Postal Service. The proposals for each of these services is justified individually in the testimonies of witnesses Needham (USPS-T-39) and Plunkett (USPS-T-40).

Brooklyn Union Brief at 16. While this is true, the only resulting change to witness Schenk's cost model would be to use the current BRMAS coverage factor (14.24 percent), instead of the adjusted coverage factor of 5.87 percent.[2] Using the current coverage factor has only a small impact on QBRM costs for counting, rating, and billing. The resulting cost is 4.94 cents, rather than 5.54 cents. The Postal Service's proposed six-cent fee is still the lowest reasonable fee to cover costs and provide some significant contribution.

The primary basis of Brooklyn Union's argument is not that the costs would justify a two-cent fee, but rather that it would be "unfair" to make BRMAS mailers pay a combined 39 cents for BRMAS (Qualified) BRM. Brooklyn Union Brief at 16. Brooklyn Union justifies the 2-cent fee in terms of the combined postage and fee total of 35 cents, stating that such a total would be "clearly exorbitant". But even if PRM is not implemented, the separate 30-cent QBRM rate might be. Thus, the combined rate and fee would be only 36 cents under the Postal Service's proposal, for an overall increase of under 6 percent, not much more than the average increase in this rate case. USPS-T-39 at 18.

Even if the QBRM postage rate is also not implemented, the BRMAS fee must be 6 cents in order to cover the costs of counting, rating, and billing. As the Commission has concluded, the BRMAS fee is designed to cover those costs. Postal Service Brief at VI-7-8. Other cost characteristics of QBRM should be

[2] This is one of the changes that MPA witness Glick made in deriving an alternative cost estimate for QBRM, but he included the change even if PRM is implemented. Tr. 27/15002, 15014.

addressed through the postage rate. The Commission does have a record basis for a reduced postage rate for Qualified BRM. USPS-T-32 at 44-47. But there is no record basis for concluding that the counting, rating, and billing costs for Qualified BRM can be covered with a 2-cent fee. The Postal Service has explained why MPA witness Glick's cost estimate does not reflect counting, rating, and billing costs only. Postal Service Initial Brief at VI-7-11. The way for the Commission to be fair to mailers like Brooklyn Union is to recommend a postage rate that is appropriate for their mail, as proposed by the Postal Service, and not to link it to other more controversial recommendations.

MPA argues that if Prepaid Reply Mail is not recommended, then the QBRM special service fee should reflect prebarcoding savings. MPA Brief at 3. Thus, prebarcoding savings would be treated the same way as delivery savings were treated by MPA witness Glick. This treatment would be contrary to the purpose of the special service fee, as explained by the Postal Service in its initial brief. Postal Service Brief at VI-7-9. Moreover, the four-cent prebarcoding cost savings would bring witness Glick's estimate of QBRM costs to a negative number (-2.72 cents), showing clearly that MPA is not interested in measuring the additional costs for counting, rating, and billing.

B. Mr. Popkin Is Mistaken About Certificate Of Mailing Service.

Mr. Popkin argues that delivery confirmation service provides the equivalent of certificate of mailing service. Popkin Brief at 17. But Postal Service witness Plunkett explained that the delivery confirmation mailing receipt is not the same as a certificate of mailing, but rather a receipt showing the amount paid, the tracking number, and the telephone number to call in order to verify delivery. The receipt, unlike a certificate of mailing, may not even include a date. Tr. 3/871. A certificate of mailing provides evidence of mailing for articles for which there otherwise would be no record of acceptance by the Postal Service, and is available for all classes of mail, unlike delivery confirmation service. USPS-T-40 at 1-2; DMCS § SS-4.020.

Mr. Popkin is also incorrect in his comparison of Form 3877 (firm mailing book) with 3817 (individual certificate of mailing). Popkin Brief at 17. According to DMM § S914.1.4, firm mailing books are permitted only when a customer requests certificates of mailing for 3 or more pieces presented at one time. Thus the fee anomaly Mr. Popkin sees is illusory.

C. The Commission Should Recommend Delivery Confirmation Service As Requested By The Postal Service.

The Postal Service addresses delivery confirmation at pages VI-13-21 of its Brief. That discussion shows that the Postal Service request for Priority Mail and Standard Mail (B) delivery confirmation service is consistent with the Postal Reorganization Act and should be recommended by the Commission. The Postal Service Brief fully addresses the arguments presented by UPS, UPS Brief at 53-55, which predictably makes proposals for delivery confirmation service consistent with its own competitive interests.

The OCA argues that delivery confirmation service as requested by the Postal Service is unduly discriminatory because it is not proposed for all classes of mail, and because it provides no fee break for household mailers who use the Internet to obtain delivery confirmation information. OCA Brief at 116-26. In the course of its argument, the OCA variously mis-cites witness Treworgy as stating there is no reason not to extend delivery confirmation to other classes of mail (OCA Brief at 118), postulates a non-existent link between certified mail and the structure of the delivery confirmation request (OCA Brief at 119), proposes -- without the benefit of supporting record evidence -- that household mailers be offered delivery confirmation at a separate fee if they access delivery confirmation information via the Internet (OCA Brief at 120-24), and asserts that the OCA's mere posing of an interrogatory beyond the scope of a witness's testimony obligates the witness to study the matter (OCA Brief at 125-26). As explained below, the OCA's argument is every bit as weak as these ludicrous assertions.

1. The Postal Service's request for delivery confirmation service is consistent with the Postal Reorganization Act.

The Postal Service proposes to offer a delivery confirmation service available to Priority and Standard (B) mailers. The testimony of witness Treworgy (USPS-T-22) presents the volume variable costs related to delivery confirmation, including 8.47 cents relating to corporate call management costs for manual delivery confirmation users. USPS-T-22, Input Sheet B-6. The testimony of witness Plunkett (USPS-T-40) proposes a new classification and associated fees for Priority Mail and Standard (B) delivery confirmation.

Witness Plunkett proposes the fee structure and fees for the new delivery confirmation service available on Priority and Standard (B) mail. He discusses Standard (B) and Priority Mail delivery confirmation, including how the need for delivery confirmation for each product was assessed. USPS-T-40 at 17-18. Surveys were used to assess customer interest for both Standard (B) and Priority Mail delivery confirmation. LR-H-163; USPS-T-33. The proposed classification and fees are consistent with the criteria set forth in the Postal Reorganization Act.

The requested delivery confirmation fees and fee structure are both fair and equitable (Criterion 1). Fairness requires the cost of delivery confirmation to be borne by those who benefit from it, which is exactly what the Postal Service has requested. All Priority mailers, for example, will benefit from delivery confirmation, even if they don't use it. Tr. 35/19036. Since Internet users also have access to the call center and the Postal Service cannot prohibit customers from using the call center, all manual customers can benefit from the call center. Another tier of fees for delivery confirmation, as the OCA proposes, would add an unnecessary level of complexity to the proposed fee structure and not be in accordance with Criterion 7.

2. The Commission should reject the OCA's arguments that the delivery confirmation request is unduly discriminatory and should either be withdrawn or not recommended.

The OCA Brief presents two reasons why it alleges the delivery confirmation proposal is unduly discriminatory. The first is that it will not be extended to First-Class, Periodicals, and Standard (A) mailers. The second is that manual delivery confirmation mailers are precluded from taking advantage of the lower cost Internet access. OCA Brief at 116.

The Postal Service has requested delivery confirmation only for Priority Mail and Standard (B). The OCA uses flawed reasoning and selective blindness regarding record evidence in its attempt to block introduction of a proposal that stands to improve service for a large and important group of Postal Service customers: Priority and Standard (B) mailers.

Witness Treworgy stated in oral cross-examination that the decision to offer delivery confirmation for Priority Mail and Standard (B) mail was an affirmative decision rather than a decision to exclude First-Class, Periodicals, and Standard (A) mail. Tr. 3/1305. "Delivery confirmation was developed in response to interest from Priority and Standard (B) mailers." Tr. 3/873. These mailers' interests are readily understood as being driven by the need to combat fraudulent claims by purchasers that an item was not delivered. Moreover, mailers expect delivery confirmation to be a standard feature of expedited services. Tr. 35/19035. Since most merchandise is shipped via Standard (B) or Priority Mail, the decision to offer delivery confirmation first for these classes is straightforward and logical.

In addition, there are sound operational reasons for the Postal Service to restrict availability of delivery confirmation service to Priority and Standard (B) mailers. Tr. 3/872-874. In rolling out delivery confirmation, the Postal Service is effectively adding to the duties of its entire carrier force by requiring that they become proficient in identifying and scanning delivery confirmation pieces at the time of attempted and actual delivery. Because of the sheer number of carriers involved, there is an immediate problem of scope. Specifically, the issue is how to make all delivery personnel sufficiently proficient in performing this task, so that performance will be at or near 100 percent. Accordingly, it makes sense to limit the service to Priority and Standard (B) packages, because parcels are larger and therefore easier to identify, and because they are far fewer in number than First-Class and Standard (A) items.

The proposed delivery confirmation infrastructure, moreover, also might be an inefficient method of providing delivery information for classes of mail that are predominantly letters. Since First-Class and Standard (A) mail is processed primarily on automated processing equipment, these pieces are "scanned" electronically at numerous points in the mailstream whether by advanced facer/cancelers, optical character readers, or bar code sorters. With the continued growth in delivery point sequencing volume, more and more of this volume receives an electronic scan just prior to delivery by the carrier. If customer interest or operational requirements lead to the offering of delivery confirmation information in all classes of mail, it may prove more efficient to leverage this existing technology base than to add an additional scan by the delivering employee. The Postal Service has not ruled out eventually offering a similar service for First-Class and Standard (A) customers; rather the Postal Service has deemed it prudent first to offer delivery confirmation where there is demonstrated need and comparatively limited volume.

The significant cost implications of expanding delivery confirmation to First-Class Mail, discussed in witness Plunkett's response to an interrogatory from Douglas F. Carlson (Tr. 3/873-874), further validate the requested delivery confirmation fee structure.

The second form of undue discrimination argued by the OCA is that household and small business mailers are not given the option to pay a lower delivery confirmation fee when monitoring delivery status via the Internet and are instead forced to pay a higher fee based on costs for call center usage. There is no undue discrimination in grouping call center and Internet users together.

Witness Treworgy states several reasons why the Postal Service has decided not to offer a two-tiered manual delivery confirmation service. Operational difficulties could impact costs, such as a clerk's increased time to explain more complex options, and the increased cost of stocking two sets of labels at each retail window. Tr. 3/1260. In addition, he states that customer satisfaction could decrease as a result of the two-tiered offering, since the likelihood of a customer buying a product which does not meet her needs would be increased. *Id.*

The OCA proposes that a version of delivery confirmation be offered that permits retrieval of confirmations only via the Internet. OCA Brief at 120-24. However, the "savings" of 8.47 cents from a customer avoiding call center costs might be fully offset by the additional costs at the retail window for increased explanation time.[3] Witness Treworgy's explanations relating to operational problems and decreased customer service are significant enough to outweigh the benefits of offering a further tier of manual delivery confirmation.

The OCA also asserts that since personal computer ownership and Internet usage are increasing, customers will be more likely to use the Internet to monitor

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[3] 8.47 cents does not equate to much window service time.

the status of their delivery confirmation items. OCA Brief at 123. Even if true, who is to say that customers are more likely to use the Internet to monitor delivery status than to use a toll-free number? No record evidence indicates how much any customer will use the Internet to access delivery confirmation information. We do know, however, that customers want the option to use a toll-free number to monitor delivery status. Tr. 35/19035. In general, telephones are more readily accessible and easier to use. Even a frequent Internet user may find it more convenient to simply dial a toll-free number than to face Internet service provider busy signals, access protocols, Internet congestion, and the like.

In addition to the operational and cost reasons why the Postal Service should not offer two levels of manual delivery confirmation service, the issue of enforcing proper usage of the two levels should be considered. No means of preventing an Internet customer from calling the call center exists.[4/]

The OCA further argues that the delivery confirmation fee structure forces customers who could use the Internet to pay a needlessly high fee. OCA Brief at 123. The actual difference in costs of call center versus Internet access is a mere 8.47 cents, an insufficient amount to warrant grappling with the potential operational and customer service related issues that would arise from a two-tiered manual delivery confirmation fee structure. As the Postal Service gains experience with how customers actually access delivery confirmation information, it can re-estimate

[4/] Had the OCA put its proposal for a new delivery confirmation tier in testimony rather than its brief, this likely would have come to light sooner.

access costs in future proceedings, and pass along any savings in the single tier. The implicit assumption that all customers use the call center is reasonable given that call center usage cannot be restricted.

The Postal Service is committed to offering a delivery confirmation service to Standard (B) and Priority mailers. Through the testimonies of witnesses Treworgy, Sharkey, and Plunkett, and the rebuttal testimonies of witnesses Rios and Lewis, the Postal Service has requested delivery confirmation in a form that is both fair and equitable. From a customer viewpoint, PSA supports the delivery confirmation request, PSA Brief at 5, 9, noting that 73 percent of PSA members would use delivery confirmation. Tr. 24/12950. No customer demand from First-Class, Standard (A) and Periodicals mailers has been presented on the record or in briefs in this proceeding.

The Postal Service has shown that the proposal for delivery confirmation is not discriminatory. Delivery confirmation is a new service requested by the Postal Service to meet the needs of expedited and package mailers, and the new service is accordingly limited to Standard (B) and Priority Mail. Tr. 3/1238. The OCA's arguments regarding undue discrimination amount to no more than the ludicrous claim that the Postal Service may not discriminate among the service attributes of respective classes of mail. Delivery confirmation should have only two levels of service, electronic and manual, based on mailer preparation. Customers willing to undergo the additional costs of electronic manifesting -- regardless of how large or small they are -- pay less, in keeping with the diminished workload experienced by the Postal Service. This structure should not be made overly complicated by introducing a third service level, the demand and use of which can not be quantified, and for which the cost differential is insignificant. The Commission should accordingly recommend delivery confirmation service at the fees and with the fee structure requested by the Postal Service.

D. The OCA's Request That The Commission Require Distribution Of Pamphlets To Inform Parcel Customers About Insurance Is Unsupported In The Record, Unnecessary, And Intrusive.

On brief, the OCA for the first time argues that the Commission should withhold any fee increase for insurance until the Postal Service distributes an insurance information pamphlet during every parcel transaction. To address the OCA's concerns, this pamphlet would need to inform prospective customers that the Postal Service does not insure the delivery of parcels unless the customer purchases insurance for an additional fee. Moreover, the pamphlet would discuss the limitations on insurance coverage that are now included in the DMM. OCA Brief at 221-22, 228-29. The OCA's proposal must be rejected.

1. The OCA has not provided statutory authority or a record basis for their proposal.

The OCA does not discuss under what statutory authority the Commission would require the Postal Service to hand out certain information to customers as a prerequisite to a fee increase. The OCA does not argue that the Postal Service's proposal to increase insurance fees is unjustified. Rather, they appear to be asserting that the entire insurance classification is unfair and inequitable, absent the

Postal Service's handing out of a pamphlet.[5/] The OCA has not explained how the Commission would require this action, nor proposed any DMCS language to implement it. In fact, the OCA did not file any testimony in support of its proposal. The Commission has no basis upon which to act, except to reject the OCA's position.

The OCA proposal is completely unsupported by market research, cost data, or sound judgment. The OCA has not provided any record evidence on the costs of providing an information pamphlet for every parcel transaction, or the need for the required offering of additional information to every parcel customer. Do customers already receive adequate information from the insurance form and the clerk at the window? Is there a customer interest in obtaining more written information at each transaction? Is there substantial customer dissatisfaction with the current approach of the Postal Service? To what extent do customers believe that their parcels are automatically insured when they mail them? Until these questions are addressed with specific information, rather than OCA hypotheses, there is no basis for requiring the distribution of more information.

[5/] This issue, if appropriate at all, should have been raised long ago, and certainly not for the first time on brief with respect to the fee increase proposed in this proceeding. The insurance classification and the conditions under which parcels are insured is not new. Insurance was recently addressed in a more limited proceeding in Docket No. MC96-3, but the OCA did not raise their concerns at that time.

2. A requirement that the Postal Service distribute insurance pamphlets at every parcel transaction would intrude upon management prerogatives.

The OCA's proposal that the Commission withhold a recommendation of higher insurance fees, in order to force the Postal Service to change the information it provides customers during each insurance transaction, would be an unwarranted intrusion on the Postal Service's management discretion. The OCA's suggestions transcend the scope of ratemaking proceedings. As the OCA acknowledges, the D.C. Circuit Court of Appeals recently reaffirmed that the Commission's ratemaking function is limited, and should not be exercised in a way that intrudes on the management of the Postal Service's operations.

> [The Commission] may not, however, under the statute's ratemaking structure, forge ahead with a recommendation that surpasses its ratemaking function and unduly intrudes on management.

Mail Order Ass'n v. United States Postal Serv., 2 F.3d 408, 424 (D.C. Cir. 1993), *amended, reh'g denied*, 1993 U.S. App. LEXIS 24994 (D.C. Cir. Sept 22, 1993). Marketing and sales practices for insurance service are clearly outside the scope of ratemaking practice; rather, these matters are within the Board's and postal management's purview. The Postal Service is quite capable of assessing its customers' needs and expectations, and devising solutions to address the concerns that the OCA raises on brief.[6]

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[6] The Postal Service could, for example, elect to give its insurance customers greater notice of insurance provisions by printing information about the terms and conditions of insurance service directly on the insurance label that customers (continued...)

In proposing its scheme, OCA attempts to deal with its potential costs with a blithe dismissal. OCA Brief at 227. In fact, the OCA proposal would require the Postal Service to print tens of millions of brochures annually, distribute those brochures to tens of thousands of retail outlets (and also to thousands of rural carriers, who also accept parcels). Once distributed, providing the brochures to customers would add time to every parcel transaction, not only for distribution of the pamphlet, but to answer questions that distribution of written matter would inevitably generate, regardless of whether insurance is actually purchased.[7/] Nowhere does the OCA consider that many parcel customers may consider themselves adequately informed, and are likely to view the creation and distribution of pamphlets as a needless intrusion and waste of paper.

In fact these are all costs that must be balanced against the alleged benefits of the OCA's proposal. Though the OCA implies that the Postal Service has been duplicitous in withholding information from consumers, the fact is that the Postal Service's existing information sources represent management's attempt to balance the costs and benefits of providing information regarding its products. Included in

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[6/] (...continued)
complete when purchasing insurance. The Postal Service is currently reviewing its special service labels, and is considering design changes that would allow more information to be included.

[7/] This kind of transaction leads to an interesting costing issue. When no insurance is purchased, should insurance users be compelled to cover these "information costs" that they did not cause to be incurred? Or should parcel customers who did not want and did not choose insurance be compelled to cover the cost of affirming that they did not want insurance? In either event, customers would be burdened with costs they did not cause.

this equation is the potential loss or gain of future business from customers who will either seek other providers or continue to use Postal Service products depending on whether they are satisfied.

3. The Postal Service already provides adequate customer information, and protects its customers fairly.

The OCA claims that "the Postal Service has no incentive to disclose" insurance information to consumers. OCA Brief at 221. The OCA seems oblivious to the fact that the Postal Service has a relatively small share of the parcel market, or that customers are already provided with information regarding the limits of insurance coverage. The Postal Service already disseminates many consumer information brochures annually, with detailed information on the limits of insurance coverage. Tr. 3/885; LR-H-273. Moreover, as OCA indicates, OCA Brief at 222, a summary disclaimer describing limits on insurance coverage appears on the reverse of every insurance receipt.[8/]

The OCA argues that insurance customers need more protection, and focuses on the difficulties of litigation for customers, and the lack of protection by government consumer protection agencies. OCA Brief at 223. However, the OCA has not shown that the Postal Service's claims system has been unfair to its customers. In FY 1997 only 408 appeals were taken from the decisions of the

[8/] It should be noted that the insurance form in LR-H-273, referred to by OCA, has been superseded by a 1991 edition which specifically informs customers that insurance coverage is limited to the depreciated value of the article. Both versions of the insurance form also provide information on how to properly document and file claims.

Postal Service's insurance claims system. Of those appeals that have been decided, over half of the claims were paid. Tr. 3/886. The OCA moreover does not base its proposal on any actual data concerning customer dissatisfaction with the current system.

Furthermore, there are competitive alternatives to the Postal Service with respect to insured parcels. The Postal Service needs to keep its customers satisfied or they will be lost to competitors.[9] Thus, there is no need for Commission action to make the Postal Service provide additional information to customers.

4. David B. Popkin's concerns are readily dismissed.

David Popkin opposes the Postal Service's insurance proposal because insurance fees exceed the registered mail fees for high value items. Insurance has only recently been made available for high value items, as a result of Docket No. MC96-3. The Postal Service's proposed fees are based on its best estimate of costs for high value items, and may be adjusted as more information from actual experience becomes available. USPS-T-40, at 7, WP-2, WP-15. Comparison with registered mail fees also reflects the much lower indemnity costs for registered mail resulting from the extra security the Postal Service provides for such mail. Tr. 3/1032-33.

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[9] In this regard, customers who want their parcels to be automatically insured can choose competitors like UPS and FedEx.

Mr. Popkin also claims that insured mail receives less security than other accountable mail, reducing the value of service. Popkin Brief at 16-17. Insured articles may not be signed out to carriers, but witness Plunkett explains that the carrier is still accountable for the article, and is expected to obtain a signed receipt acknowledging delivery to the customer, and to return those receipts to the accountables clerk. Tr. 3/981-82.

E. The Commission Should Recommend The Post Office Box Fees Requested By The Postal Service, Which Are Based On The Existing Fee Groups, Rather Than The Fees And New Fee Groups Proposed By The OCA.

The Commission is faced with two record-based alternatives for post office box fees and fee groups. The Postal Service has requested new fees for the existing groups that will facilitate a future transition to more cost-homogeneous fee groups, by spreading the fees better without further increasing fee differences between Groups C and D. The Postal Service has also indicated how the future transition will be based directly on respective facility costs -- including interpolated values for postal-owned facilities and perhaps with an overlay based on capacity utilization -- and has proposed moving a few high-cost/low-fee offices to the next highest fee group and a few low-cost/high-fee offices to the next lowest group now, as a means of facilitating that transition.[10]

[10] The plans set forth in witness Kaneer's testimony respond directly to the Commission's Docket No. MC96-3 recommendation that "the Postal Service . . . explore alternative post office box groupings in the future." PRC Op., MC96-3, at 63.

The OCA's alternative proposal attempts to respond to some of the same goals relied upon by the Postal Service, including a better alignment of costs and fees, greater cost homogeneity within each group, and the minimization of fee shock. However, that proposal, because it relies upon CAG as a proxy for facility cost, really does not improve upon the present fee groups but would inhibit and complicate any transition to fee groups based more directly upon costs. Accordingly, the Commission should not recommend the OCA's proposal, and should instead recommend the fees requested by the Postal Service.

1. CAG is an inadequate proxy for costs.

The OCA bases its proposal to regroup post office box fees by CAG on the claimed basis that this approach "more accurately reflect[s] post office box costs". OCA Brief at 17. Yet the OCA relies only upon group averages derived from highly variate data to support its position.

For example, OCA states that "It is well documented on this and previous records that average postal rental costs vary by CAG". OCA Brief at 135. While this much is true, OCA's assertion that grouping post office box fees by CAG more accurately reflects post office box costs unfortunately is not.

It is true that *average* postal rental costs vary generally with the CAG-based groups proposed by OCA.[11] Average rental costs of the existing fee groups share this same attribute. Averages alone, however, cannot elucidate whether the CAG-

[11] Even with averages, the relationship is not completely as expected, however. For non-city delivery offices, the middle CAG group has a higher average than the highest CAG group. Tr. 23/12294.

based groups are also cost homogeneous. One must compare the variation *within* the proposed groups with the variation *between* those same groups. The latter should be larger, and the ratio of the latter to the former should be increased by any new fee group definitions that increase cost homogeneity. Otherwise, no change is warranted.

This can be analyzed by charting the complete distribution of rental costs across each of the OCA's proposed fee groups, as witness Kaneer has done in his Chart A (Tr. 32/16956). That chart leads to one clear-cut conclusion: the CAG groups are in no way cost homogeneous, since the variation within groups is fully co-extensive with the between group variation.

The OCA admits that there is "some variation", OCA Brief at 137, but somehow fails to appreciate that the overlap is 100 percent. There is, of course, overlap between the fee groups now in use. This is a necessary part of almost any averaging scheme, as OCA acknowledges. *Id.*[12/] However, whatever the overlap in the existing groups, it cannot be worse than the OCA's proposal for fee groups that overlap completely. These are clearly not the "rent-homogeneous" groups that witness Callow purports to seek. Tr. 23/12293-95.

While Postal Service consultants may have found in 1988 a "significant" relationship between CAG designation and rental costs, LR-F-183, in this

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[12/] While overlap in respective fee group cost ranges can be expected of any grouping based on averages, overlap is not a necessary part of fee groups based on rental costs themselves; this latter approach is the one described in witness Kaneer's rebuttal testimony.

proceeding witness Kaneer has presented the first analysis that goes beyond looking at average costs by CAG. Kaneer's new analysis shows that CAG is not a valid proxy for costs, because each CAG includes facilities with a wide range of costs. OCA-LR-2 at 15; *see* Tr. 32/16975-79.

The OCA argues that deaveraging of post office box fee groups is necessary because averaging rental costs by delivery group "masks important differences in cost by office size, as measured by CAG." OCA Brief at 135, 139. This is a circular argument that ignores the Postal Service demonstration that deaveraging by CAG does not align fees with costs in any meaningful sense. The CAG-based fee groups proposed by OCA witness Callow each include a large number of facilities from both the top and bottom cost deciles, Tr. 32/16956, and they exhibit large coefficients of variation. Tr. 23/12390-93. Callow's fee groups do not constitute a significant improvement over existing fee groups C and D since both sets of fee groups exhibit similar coefficients of variation.[13/]

CAG designation, moreover, does not pertain directly to all facilities offering post office box service, but rather applies to the revenue for a particular office, which can include a wide variety of stations and branches. Despite an office's high CAG designation, many of its stations and branches may have neither high revenue nor high cost. For example, Manhattan consists of a single CAG A office, but has a

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[13/] Tr. 23/12390-91. Moreover, Callow shows that the difference in average costs between city and non-city offices ($1.73, Tr. 23/12288) is in the same order of magnitude as the differences between his proposed groups. The biggest difference is between C-I and C-II, $2.19, while the smallest difference is only $0.06. Tr. 23/12294.

large number of stations and branches of varying costs. Tr. 3/1066. In fact, witness Kaneer has identified one Manhattan station that has such low costs that the Postal Service believes it should be moved to a lower fee group. Tr. 32/16987 (Exhibit USPS-RT-19C, page 3, line 1).

2. The OCA's re-allocation of All Other costs is unwarranted and inappropriate.

The OCA argues only weakly for what remains of witness Callow's proposal to allocate a portion of All Other post office box service costs by CAG, claiming that the OCA's proposed methodology is "reasonable. OCA Brief at 140-43. OCA no longer argues for treating some All Other costs as mailhandler costs to be allocated primarily to higher CAG offices. The OCA therefore asks only to allocate postmaster costs so that more are assigned to lower CAG offices, and supervisor costs so that more are assigned to higher CAG offices.[14] But OCA has not presented any defect in the Postal Service's assumption that All Other costs are distributed evenly to each box. Until the assumption of equal costs per box is shown to be unreasonable, it makes no sense to complicate the analysis by trying to assign costs for each function.

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[14] Witness Kaneer described the defects in this treatment of postmaster and supervisor costs in his rebuttal testimony. Tr. 32/16963-95.

3. Regrouping offices based on CAG as an interim change would be inefficient and confusing to customers.

The OCA agrees with the Postal Service that delivery group should not be eliminated from the fee structure yet. OCA Brief at 145. Therefore, the issue is whether an additional criterion, CAG, should be added to the fee structure.

The OCA argues that the Postal Service's plans to redesign the post office box fee structure should not be used to postpone some regrouping of offices. OCA Brief at 127. This argument appears to be based on the OCA's determination that "data to carry out the Postal Service's grouping are unlikely to exist for many years." *Id.* at 127-28. Such a determination has no record basis. Instead, the record suggests that much of the needed data already exist, and that the data to prepare a cost-based fee structure can be completed without a long delay.[15] Witness Kaneer's rebuttal testimony explains that automation is making the development and compilation of cost data easier, and that the Postal Service is already working with existing data. Tr. 32/16967. In response to questioning from Commissioner LeBlanc concerning the development of the necessary cost data, witness Kaneer stated that:

> the data exists and it shouldn't be a difficult problem to arrive at a cost in order to make those determinations for a movement from one group to the other.

[15] The large majority of postal facilities are leased, not owned (*see, e.g.*, LR-H-216 at 1 (24,860 facilities are leased)), so the need to develop cost data for the owned facilities should not cause substantial delay. Tr. 32/17038.

Tr. 32/17040. Thus, any perceived need to deaverage fees based on CAG designations would be short-lived. Adoption of the OCA's proposed fee groups would accordingly require an extensive effort to educate customers as to the erstwhile basis for the changes, only to require the Postal Service to retract or rebut those same positions when more comprehensive fee group redefinitions are implemented. This inefficient and disjointed approach would most certainly confuse customers.

a. Adding CAG as a factor onto the existing fee structure would be overly complex.

The OCA recognizes that "the benefits of deaveraging should not outweigh administrative and other costs, such as consumer information-gathering costs." OCA Brief at 139. Given the need to move to a cost-based system, use of CAG would create too much administrative cost.

In Docket No. MC96-3, the Commission concluded that the Postal Service had "presented plausible difficulties in implementing" fee groups based on CAG level. PRC Op., MC96-3, at 63. These difficulties include the fact that CAG is based on revenue, rather than cost. CAG can change with relative frequency, potentially requiring fee group moves. *See* Docket No. MC96-3, Reply Brief of the United States Postal Service at 56.

Like the Postal Service's proposal, the OCA's proposal continues to use delivery group as a basic determinant of fee group assignment. Determining an office's fee group has become complicated, as shown by the detailed DMM regulations describing the rules for such a determination. DMM § D910.5.1.

However, under the OCA's proposal the Postal Service would in addition have the burdensome task of explaining to facilities how to add one more factor in determining their fee group assignment. This factor, moreover, would raise questions from both customers and postal employees about why the Postal Service is introducing an additional revenue-based factor that has little direct relationship to costs for post office box service.

b. The OCA's proposal would move many fee relationships in the wrong direction compared to the Postal Service proposed fees.

As explained in the Postal Service Brief, at VI-30-31, the OCA's proposed fee changes would complicate efforts to implement the Postal Service's planned cost-based fee structure. As witness Kaneer's Exhibit A, page 2 (Tr. 32/16976), shows, there are a large number of facilities that would be treated incorrectly. Thus, nearly 20 percent of CAG A-D facilities have rental costs in the bottom decile of all facilities, but would receive a 40 or 100 percent fee increase under the OCA's proposal, much higher than the Postal Service's proposed increases.[16/] Over 10 percent of CAG H-L facilities have costs in the top two deciles of all facilities, but would receive no increase or a 25 percent increase under the OCA's proposal. The Postal Service would need to counteract such fee increases when it introduces a truly cost-based proposal.

[16/] Since CAGs A through D include over 5 million boxes, the unwarranted increases for the lowest cost 20 percent of CAG A through D facilities would be expected to apply to about 1 million boxes. Tr. 23/12309-10.

Kaneer's Exhibit B (Tr. 32/16981-83), moreover, shows examples of facilities that would be moved in the wrong direction if CAG were used for fee assignment purposes. Low cost facilities in Hazleton, Pennsylvania, Hales Corners, Wisconsin, and Kalispell, Montana, for example, would have their fees pushed up by the OCA proposal simply because they have a high CAG designation.[17/]

While the OCA claims that its proposal includes the appropriate degree of deaveraging, now is not, in fact, the time to introduce six new fee groups to replace Groups C and D. In making the transition to a cost-based fee structure, dealing with the large gap between Group C and D fees will be enough of a challenge without also having to apply a variety of fee changes to each of six new fee groups.

c. Changing fees based on CAG, when each CAG includes both high cost and low cost facilities, is not fair and equitable.

The OCA argues that its proposal creates a more fair and equitable fee schedule. OCA Brief at 127. To the contrary, the Postal Service has shown that each of the OCA fee groups will contain the whole range of costs. Thus, witness Callow's proposal will treat facilities with similar cost differently, and facilities with different costs the same. The proposal therefore is not fair and equitable. The current fee schedule may have shortcomings, but the addition of a new factor would further obscure the goal of aligning fee groups directly with costs, thus raising

[17/] The examples in Exhibit USPS-RT-19B (Tr. 32/16981-83) were culled from the 80 facilities identified in Exhibit USPS-RT-19C (Tr. 32/16985-87), which excluded facilities unless they had high cost and high box utilization, or low cost and low box utilization. Thus, many more similar examples of inconsistency between CAG designation and rental costs likely exist.

fairness and equity concerns. At this point, customers are settled in the current system, but they would rightly be concerned about the poor justification for adding CAG as a factor determining their particular fees. The Postal Service expects that it would not be able to explain to its customers' (or its employees') satisfaction why fee changes should depend upon a revenue-based CAG designation.

4. The Postal Service alternative is better, especially if small improvements are made to take advantage of the discretion resulting from Docket No. MC96-3.

The Postal Service has explained the benefits of witness Needham's proposal, which maintains the current fee structure while spreading the fees so they will better represent the entire range of costs. Postal Service Brief at VI-25. It will be simpler to make the transition to new fee groups if the fees have already been established at the appropriate intervals.

Witness Kaneer explains how further progress can be made in moving toward a cost-based fee structure. The Postal Service has identified 80 facilities which are most in need of reassignment to a higher or lower fee group. Tr. 32/16970-72. Reassigning these facilities up or down one fee group now will avoid the need for large fee changes later. Since the Postal Service believes post office box fees should not be changed too frequently, the Postal Service hopes to change the fee group assignment for these facilities at the same time fees are already expected to change for rate case implementation. The Postal Service therefore has notified the Commission and participants of its plans, specified the small revenue impact, and explained why it has the discretion to implement changes in fee group assignments. *See* Postal Service Brief at VI-32-37.

The OCA challenges the fairness and equity of this limited regrouping because "[p]ost office box customers in leased facilities not on the list, but who otherwise meet the 'facility respecification' criteria, will not be regrouped and thus will not face changes in box fees." OCA Brief at 129. The OCA provides no cite for its claim, and in fact the Postal Service is not aware of any record evidence indicating that leased facilities meeting the facility respecification criteria are not on the list. The OCA also points out that the regrouping does not include any postal-owned facilities. *Id.* This may be so, but the regrouping is not unduly discriminatory because the Postal Service is treating all postal facilities which can be identified as high or low cost the same. Given the ongoing development of costs for postal-owned facilities, any gap between postal owned and leased facilities will likely cease to be an issue when more comprehensive fee regrouping is accomplished. The Postal Service has limited the regrouping to the most extreme cases, at most 80 facilities out of over 30,000. Reassigning these extreme cases up or down one fee group is justified and fair.

5. The Postal Service has and should have the discretion to reassign offices or facilities among the fee groups, as long as there is a substantial basis for doing so.

The OCA claims that the Postal Service must receive a Commission recommendation before moving any facilities between fee groups. OCA Brief at 129-33. The Postal Service disagrees because the regrouping presented by witness

Kaneer would not change any language in the DMCS, and would be, in fact, consistent with the development over several cases of the current DMCS language. In particular, the Postal Service is using rental cost, which is consistent with the way that Groups A, B, and C have traditionally been divided: "very high cost", "high cost", and other.[18] Moreover, in Docket No. MC96-3 the Commission removed from the DMCS the type of carrier delivery as the distinguishing characteristic between Groups C and D. While the Postal Service has so far maintained that distinction in the DMM, the Postal Service certainly has the discretion to move offices between these two groups without regard to the type of carrier delivery.[19]

The OCA suggests that the Commission can stop the Postal Service's plans to make the fee structure more cost-based by "simply incorporating the relevant fee group definitions from the Domestic Mail Manual into the DMCS." OCA Brief at 132. However, the DMM rules for determining which fee group applies to which office are very detailed and complex, involving matters such as the "geographic delivery ZIP Code boundaries" of a post office, and "out-of-bounds delivery receptacles". DMM § D910.5.1.

Inclusion in the DMCS of the complex DMM rules for determining whether offices are in Groups C or D would be contrary to the Commission's definitional approach to the scope and extent of the DMCS. In Docket No. MC76-5, the

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[18] *See* Postal Service Brief at VI-35-36.

[19] Movement of offices between fee groups C and D, however, is difficult because of the large fee difference between the two groups. *See* Tr. 32/16970-71.

Commission rejected the recommendation of the Commission's Officer of the Commission (now the OCA) that the DMCS should be a detailed, tariff-like classification schedule. *See* PRC Op., MC95-1, at VI-6. The Commission also addressed the addition of complex and lengthy additions to the DMCS in Docket No. MC93-2, concerning the definition of prebarcoded mail:

> The apparent desire of NAPM to incorporate many pages of detailed DMM regulations into the DMCS [footnote omitted] is not consistent with the classification principles established in MC76-5. It was this sort of wholesale incorporation of Postal Service regulations into the DMCS that was rejected by MC76-5.

PRC Op., MC93-2, at 38. The DMM rules for deciding fee assignments simply are not appropriate for the DMCS.

Any lesser changes to the DMCS concerning the post office box and caller service fee groups would not be based on any record evidence, would suffer from a lack of input from intervenors and the Postal Service, and might be inconsistent with prior Commission decisions. For example, limiting Groups A through C to offices offering carrier service would reverse the Commission's decision to eliminate such language in Docket No. MC96-3. Limiting Group A to Manhattan would eliminate the Postal Service's discretion to move other very high cost facilities -- such as ones identified in Exhibit USPS-RT-19C, including San Francisco and Santa Monica, California -- into Group A, or to move low cost Manhattan facilities out of Group A. Limiting Groups A or B to their current locations also would be inconsistent with the "high cost" language used in Docket Nos. R90-1 and R94-1. *See* Postal Service Brief at VI-35-36.

The OCA argues that the Postal Service cannot move a few facilities between fee groups A through D without first proposing the changes to the Commission. OCA Brief at 130. They apparently are concerned because "people using boxes in those facilities being regrouped would be affected substantially." *Id.* But regrouping that affects the fees box customers pay is inevitable under any DMCS language. Thus, without Commission involvement, offices have been regrouped under both the current and pre-MC96-3 DMCS language because of a change in the type of carrier delivery there, or a conversion between carrier delivery and non-delivery. Tr. 19C/9259-60. Under the OCA's proposal, offices might be regrouped annually when they are assigned a new CAG designation. *See* Tr. 19B/9262-68; Tr. 23/12361, 12402.

The facilities witness Kaneer identifies for regrouping were selected primarily because of very high or very low costs relative to the average costs in the Group to which the office is currently assigned. Thus, the changes would reflect the cost of post office box service, which directly underlies the fees established in the DMCS. When offices are regrouped because of the type of carrier delivery or CAG designation, on the other hand, the reason for the regrouping is not directly related to the costs of post office box service. The limited regrouping described by witness Kaneer thus should raise even less concern than regroupings related to type of carrier delivery or CAG designation.

All three types of changes do not change any DMCS language, and should not be of concern to the Commission. The limited regrouping described by witness

Kaneer involves between $46,000 and $396,000 of revenue.[20] Tr. 32/16970-71. It is not even clear what the Postal Service would include in its Request should a Commission filing have been contemplated, given the absence of a need for DMCS fee or classification changes. The Postal Service also wonders whether it is a good use of the Commission's resources to review changes for just a few locations.

a. The Postal Service is cognizant of the need to administer the flexibility provided by the DMCS carefully.

The Postal Service recognizes that the fee groups are not specifically defined in the DMCS. This reflects the need for considerable discretion on the part of the Postal Service in determining what post office box fees should apply to each of the tens of thousand of postal facilities. Absent any indication that the Postal Service is abusing this discretion, the Commission should not change the DMCS language.[21] The Postal Service recognizes that the Commission has provided a broad amount of

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[20] As witness Kaneer points out, such a limited revenue increase would be more than offset by the recent offering of boxes at no charge for customers who are not eligible for carrier delivery because of the quarter-mile rule. Tr. 32/16972. The quarter-mile change was completed expeditiously without prior Commission review. While the OCA endorsed this effort, OCA Brief at 145-47, the OCA's standard for Commission review would suggest that the Postal Service first should have presented the quarter-mile rule change to the Commission, since quarter-mile customers "would be affected substantially." In fact, the change might have an impact on the fees for other customers, because the lost post office box service revenue may need to be made up through those fees. Nonetheless, the better approach was to avoid the delay of a Commission proceeding, and permit the Postal Service to make the quarter-mile change unilaterally, just as the Postal Service should be able to implement the limited regrouping discussed by witness Kaneer. *See* Letter from Chairman Gleiman to Board of Governors Chairman Sam Winters, distributed by the Commission via a Notice to Participants dated April 2, 1998.

[21] *See* the discussion of appropriate limits on flexibility in fee group assignments, Postal Service Brief at VI-36-37.

discretion for post office box service, and intends to act responsibly in exercising that discretion so as not to lose it, or turn the Commission away from providing such discretion in other areas where it may be warranted. In this regard, the Commission should note the Postal Service's actions with respect to the quarter-mile rule, and its providing notice through witness Kaneer's rebuttal testimony of its current limited plans to regroup some facilities.

b. The OCA's reliance on case law is misguided.

The OCA cites cases that do not support its position. OCA Brief at 130-33. In *Associated Third Class Mail Users v. U.S. Postal Service*, the Court held that "the Postal Service cannot increase its fees for these [special] services" without prior Commission involvement.[22] The Postal Service accepts that it cannot increase the fees for post office box service without a Commission recommended decision. But that restriction does not preclude Postal Service action that, while not changing any fee in the DMCS, does have the effect of increasing the fee for a particular customer, especially when that customer can still obtain box service at the lower fee by using box service at another location.

Combined Communications v. U.S. Postal Service involved a DMM change that the court found "effectively overruled" a provision of the DMCS.[23] No such change is contemplated with respect to the limited regrouping for post office box fee

[22] 405 F.Supp. 1109, 1118 (D.D.C. 1975), *affirmed*, 569 F.2d 570 (D.C.Cir. 1976), *vacated on other grounds*, 434 U.S. 884 (1977).

[23] *Combined Communications v. U.S. Postal Service*, 891 F.2d 1221, 1229 (6th Cir. 1989).

groups. In fact, by moving higher cost facilities into higher fee groups, and lower cost facilities into lower fee groups, the regrouping would tend to make the group assignments more consistent with the DMCS.

National Retired Teachers Ass'n v. U.S. Postal Service upheld a Postal Service DMM change that denied the third-class nonprofit rate to certain matter mailed by nonprofit organizations, thereby requiring such organizations to pay higher rates. That decision also noted that the Postal Reorganization Act "requires that USPS request a recommended decision from the PRC only 'on changes in the mail classification schedule.'"[24] The limited regrouping presented by witness Kaneer would not change anything in the Domestic Mail Classification Schedule.

6. The Postal Service's proposal for moderate fee increases for Group C boxes is justified.

Intervenors Douglas Carlson and David Popkin attack the Postal Service's proposal to increase Group C box service fees by 10.6 to 12.5 percent.[25] As explained in the Postal Service's Initial Brief, at VI-27, Group C must pay its share to raise the post office box and caller service cost coverage above 100 percent. Mr. Carlson does not challenge the proposed cost coverage of 115 percent. Carlson Brief at 2. Mr. Carlson claims that " . . . the only way in which additional costs could be 'reasonably assignable' to boxes would be upon a showing of a high value of

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[24] *National Retired Teachers Ass'n v. U.S. Postal Service*, 593 F.2d 1360, 1363-64 (D.C. Cir. 1979).

[25] Carlson Brief at 2-5; Popkin Brief at 12.

service . . . ." Carlson Brief at 4. But given the low proposed cost coverage for box service, including Group C fees, no showing of high value of service is required.

In any case, Postal Service witness Needham has presented expert testimony concerning the high value of box service. She has explained that the high value of post office box service is not dependent on a particular quality of service, because in most cases customers are choosing to pay for box service instead of, or in addition to, free carrier delivery. Tr. 32/17092-93. That choice itself indicates a high value of service. Moreover, Mr. Carlson himself has also provided evidence of the high value of service he obtains through box service. Tr. 24/12835.

In trying to use anecdotes about box service problems in Berkeley to justify a nationwide reduction in the Group C fee increase, Mr. Carlson claims the Postal Service has failed to show that Berkeley is not representative of other facilities. Carlson Brief at 3, 4. But the box delivery cutoff time in Berkeley is 11:00 a.m., while a "common" cut-off time is 8:30 to 9:00 a.m. Tr. 19A/8653. Mr. Carlson also admits that at other facilities at which he has obtained box service, mail was delivered into the boxes by 9:30 a.m. Tr. 24/12812. Finally, with regard to Berkeley's 11:00 a.m. cutoff time, witness Needham explained that it may be possible to move that time up if sorting of the box mail can be done at Oakland, so the mail can be deposited directly into the boxes at Berkeley upon arrival there. Tr. 32/17086.

Mr. Carlson claims that Group C is "under siege." Carlson Brief at 2. Group C, far from being under siege, has not had a fee increase for over three years. The implicit cost coverage for Group C boxes alone, while higher than those for other Groups, is nonetheless well below the proposed systemwide coverage. *See* Tr. 3/572; Tr. 32/17073. The OCA proposal, which is justified by the OCA as more fair and equitable than the Postal Service's, proposes a 40 percent increase for much of Group C, including Mr. Carlson's box in Berkeley.[26] The Postal Service moreover has presented a plan which would lead to lower fees at lower cost facilities, including many now charging Group C fees. Witness Kaneer has already identified 34 facilities which currently pay Group C fees but clearly need to be moved down. Tr. 32/16966-68, 16987. The Commission should recommend the Postal Service's proposal, included its Group C fees, as a significant step in improving the fee design for post office box and caller service.

F. The Postal Service's Proposed Return Receipt Fees Are Justified Despite Intervenor Criticisms Of The Quality Of Service.

As explained in its initial brief, the proposed fee increases for return receipt service are justified in order to restore the Docket No. R94-1 cost coverage for the service, and increase this coverage moderately to reflect the high value of this service. Postal Service Brief at VI-39-42. Intervenor criticisms of the quality of return receipt service do not support a rejection of the Postal Service's proposal.

1. The high value of return receipt supports the Postal Service's proposed fee increase.

Douglas F. Carlson opposes the Postal Service's request for an increase in the fees for return receipt service, suggesting that the Postal Service has not

[26] Tr. 24/12846; OCA Brief at 127; Tr. 23/12401.

demonstrated its high value. Carlson Brief at 10. However, just last April the Commission concluded that return receipt service has a high value. PRC Op., MC96-3, at 111.[27] In Docket No. MC97-5, moreover, the Commission concluded that a coverage below the systemwide average would be inconsistent with the high value of the recommended packaging service. PRC Op., Docket No. MC97-5, at 49. These views alone provide sufficient support for the Postal Service's request for a higher cost coverage for return receipt service.

Mr. Carlson also argues that Docket No. MC96-3 established that return receipt service does not deserve a higher cost coverage, despite its high value of service. Carlson Brief at 9. Carlson focuses on the Commission's decision in that docket not to increase the cost coverage for return receipt service. That decision, however, resulted from the limited nature of Docket No. MC96-3, which concerned a Request dealing with only selected products. The Commission did not use value of service to re-evaluate cost coverages in that proceeding, because the values of service could not be compared for all Postal Service products. Cost coverages for all classes and special services are at issue in this proceeding, so a cost coverage reflecting return receipt's high value of service, in comparison to other products, can be recommended.

Intervenors Carlson and Popkin try to diminish the value of return receipt service by alleging problems with the quality of service. However, what value as

[27] That proceeding increased the value of return receipt service by providing address change information for all return receipts. USPS-T-40 at 13.

used in the statute means is "the economic concept of 'value of service,' an approach which looks to demand factors, 'what the traffic will bear.'"[28/] The demand evidence for return receipt service strongly supports a high value of service, and higher fees. Tr. 32/17117-19, 17129.

2. Intervenors Carlson and Popkin are wrong to claim that demand evidence does not show a high value for return receipt service.

Intervenors Carlson and Popkin argue that the consistent volume growth for return receipt service reflects the lack of reasonable alternatives, rather than high value.[29/] They believe that UPS's three-day service with signature confirmation is too expensive and inconvenient, and that Express Mail is too expensive, and does not provide a signed delivery confirmation that could be used in legal proceedings. Carlson Brief at 7-8; Popkin Brief at 5. Their belief in the absence of alternatives suggests the unlikely possibility that the Postal Service could fail to provide any service half the time, and yet still increase return receipt volume.

Carlson and Popkin's limited view of alternatives ignores the wide variety of return receipt customers. Different groups of customers will perceive different alternatives. Some will view UPS as an alternative, especially when they are

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[28/] *Association of Am. Pub. Inc. v. Governors of U.S. Postal Service*, 485 F.2d 768 (D.C. Cir. 1973), *citing Payne v. Washington Metropolitan Area Transit Com'n.,* 415 F.2d 901, 916 (D.C. Cir. 1968). The Commission showed in its recent packaging service decision that a service can have an "intrinsic" high value of service without regard to the quality of service. PRC Op., MC97-5, at 49.

[29/] Carlson Brief at 8-9, Popkin Brief at 5. By complaining about the convenience and cost of the alternatives to return receipt service, Mr. Popkin and Mr. Carlson provide additional support for the high value of return receipt service. Carlson Brief at 7-8, Popkin Brief at 5.

sending a piece that weighs more than one ounce.[30] Some will consider Express Mail as an alternative, especially if they recognize that expedited delivery might serve similar goals as return receipt service. Tr. 32/17118. Intervenors Carlson and Popkin both suggest a cheaper alternative: stamped, self-addressed post cards which recipients are requested to sign, date, and return.[31] Delivery confirmation also is proposed as an alternative for Priority Mail and Standard Mail (B). Some customers will simply stop using return receipt service if they are disappointed in the results of such use. Tr. 32/17157-59.

Mr. Carlson has suggested that return receipt volume is growing simply because customers need the service. Carlson Brief at 8. However, as technology improves, electronic communication, such as electronic filing of tax returns, may actually be decreasing the need for return receipt service. Tr. 32/17151-52.

3. Intervenors Carlson's and Popkin's concerns about the quality of return receipt service are being addressed by the Postal Service, or are misplaced.

Intervenors Carlson and Popkin allege that they have revealed serious deficiencies in return receipt service. Carlson Brief at 5; Popkin Brief at 6. As

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[30] The UPS price of $5.65 presented by witness Plunkett applies to up to 1-pound articles. *See* UPS web site, www.ups.com/using/software/998rates/rate-text/3ds.txt.

[31] Carlson Brief at 6; Popkin Brief at 5-6. Mr. Carlson claims that the fact that return receipt customers are willing to pay more for return receipt service than for such cards is because they want more than acknowledgement of delivery. Carlson Brief at 6. Instead, the use of return receipts most likely reflects the belief that a return receipt is much more likely to be returned at all than an enclosed card. For example, the IRS has a procedure for returning return receipt cards, Tr. 32/17170-71, but probably would not return a taxpayer's enclosed card.

discussed in its initial brief, the Postal Service has made organizational changes which are directed toward improving the quality of its special services, including return receipt service. Postal Service Brief at VI-41, n.41. Providing fees with only a minimal cost coverage may actually discourage such service improvements, however, since attention might be diverted to products with higher contributions.

The focus of intervenor attention has been on the delivery practices at IRS service centers, and other large organizations.[32] It should not be forgotten that, in general, return receipts are signed for at the time of delivery. However, obtaining signatures on each return receipt before delivery is not always practical when many return receipts are delivered at one time. Perhaps employees could be added, as

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[32] The Postal Service vehemently denies Mr. Carlson and Mr. Popkin's charges of deception and dishonesty in providing information about its field practices for return receipt service. Carlson Brief at 9-10; Popkin Brief at 2. Believe it or not, the Postal Service is represented by an honest and decent team in this proceeding. With respect to return receipt practices in the field, the best information available to this team has been provided by the Postal Service in Docket No. MC96-3 and this proceeding.

Initially, Mr. Carlson only asked general interrogatories to witness Plunkett (Tr. 3/866-68), rather than specifying situations about which he was aware in an attempt to get the best information into the record. Witness Plunkett answered to the best of his knowledge at the time, given the general nature of the interrogatories. He was not answering in hopes of concealing a problem. *See* Tr. 32/17122, n.5.

Mr. Carlson claims his cross-examination exhibits of correspondence with the Postal Service forced revelation of return receipt problems. Carlson Brief at 10. In fact, Mr. Plunkett made additional field inquiries after receiving tardy interrogatories from Mr. Carlson, which did not mention his correspondence, and to which the Postal Service was not required to respond. Tr. 32/17163; Presiding Officer's Ruling No. R97-1/89, at 2-4. When witness Plunkett learned of inconsistent information from the field, he clarified the record in rebuttal testimony, despite the lack of an obligation to do so.

Mr. Carlson suggests, Tr. 32/17171-73, but staffing increases for return receipt processing would tend to raise return receipt fees even more substantially.[33]

The Postal Service believes that its practices for delivery of return receipt mail to large organizations is efficient, and meets customer needs in most instances. Tr. 32/17124-25. The Postal Service continues to serve as an independent third party in such cases, by requiring the signature of a manifest, and maintaining a record of delivery. The IRS should indicate a correct date on the return receipt, given its signing of the manifest and its procedures for separating return receipts by date of delivery.[34]

As Mr. Popkin points out, the Postal Service has proposed a rule change that would conform its DMM regulations to existing practices at IRS service centers. 63 Fed. Reg. 12874 (March 16, 1998). This change would not reduce the level of service for return receipts, as Mr. Popkin claims. Popkin Brief at 2. The Postal

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[33] Mr. Popkin misrepresents the Postal Service's return receipt costs, claiming that the cost study does not reflect the Postal Service's more efficient practices for obtaining return receipts. Popkin Brief at 2. In response to an interrogatory from Mr. Popkin, witness Plunkett explained that the cost study underlying the Postal Service's fee proposal is likely to have included, in its sampling, return receipt deliveries to large organizations. Tr. 3/922. Despite Mr. Popkin's assertions to the contrary, moreover, the Postal Service incurs costs for processing return receipts at IRS service centers, including the cost of preparation and verification of manifests, obtaining a signed manifest, and, in some cases, waiting for the individual return receipts to be completed. *See* Popkin Brief at 3; Tr. 32/17122.

[34] Tr. 32/17170-71. Mr. Popkin's implication that the IRS would intentionally place an incorrect date on a return receipt because it is in an adversarial relationship with taxpayers concerning the date of receipt is dubious, especially when the IRS signs a manifest acknowledging receipt on a certain date, and the date of postmark, rather than delivery, is the key date for IRS purposes. *See* Popkin Brief at 4; Tr. 32/17123, n.7.

Service rather is proposing to conform a regulation with the efficient practices already in place. The revised rule is limited to "organizations such as the IRS, which receive large numbers of return receipts", and requires the preparation and signature of a manifest. This proposed rule change is open for public comment.

Mr. Popkin argues that the proposed rule is inconsistent with DMCS provisions for return receipt service. Nothing in DMCS §§ 945.11 and 945.23, or Fee Schedule 945, is inconsistent with the proposed rule, since the current practices at IRS service centers provide an efficient method to get the signature and date of delivery on the return receipt card. In fact, this proposed rule is comparable to POM 822.2, which permits use of a signature stamp for government officials, and large companies or organizations. Tr. 3/919. Both provide procedures which enable the Postal Service to provide return receipt service so that recipients will cooperate with completing cards for return to return receipt customers. Absent such cooperation, the Postal Service would not be able to provide the service at all. Tr. 32/17173.

4. Mr. Popkin's other suggestions are misguided.

Mr. Popkin misunderstands the Postal Service's plans for "signature confirmation", claiming that the fee for such a service would be the same as the delivery confirmation fees. Popkin Brief at 7. Signature confirmation is another name for return receipt service when offered in conjunction with delivery confirmation service. The proposed return receipt service fee of $1.45 would apply.

Mr. Popkin proposes, without having filed testimony in support, that the combined fees for certified mail and return receipt service be lowered from $2.45 to

$1.70, the Postal Service's proposed fee for return receipt for merchandise service. This proposal ignores the different costs for return receipt for merchandise, and certified mail/return receipt services, as presented by the Postal Service.[35] In particular, return receipt for merchandise costs are lower because that service generally is limited to Priority Mail and Standard Mail (B) parcels, which often require carrier contact with the recipient absent any special service. Moreover, the two types of return receipt services are not identical. Tr. 3/907-08.

G. The Proposed Special Handling Fees Are Needed To Cover The Best Available Estimate Of Special Handling Costs.

The OCA argues that the Commission should reject the Postal Service's proposed special handling fees, and "keep the fees as they are now." OCA Brief at 176. This argument ignores the requirement that fees cover costs, and must be rejected.

The OCA argues that special handling data is too thin, like Library Rate. OCA Brief at 175. There may be a limited number of tallies, but there is no evidence of erratic cost behavior since 1991. Tr. 31/16434. Instead, there has been a steady upward trend in costs, which is consistent with the fee increases, and the resulting increase in the proportion of special handling use by honeybees and day-old poultry. Postal Service Brief at VI-44. This lack of erratic behavior provides

[35] Tr. 3/909; LR-H-107 at 40-42; Exhibit USPS-15J at 23, as revised August 22, 1997.

adequate confidence in these numbers.[36] Moreover, the Commission faces a situation in which costs have not been covered since 1990. Tr. 31/16434. This circumstance needs to be corrected. Also, unlike postal cards (Postal Service Brief at V-73-75), there is no evidence that special handling costs or volumes have been misestimated because of misidentified tallies. To the contrary, special handling parcels containing honeybees or day-old poultry should be distinctive enough to avoid any risk of misidentification.

OCA relies on the Supreme Court's decision in NAGCP that "when causal analysis is limited by insufficient data, the statute envisions that the Rate Commission will 'press for better data' rather than 'construct an attribution' based on unsupported inferences of causation." OCA Brief at 174-75. That holding does not apply because no issues have been raised concerning whether the tallies for special handling have been caused by special handling service. No inferences of causation are necessary.

OCA claims Postal Service has a monopoly on shipments of live animals. But there are no statutory restrictions on competition. Perhaps there will be alternative providers at or below the higher fees proposed by the Postal Service. Moreover, as pointed out in the Postal Service's Initial Brief, at VI-45-46, Priority

[36] While the coefficient of variation for FY 1996 may be large, Tr. 31/16459, the FY 1996 unit cost is the same as the FY 1995 cost. The coefficient of variation over this two-year period might be more meaningful.

Mail currently provides an alternative to special handling service, for some purposes.[37]

Unlike Classroom Publications, there is no reasonable classification with which to merge special handling for purposes of ratemaking. Ratemaking for small classifications may be difficult, but the Commission should not abdicate its responsibilities by simply extending an existing fee.

OCA claims the Postal Service proposal is unconscionable. OCA Brief at 176. But all the Postal Service is proposing is to cover a reasonable estimate of costs. There is no evidence that costs are less than the current fees. Thus, OCA is suggesting that other ratepayers subsidize this service. The OCA proposal should be rejected.

H. Attacks On The Postal Service's Stamped Card Fee Proposal Ignore Previous Commission Determinations.

Mr. Carlson and Mr. Popkin oppose the Postal Service's stamped card special service fee proposal. Carlson Brief at 2. Their opposition is based on a belief that the fee would discourage use of what they assert is a less costly product. As explained in its initial brief, the record lacks adequate information to conclude that stamped cards are less costly than private cards. Postal Service Brief at V-72-75. In any case, the Postal Service's proposal is intended to fill the shell

[37] While the Postal Service stated in its initial brief, at VI-45, that "the DMM allows bees to be shipped without special handling if they are sent Priority Mail," DMM § C022.3.7 also states that only queen honeybees may be shipped by aircraft. This apparently makes Priority Mail unavailable for worker bees, and thus removes this alternative to special handling.

classification recommended by the Commission, in order to recover the manufacturing costs for stamped cards in a separate classification. Postal Service Brief at VI-46-48.

Mr. Popkin once again raises his concern that a stamped card fee would violate Section 1721 of Title 18. The Presiding Officer explained the errors in Mr. Popkin's analysis in Presiding Officer's Ruling No. R97-1/31, which denied Mr. Popkin's motion to dismiss the Postal Service's request for a stamped card fee. Mr. Popkin is simply repeating arguments on brief that were dismissed by the Presiding Officer earlier in the proceeding.

I. Mr. Popkin's Criticisms Of The Postal Service's Stamped Envelope Proposal Should Be Dismissed.

Mr. Popkin argues that the Postal Service's clarification of its stamped envelope proposal during this proceeding cannot be considered by the Commission. Popkin Brief at 13. The Presiding Officer has already accepted the Postal Service's clarification in Presiding Officer's Ruling No. R97-1/65.

Mr. Popkin also proposes, without having filed testimony in support, that the fee for buying 50 plain stamped envelopes should be one-tenth of the price for buying 500 envelopes. Popkin Brief at 13. This proposal ignores the higher selling (window service) costs for purchases of envelopes in less than a box of 500. LR-H-107, at 48. The 50-packs of printed stamped envelopes that Mr. Popkin uses for comparison purposes avoid window service costs because they are ordered directly from the Philatelic Service Fulfillment Center.

Once again, Mr. Popkin challenges the shipping and handling charge used by the Philatelic Fulfillment Service Center. Popkin Brief at 14. The Commission determined that this charge was a permissible philatelic charge, even when applied to the purchase of personalized stamped envelopes, in Docket No. C95-1.

CONCLUSION

For the reasons stated above, and in the Postal Service's Initial Brief, the rates for postal services, fees for special services, and the modifications to 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 the rates and fees and changes in the domestic mail classification schedule requested by the Postal Service in this Docket.

Respectfully submitted,

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Attachment A

Analysis of ANM Attachment A

General Issues

ANM seems to have a problem with sites that said they had no mailings sent at commercial rates with nonprofit indicia in FY96. Why is this so unbelievable? Even Haldi's Exhibit 1 show that there were mailers with no problems. Are there so many nonprofit mailers ignorant of the rules for nonprofit mailings that they would be everywhere?

Mailers have strong incentives to prepare their mailings correctly (monetarily, so they do not have to pay regular rates, which are almost double nonprofit rates, as well as to receive timely service). Therefore, one would expect *a priori* that the rule, rather than the exception, would be for nonprofit mailings to be prepared correctly, with the proper contents and properly endorsed.

In several places ANM implies that increased numbers of disqualifications naturally follow from increased scrutiny of nonprofit mail contents. The "logic" applied by ANM here is that their hypothesis proves itself.

In analyzing the log entries, ANM never looked at the "disposition of mailing" column. Witness Schenk explained the importance of the information on mailing disposition (37/19973, lines 8-13). Had ANM looked at that information, they would have discovered that most of the mailings they identified as being disqualified and mailed at regular rates were actually mailings that had been disqualified and *returned to the mailer* (and therefore never sent through at regular rates; returned to mailer is code "C" in that column). Witness Schenk addressed the distinction between mailings disqualified and sent through, and mailings returned to the mailer (37/19977, lines 4-15). The other disposition code ignored in ANM's Attachment A analysis was code "A," which indicates that the problem was corrected. Witness Schenk discussed this at 37/19974, lines 10-17.

ANM's logic in interpreting entries is faulty. On p. 3, for example, ANM states that the "fourteenth entry on page 0000138 uses Reason Code for Disqual. 11 in a case were [sic] there is 'advertisement in N.P.' This means [code] 11 is used to indicate a disqualification for nonprofit rates." This logic is used throughout Attachment A, but there is one major problem with this logic. If all code "11" entries were nonprofit mailings, then that would have been the description for this code on the form. Instead, a general description is used, with the obvious implication that the code is used for multiple purposes. Given that the code is used for multiple purposes, the clerk had to put an explanatory note for some of the entries for potential problems with nonprofit mailings, to clarify that this was the problem to focus on in subsequent discussions with the mailer. Obviously, codes 6, 8, and 11 especially are used for multiple purposes, and when the use of any of these codes relates to nonprofit mailings, an explanation to that effect is written in the notes section. Under ANM's reasoning, at least 3 of the 11 codes used for explanation of the potential problem with the mailing would be used exclusively used to report nonprofit content problems. Do nonprofit mailers have that much difficulty preparing the mailings that they need three different codes to cover content-related problems?

The other general insight not made by ANM is that they did not recall that there was a rate change in 1995, and so entries noted as "wrong rates" indicate that the mailer was still using the old rates.

Specific Misunderstandings demonstrated by ANM in its Attachment A

Site 1:
The mailing of 29,555 pieces noted from the attachment on page 9 was the result of a revenue investigation, and as stated in witness Schenk's testimony (USPS-RT-22, 13-14) this would have been accounted for in AIC 119, so there was no discrepancies between volume and cost data for this mailing.

ANM's confusion about the class entered for mailings in AP11 is quite amusing. The "backward 2" cited is clearly an "S," as in 'S'tandard mail (AP11, as ANM should be aware of, is when reclass occurred, and the name of "Third-Class" changed to "Standard (A)").

Entry Cited (line, page*)	Explanation
6, 0000007	Bad logic (see above explanation); returned to mailer
6, 0000012	Second-class mailing
1, 0000013	No claim was made that the stars denoted mailings included in the estimates of witness Schenk
5,0000015	Bad logic (see above explanation); returned to mailer
6,0000021	Bad logic (see above explanation); problem corrected (disposition code A)
7,0000023	Bad logic (see above explanation); problem corrected

*Unless otherwise noted, all page references are to ANM-XE-2a-b

Site 2:
As explained by witness Schenk (37/19980, 11-25) all problem mailings at this site in FY96 were either returned to the mailer or given a one-time exception.

Site 4:

The first two sentences of the first paragraph of ANM's analysis of site 4's log entries do not even refer to Site 4 – they are information for Site 3, and clearly indicate why we did not use that site in our estimates.

The fact that clerks wrote "$" or "$$" as an explanation refers to the fact that there are insufficient funds in the account to pay for the mailing, and does not in any stretch of the imagination refer to mailings that did not qualify for nonprofit rates.

Entry Cited (line, page)	Explanation
5,0000036	Included in estimates
1,0000039	Released (at nonprofit rates)
7,0000039	Endorsed correctly
1,0000042	Released (at nonprofit rates)
6,0000042	Released (at nonprofit rates)
8,0000048	Only problem is return address, was corrected (disposition code A)
11,0000058	Was consultation for a future mailing, as noted in last three columns of entry
9,0000061	Entry states was "not eligible for BC rates" (i.e., ineligible for barcode rates, not ruled ineligible for nonprofit rates)
5,000077	Bulk rate indicia, regular rates paid , so no problem
12,0000107	Barcode, presort errors
13,0000117	Returned to mailer
5,0000121	Returned to mailer
11,0000124	Piece count error; old rates (see explanation above)
12,0000124	Old rates
1 (also 10, 11),0000127	Old rates
12 (and 14),0000127	Old rates
3,0000129	Problem corrected (disposition code A)
9,0000131	Included in estimate
2,0000132	Bulk rate indicia, regular rates paid , so no problem
14,0000138	Included in estimates
6,0000138	Problem corrected
7,0000139	Included in estimates
4 (and 5), 0000139	Presort errors
9,0000140	Presort errors
10,0000141	Bulk rate indicia, regular rates paid , so no problem
5,0000161	"Claimed letter rates for flats"
14,0000161	Code 6 – needs help @ counter
5,0000172	Problem corrected
3,0000174	Returned to mailer

13,0000175	Included in estimates
5,0000178	Included in estimates
4,0000202	Released (at nonprofit rates)
3,0000213	Bulk rate indicia, regular rates paid , so no problem
13,0000236	Problem corrected
15,0000236	Returned to mailer
3,0000262	Problem corrected
13,0000265	Problem corrected

ANM's last paragraph for this site (p. 5) amusingly implies a conspiracy theory: "It is odd that every month or so someone with a good identifiable hand writing does one page of entries, exactly one page, no more, no less, then the other person or persons return." ANM's implication that somehow data were falsified is not credible.

Site 5:
On page 0000058, the reasons why "this is not really a problem" are explained. The contact further explains that, while there "were some problems in 96" (0000060), they were resolved (citation). ANM incorrectly states (p. 5) that "Dr. Schenk resolved uncertainty;" as stated on page 0000310 (ANM-XE-2a), this is what the contact reported. The information provided is not discredited by the contact's statement that nonprofit cannot be mailed at regular rates under a pending application – the contact stated that it was not allowed *at this site* (a local decision).

Site 6:
The fact that the respondent was probed for further information after her initial responses was discussed by witness Schenk (37/19961, 22-25; 19962, 5-9). The logs for this site show that disqualified mailings are returned to the mailer, so in fact the respondent overestimated the volumes in FY96 sent at regular rates with nonprofit indicia.

Site 7:
The information provided for the most recent AP was *not* used, but rather the information provided for FY96 (37/19982, 3-11).

Site 8:
Logs were produced (ANM-XE-2b, 0000389-0000401). The estimates for this site were based on the information provided by the respondent (ANM-XE-1, 0000122-123), so actually the estimate of volumes mailed at regular rates with nonprofit indicia for this site is higher than what they actually experiences, as demonstrated by the logs.

Site 10:
"While 65% of mailers re-endorse mail only 20% of mail is re-endorsed" supports, not undermines, the assertion that this affects small mailers (to illustrate: if 50 percent of all smokers quit smoking yesterday, but sales of cigarettes fell only 25 percent, then, ceteris paribus, it must have been the lighter smokers that quit).

It should be noted however that the estimates developed by witness Schenk *assumed that none of the volumes reported by the respondent were reendorsed* (so that the estimate would be overly conservative.

Site 11:
Contacts at each site were those aware of activity in FY96, the base year for the rate case. Given personnel assignment changes, the person contacted may not *know current volumes, but would nevertheless be aware of FY96 volumes.* What are purse swags?

Site 12:
Just because they saw problems does not mean that mail went through at regular rates with nonprofit indicia (see explanation above). It was not assumed that "small" equated to "less than 500 pieces," but rather the respondent indicated that "small" meant less than 500 pieces when the questioner further probed.

Site 16:
The data from the most recent AP was *not* used to develop estimates for this site, as implied by ANM on page 7, because estimates from FY96 were given by the respondent. The volume estimates on page 0000220 account for only 8 of 10 disqualified mailings because, as stated by the respondent on page 0000219, two of the mailers fixed their mailing, so were sent at nonprofit rates. According to the respondent, code 12 means problems with presort preparation.

Site 17:
According to the respondent, the "2-3 rare occurrence(s)" were all endorsed "bulk rate" (ANM-XE-2b, 0000236), and therefore the mail was sent at regular rates with the proper indicia, and so were (properly) not included in the estimates. Obviously, the customer did not need to correct endorsements that were already correct.

Site 18:
It does not necessarily follow, as claimed by ANM, that "the practice of contacting customers to discuss problems" should "produce at least some regular rate std (A) mail by nonprofits." Acceptance units will also (sometimes at the mailer's request) send the disqualified mail back to the customer, so it can be reworked. Since the regular rate is almost twice as high as the nonprofit rate,

this is often a cheaper option for nonprofit mailers, especially ones that rely on volunteers to prepare their mailings (and so the cost of reworking the mail is less). In this case, ANM portrays the information received from the site incorrectly – the volumes were not unknown.

Site 19:
"N/A" means "not applicable," which is the proper notation when the respondent indicated that they had no problems with regular rate mailings with nonprofit indicia.

Site 20:
"N/A" means "not applicable," which is the proper notation when the respondent indicated that they had no problems with regular rate mailings with nonprofit indicia.

Site 21:
Question 1 and Q4A are different questions, and so the respondent did not contradict themselves with their answers. The comment cited by ANM: "...probably more content rejections at the beginning of 1996, then leveled off" demonstrates that sites rejected mailings, rather than disqualifying them for nonprofit rates.

Site 22:
Some advertisements are ok in nonprofit mail as well, as ANM should be well aware of. Respondent said that they "don't have this problem" (p. 0000296).

Entry Cited (line, page)	Explanation
3,0000564	Entry states "no money" which means insufficient funds in account
1,0000566	Not a nonprofit mailer
2,0000566	Not a nonprofit mailer
4,0000567	No documentation; released (at original rates)
4,0000569	No documentation; problem corrected
1,0000570	Problem corrected
1,0000572	Problem corrected
1,0000574	Insufficient funds; problem corrected
3,0000574	Problem corrected

Of the entries on page 0000573, 3 had insufficient funds, one had not paid bulk rate fee (annual fee for mailing bulk transactions), and 3 had no code given but the disposition code indicated that the problem was fixed.

Site 23:
The fact that acceptance personnel helps mailers prepare their mail indicates that there would be no problem with that mailing; if they came in at regular rates, it would be with regular rate indicia. On page 0000318, the respondent does state that "...2 customers have NP status but mail reg. Rate because too much advertising..." as ANM claims, but that same page shows that the respondent went on to say that the mail is "never endorsed NP though."

Site 25:
Estimates were made *because* there were no logs available. This goes to the Postal Services contention that these data are not available on a national basis, and so a survey of this type was needed.

Site 27:
In the statement "...rejected because of volume..." the use of the word "volume" was obviously a "typo." ANM does not specify why the logs are illegible.

Entry Cited (line, page)	Explanation
12,0000580	Returned to mailer
2,0000581	Returned to mailer
15,0000583	SCF rates problem
15,0000584	Returned to mailer
17,0000585	Insufficient funds (in account)
19 (and 20), 0000585	?
6(and 7,8),0000586	?
8(and 9), 0000582	Bulk Fee is the accounting fee paid to mail at bulk rates; not content related, and would not lead to disqualification of nonprofit mailing
1 (and 6),0000589	Returned to mailer
1,0000591	Returned to mailer
7,0000598	Returned to mailer
8 (and9),0000608	No code 10's used on page 0000608
3,0000599	First-Class mailing
4,0000600	Not nonprofit mailer
5,0000601	Presort verification problem
3 (and 10), 0000604	Not nonprofit mailers
4,0000607	Presort verification problem
2,0000608	Returned to mailer
6,0000609	Returned to mailer
Bottom, 0000609	Returned to mailer
2, 0000670	? (don't know the disposition)
3, 0000670	? (don't know the disposition)
5, 0000670	Insufficient funds
10, 0000670	Returned to mailer
4, 0000672	Automation incompatible
10,0000672	Returned to mailer (mail not prepared under new (post-reclass) rules)
5,0000673	Code 3 – insufficient funds
Last (and 10), 0000674	Mail prepared under old rules; returned to mailer
6, 0000676	Code 1 – labels wrong; returned to mailer
2, 0000678	Code 7 – piece count error
10, 0000678	Code 4 – fees not paid
9, 0000620	Returned to mailer

The reasoning used for the rest of the entries cited by ANM for Site 27 has been shown to be deficient above.

Site 28:
The logs for this site do not help shed light on the magnitude of mailings sent at regular rates with nonprofit indicia, because the information on the disposition of the mailing is not noted for many of the entries.

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.

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April 10, 1998