

ORIGINAL

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

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MAILING ONLINE SERVICE

Docket No. MC98-1

RESPONSE OF UNITED STATES POSTAL SERVICE
TO NOTICE OF INQUIRY NO. 1
(NOI NO. 1, ISSUES 1-6)

The United States Postal Service hereby provides its responses to the Commission's Notice of Inquiry No. 1, Issues 1-6, filed on October 16, 1998.


Each issue is paraphrased briefly and is followed by the response. Witness declarations are attached to respective responses as appropriate.

Respectfully submitted,

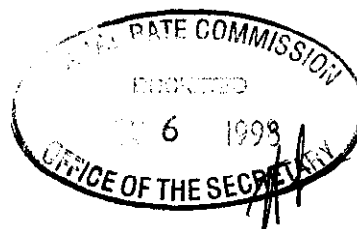
UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking


Kenneth N. Hollies

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-3083; Fax -5402
November 6, 1998



**RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO NOTICE OF INQUIRY NO. 1, ISSUE 1**

Issue 1: The Commission inquires regarding the effect on competitors of waiving the eligibility requirements for automation basic rates.

A major reason for proposing exceptions to the eligibility requirements is to simplify the Mailing Online transaction in the face of conflicting requirements. The Postal Service has determined to charge a firm fixed price at the time the transaction is confirmed, and then merge customer documents into larger batches prior to printing. The decision to use a single rate from the middle of the potential range of existing categories is a strategic one to provide customers a convenient and simple means of inducting mail into the postal system.

The alternatives have significant shortcomings. For instance, the Postal Service could simply offer a discount commensurate with a customer's volume and depth of sort. This alternative would preclude extension of the benefits of automation to small-volume customers. If postage discounts for Mailing Online customers were dependent on the size of the mailing, Mailing Online would merely extend further benefits of automation to large volume customers. In such a case, the choice of digital printing, with its flat rate pricing, would also seem inappropriate. Large volume customers are already well served by existing providers and, it could be argued, might not materially benefit from the Postal Service's entry into this segment of the hybrid mail market. Moreover, it seems unlikely that private enterprises currently serving larger customers, e.g. lettershops, would welcome this kind of pricing structure.

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Another alternative would be to develop an automated rebate system, which the Commission discusses in its Market Test Opinion (at 27). Under such a system, customers whose mailings are under the threshold volume would be charged single-piece rates for First-Class Mail, and denied access to Standard Mail rates at the time the transaction is confirmed. Customer accounts would then be credited with a rebate when cost savings from batching arise. The technical complexity of this approach, especially in light of the strategic necessities discussed above, would militate against this alternative. In a single printer system, customer transactions could not be completed when orders are placed, and, at a minimum, an additional round of communication between the customer and the Postal Service would be necessary. In a multiple printer system, customer rebates would require reconciliation originating from each involved print site, as well as aggregation of that information, while still requiring another round of communication with customers. This alternative thus is not consistent with the goals of convenience and simplicity. The Postal Service has not attempted to estimate what such a system would cost; but, it presents programming challenges which, though not technically insurmountable, are formidable.

The need to simplify the transaction where possible arises out of the Postal Service's main goal for Mailing Online: convenience. Mailing Online employs technically sophisticated systems that enable customers to easily create and use mailpieces at their desktop. This approach embodies a strategic

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decision to favor customers who value convenience at the risk of alienating customers who are willing to expend greater effort in order to attain the lowest possible price. Indeed, a consequence of the Postal Service's approach is an opportunity for competitors to develop a system that employs the kind of rebate system to which the Commission refers.

When dealing with traditional hard copy mail, minimums are necessary. Enforcement of automation compatibility requirements necessitates somewhat labor-intensive acceptance procedures that militate against making discounts available to smaller mailers, i.e., the high transaction cost of assuring automation compatibility results in a minimum volume requirement. The hybrid nature of Mailing Online reduces the need for these acceptance procedures. In effect, the Mailing Online system performs an analogous function at essentially zero cost. Thus, one of the bases for volume minimums is eliminated due to the electronic interface between the Postal Service and its customers.

It would be premature to assume that the factors arguing in favor of specific minimums for traditional mail are equally well-suited to hybrid mailproducts. As the Mailing Online experiment unfolds, we can expect to learn a great deal about the cost causative characteristics of Mailing Online. Though it is impossible to predict with precision what the salient cost causative elements of Mailing Online will be, deferring this issue until the experiment has shed additional light on the effect of the waiver is preferable to application of existing

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DMCS limits based on an untested assumption that hybrid products are directly comparable to traditional mail.

Examination of the traditional uses of the automation presort categories provides additional support for making these categories available to Mailing Online customers. The existing automation basic categories are most often applied to the residuum of larger mailings wherein most pieces qualify for deeper discounts. In such cases, the number of pieces to which the automation basic rate is applied may be well below the threshold minimums. Mailing Online mailings will therefore be substantially indistinguishable from the traditional mail that currently makes use of automation basic rates. Implied in the availability of automation basic rates for small residual volumes is an acknowledgment that pieces which are compatible with the physical automation requirements cost less to process and therefore warrant a discount. In those instances where batching does not result in a mailing that complies with volume minimums, Mailing Online pieces will nevertheless comply with all existing physical eligibility requirements, and therefore resemble the portion of the current mailstream that uses basic automation rates.

In the event Mailing Online becomes a permanent service, competitors offering functionally equivalent services may also emerge. If so, these competitors will likely assert a right to the same rates that Mailing Online uses. Existing worksharing arrangements thrive, thanks in part to cooperative efforts between the Postal Service, mailers, and third-party vendors. For example, the

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Postal Service licenses raw data to, and certifies, providers of presorting software. Assuming the Postal Service is satisfied that pieces generated by such equivalent services generate mailpieces similar in all salient respects to those created by Mailing Online, they should be accorded access to the same rate categories.

The Postal Service sought, and for the market test phase of Mailing Online the Commission recommended, exceptions to the minimum volume requirements for automation basic rates that would otherwise apply to mail produced through Mailing Online. It may be preferable for many reasons to have a unique rate for Mailing Online pieces. As is indicated in my testimony (USPS-T-5, p. 10), data collected during the Mailing Online experiment could be used to develop such a rate category. However, lacking empirical data to support such a proposal, the Postal Service instead chose to use the existing category which appears most appropriate, given what is known about Mailing Online mailpieces.

While attempting to determine the effect that Mailing Online may have on private businesses, it must be kept in mind that private businesses, in a general sense, will gain more than the Postal Service if Mailing Online is approved as proposed. With the 25 percent cost coverage, nearly eighty percent of Mailing Online fee revenues would cover printing costs and be paid directly to the private printing contractors providing Mailing Online services.

Furthermore, the Postal Service has an obvious disincentive to limit competition, because efficient providers of hybrid services are likely to increase

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mail volume by making mail more convenient and less costly to use. However, it is my understanding that no private enterprises currently provide a service with the characteristics of Mailing Online. Market research sponsored by the Postal Service demonstrates that demand for hybrid mail services exists. If Mailing Online is successful, it will provide a signal to private entrepreneurs that a potentially profitable market niche exists. The Postal Service would welcome this because, as additional customers take advantage of hybrid mail services, mail volumes will increase.

The Postal Service has chosen to pursue a conservative approach in selecting discounts. Given the batching capabilities of the Mailing Online system, it is difficult to determine at the time of mailing the level of discounting for which a customer's mail will qualify. Consequently, the Postal Service has chosen relatively modest discounts which assume that a small level of batching and sortation depth will be achieved. In fact, we expect that in most instances, the mail may be presorted more finely and dropshipped more deeply into the system than is necessary to qualify for the proposed discounts. Nevertheless, while the Postal Service recognizes that while in some instances batching may not achieve the volume minimums, in a fully integrated system much of the volume of mail will be presorted and dropshipped more finely than the discounts suggest.

The discounts proposed by the Postal Service will actually benefit competitors. By foregoing deeper discounts, the proposed pricing scheme will

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allow competitors to price below the Postal Service for larger volume mailers where greater presort and dropship potential exists.

As a practical matter, the impact of the Mailing Online on potential entrepreneurs who might be interested in hybrid mail is not easily measurable. The Postal Service, by virtue of its size, may enjoy an advantage in obtaining printing services by being able to guarantee volume levels that produce low unit costs. However, some of this advantage is dissipated through obligations that the Postal Service must meet. For instance, in order to protect the privacy of the Mailing Online electronic documents and the resulting hard copy, the printing contract requires that contractors take extraordinary measures to prevent intermingling of Mailing Online jobs with other print orders. These measures must, by necessity, restrict the flexibility with which Mailing Online contractors might otherwise manage their operations, and thereby increase costs. It is conceivable that a potential competitor, unbound by these constraints, may be able to purchase printing capacity from printers who can more easily use existing equipment and space. This may thereby enable such a competitor to achieve lower costs than Mailing Online. Alternatively, digital printers with excess capacity could choose to enter the hybrid mail business. In addition to optimizing equipment usage, such a business might enjoy a cost advantage because it would presumably charge a rate comparable to what contractors would charge the Postal Service while the Postal Service's fees would be 25 percent higher.

DECLARATION

I, Michael K. Plunkett, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.



Dated: 11/6/98

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS GARVEY
TO NOTICE OF INQUIRY NO. 1, ISSUE 2

Issue 2: The Commission inquires whether the objectives of the minimum volume waiver could be achieved through other means.

The issue of threshold volume requirements for Mailing Online gets quickly to the heart of the fundamental goals of the Postal Service in offering the PostOffice Online (POL) services. The POL is about creating and maintaining simple access to postal products and services for small business people who have neither the time nor the inclination to focus on the complexities of mailing preparation and discount rate structures, and about making sure that this access channel is responsive to the requirements of electronically enabled commerce. The POL is about designing and conceiving a uniquely postal offering that draws upon and reinforces the strengths of the Postal Service's traditional role.

In its market test Opinion (at 27), the Commission suggests an alternative to the threshold volume eligibility waiver in the form of an automated rebate system. The system would have the Postal Service quote and charge currently applicable mailstream rates to Mailing Online mailings that are initially under the current threshold requirements for automation discounts, and then make an appropriate rebate to the customer's account after batches are ultimately formed and discounts determined. The Postal Service views this approach as unacceptable both because of the immense technical complexity implicit in such a design and because it is contrary to the goal of simplicity (finalizing a transaction during a single Web-site visit).

While the determination of appropriate discounts with batching via just one print location and limited volumes may not be that difficult, as volume

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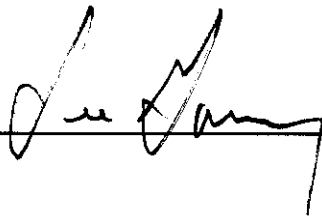
increases during the experiment and the number of print locations expands, the difficulties of tracking and matching each piece's origin to its ultimate qualifying rate would multiply the complexity many times over. Consolidating and successfully reconciling such information at an individual account level would also be very difficult. The development effort for such a complex system modification would require much time and expense.

In addition to this formidable technical challenge, the inherent complexity of such a transactional model is incompatible with the PostOffice Online's overall strategy of simplicity and ease of use. The Mailing Online interface is designed to be highly structured and automated so that the user's experience is completed quickly, efficiently and in a single session. The characteristics of the transaction -- electronic document and list submission with real-time verification, online document proofing, menu-driven finishing options, and firm final cost quotes and real-time payment processing are all part of a strategy to create a simple, straightforward service that provides the same uncomplicated process and result whether used only occasionally or on a daily basis.

Also, while such a system is similar in concept to the Value Added Refund (VAR) and "Combined" programs used by letter shops and presorters to rebate automation discounts achieved by the use of automated sortation equipment, and in fact might benefit larger mailers, those uses imply consistency of use and volume characteristics not expected of MOL customers.

DECLARATION

I, Lee Garvey, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.



A handwritten signature in black ink, appearing to read "Lee Garvey", is written over a horizontal line.

Dated: 11/6/98

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS GARVEY
TO NOTICE OF INQUIRY NO. 1, ISSUE 3

Issue 3: The Commission inquires whether the waiver of volume minimums should extend beyond Mailing Online, either on the basis of functional equivalency or some other basis, and what might constitute functional equivalency.

The Postal Service has requested a waiver of volume minimums for Mailing Online during the experiment for the primary purpose of modeling what it expects to see in a mature MOL service. This is necessary for analyzing potential interest in a new service that develops and utilizes several electronically enabled combinations of logistic and commerce functions.

Important to this discussion is an acknowledgment of the fact that the Postal Service, while requesting these waivers for the basic automation rate volume thresholds, has also foresworn any deeper discounts regardless of volume or level of sortation achieved, thus committing to a single average rate category (within class and shape) for all volume received and mailed. The use of an average rate is also critical to completion of a transaction in a single Web-site visit, as discussed in Witness Plunkett's response to Issue 1. Extension of waivers to other hybrid mail services would require similar limitations upon both larger and smaller discounts, as well as true functional equivalence.

Criteria necessary to establish functional equivalence with Mailing Online include the following:

1. Automation compatible mailpieces, including 100% standardized addresses and barcodes on all mailpieces;

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2. Co-mingling and batching of like mailpieces;
3. Sortation to the finest level of sort possible within batches;
4. Geographic batching and distribution of mailpieces prior to printing and mailing;
5. Secure and completely automated electronic submission of jobs, providing for real-time quotes and secure on-line payment; and
6. Web and browser-based access with no absolute need for client software or a point-to-point dial-up connection with the vendor.

In evaluating the criteria for functional equivalence, it must be noted that the practice of electronic file submission and job ticketing has become common among digital printers and others in the print and mail services industries.

Software utilities and Web sites are electronically linking more and more printers and mail service providers to their client companies every day. This to-be-expected extension of existing commerce is commonly designed to emulate existing business practices. Pitney Bowes DirectNET is an example of this approach. DirectNET software provides users the opportunity to design simple mailpieces and create a job ticket for electronic uploading. Users are provided an estimate of the cost of their work, but are informed that final pricing cannot be determined until some time in the future. Included in the estimated cost of each transaction is a set-up fee, a fee traditional to the printing services industry which is designed to cover the cost of providing individualized service to a particular customer. It signifies that the job paid for will be "set-up" and run just for that

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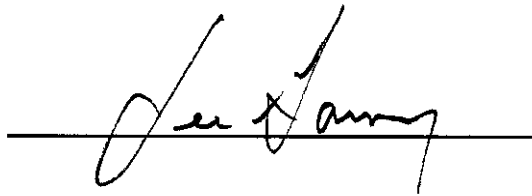
customer. Users are contacted subsequent to submitting the job and informed of the actual (often negotiated) costs of production. This is similar to the traditional printer-client interaction.

Mailing Online offers an alternative process by providing a complete single transaction approach. All parts of the job creation and specification process are conducted online and the transaction is completed in one session.

A goal of the Postal Service is to encourage the development of innovative approaches to mailing. Accordingly, the Postal Service would consider creating special licensing or certification criteria for third-party services that are full functional equivalents of Mailing Online.

DECLARATION

I, Lee Garvey, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

A handwritten signature in cursive script, appearing to read "Lee Garvey", is written over a horizontal line.

Dated: 11/6/98

**RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO NOTICE OF INQUIRY NO. 1, ISSUE 4**

Issue 4: The Commission inquires whether the requested waiver of the destination entry requirement for the DBMC discount could be accomplished in alternative ways that do not require making the discount available to Mailing Online mailings on terms different from the existing Domestic Mail Classification Schedule.

The Commission's sensitivity to the entry characteristics of Mailing Online pieces raises an important point for the conduct of the experiment, namely that until a greater number of printers are operating, mail may be entered at points that are often distant from its destination. Thus, without an exception to existing regulations, some Mailing Online pieces might not otherwise qualify for DBMC discounts until the experiment is well underway. One possible remedy would be to allow the DBMC discount for mailings destinating within the BMC service area of the facility at which the pieces are entered. However, this approach would still be problematic given the necessity for charging customers a fixed price when a job is submitted and the impractical complexity of constructing a system that would permit customer refunds. Given the relatively small size of the mailings, the Postal Service concedes that the presence or absence of the discount is unlikely to have a material impact on the quality of data collected during the experiment and is therefore willing to postpone an exception, pending the outcome of the experiment, for consideration in the context of any request for permanent DMCS language.

DECLARATION

I, Michael K. Plunkett, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

Michael K. Plunkett

Dated: 11/6/98

RESPONSE OF UNITED STATES POSTAL SERVICE
TO NOTICE OF INQUIRY NO. 1, ISSUE 5

The Commission queries in Issue 5 whether joint marketing costs that promote Mailing Online should be attributed to Mailing Online, and if so, how the cost attribution should be quantified. As the Postal Service has noted, the key facts are that no marketing is focused exclusively on Mailing Online, other products are promoted in the same ads along with Mailing Online, and further, if Mailing Online were not present in the Postal Service's product mix, the marketing cost would be undiminished. Given these facts, it would be inappropriate to attribute any joint promotion costs to Mailing Online.

Product costs can be used to help set rates in two ways. The first recognizes that a cost may vary to a certain degree as marginally more volume of a product is sold. It is widely accepted that such information should be incorporated in the rates at which the product is offered to customers. But in this case, Mailing Online advertising costs will not change as customers avail themselves of marginally more (or less) of the product.

The second way stems from an assessment of the change in total cost that would occur if a product were not offered and everything else remained the same. That change in costs is referred to as the product's incremental cost.

If a product earns revenue sufficient to cover its incremental cost, then we can be sure it is receiving no subsidy from the customers of other products. Once again, however, it may be observed that postal advertising costs would not diminish if Mailing Online, by itself, were not offered as a product. Therefore, joint promotion costs form no part of the incremental cost of Mailing Online and should not be attributed to it on this basis.

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If the Commission nonetheless chose to allocate a portion of joint marketing costs to Mailing Online, the question would remain whether a non-arbitrary method exists to determine Mailing Online's "share" of those costs. Regardless of the allocation method selected, the procedure would increase the revenue that Mailing Online would be required to earn. But since the revenue earned by Mailing Online is already great enough to cover its incremental cost, and therefore to ensure that it receives no subsidy, additional increases cannot further the goal of fairness; moreover, it is unclear what policy goal would thereby be served. Hence, any choice between allocation methods would necessarily be arbitrary.

**RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PLUNKETT
TO NOTICE OF INQUIRY NO. 1, ISSUE 6**

Issue 6: The Commission inquires about the criteria that should be used to determine an appropriate markup for Mailing Online during the proposed experiment.

In its Opinion, the Commission agrees that Mailing Online's relationship to other postal services justifies application of a 125 percent cost coverage during the market test (Opinion, at 32). The Commission rightly recognizes that "there is also a reasonable expectation that Mailing Online will substantially benefit individual, home office, and small-volume business mailers by simplifying their interface with the Postal Service's complex rates and regulations" (Opinion, at 34). The Postal Service agrees, and considers this a compelling argument for maintaining the 125 percent cost coverage during the experiment. As has been pointed out, the proposed cost coverage is consistent with the ratemaking criteria of the Act (USPS-T-5 at 17-21), not only for the market test, but for the experimental phase as well. The Commission (Opinion, at 32) compares Mailing Online's cost coverage with the cost coverages for First-Class Mail and Standard A. While these comparisons are apt, the Postal Service maintains that, by providing a system whereby small volume customers can expedite the mail acceptance process, Mailing Online fees most closely resemble permit fees, thus meriting a relatively low cost coverage. Moreover, the unique characteristics of Mailing Online weigh against application of a higher cost coverage. As has been pointed out, nearly all of the costs of Mailing Online are incurred on a unit basis

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(Opinion, at 32), thus reducing the likelihood of cross subsidization. Moreover, these costs are not based on sampling or cost studies, but are specified in contractual agreements between the Postal Service and its partners. These facts ensure that cost coverage is relatively constant, and therefore less prone to erosion than cost coverages for typical Postal Service products.

Furthermore, any comparison of cost coverages across products implies a notion of "fairness", i.e. that because of either similarities or differences between and among products, there is a fair amount that a given product ought to contribute to institutional costs. Mailing Online is perhaps unique in that most of the direct costs of the service are borne by contractors. While this characteristic of the service does not obviate fairness considerations, it does affect the context in which such considerations should be considered. Contractors pass through, both their direct costs and some additional amount to cover overhead expenses and provide an adequate return. Thus, the Mailing Online cost coverage is not fully analogous to traditional cost coverages, since a private sector profit is already included in Mailing Online.

DECLARATION

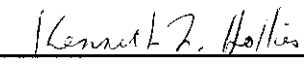
I, Michael K. Plunkett, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

Michael K. Plunkett

Dated: 11/6/98

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.



Kenneth N. Hollies

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
November 6, 1998