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MASA/PB-T-1

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

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MAILING ONLINE SERVICE

Docket No. MC98-1

**DIRECT TESTIMONY
OF
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Executive Vice President
L. E. Peabody & Associates, Inc.**

**On Behalf Of
MAIL ADVERTISING SERVICE ASSOCIATION INTERNATIONAL
PITNEY BOWES, INC.**

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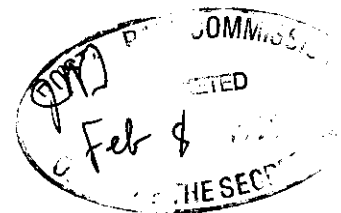


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DIRECT TESTIMONY

OF

ROGER C. PRESCOTT

My name is Roger C. Prescott. I am Executive Vice President of the economic consulting firm of L. E. Peabody & Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314. I have previously presented evidence before the Postal Rate Commission ("PRC") regarding Third Class Bulk Rate Regular ("TCBRR") mail rates in Docket No. R90-1, Postal Rate and Fee Changes, 1990 ("R90-1"), as well as Standard (A) commercial mail in Docket No. MC95-1, Mail Classification Schedule, 1995 Classification Reform I ("MC95-1") and Docket No. R97-1, Postal Rate and Fee Changes, 1997 ("R97-1"). In addition, I have on numerous occasions presented evidence before the Surface Transportation Board (formerly the Interstate Commerce Commission) on economic ratemaking and cost finding principles. My qualifications and experience are described in Appendix A to this statement.

I. PURPOSE OF TESTIMONY

The United States Postal Service ("USPS") has proposed a new service for small office/home office ("SOHO") customers utilizing the online, electronic transmission of data ("Mailing Online"). This new service allows the SOHO customer, using internet access and machine readable files, to submit a mailing to the USPS where the mail will be forwarded to a USPS' subcontractor for production. As noted by the USPS' Witness Garvey, Mailing Online "integrates electronic mail collection, mail preparation and assembly, and traditional hardcopy mail delivery..." (USPS-T-1, page 4). As noted by the PRC, Mailing Online "is designed for short-run (less than 5,000 pieces) direct mail advertising, invoices and solicitation mailings." (PRC's October 7, 1998 decision, page 1).

The PRC approved the market test for this service in its decision in this proceeding dated October 7, 1998. The PRC asked for this current round of comments from interveners as part of the consideration of the classification and rate structure for the proposed next phase of the Mailing Online project, namely a two year experimental phase.

I have been requested by Mail Advertising Service Association International ("MASA") and Pitney Bowes, Inc. ("PB") to review and respond to certain portions of the USPS' direct and supplemental testimony dated July 15, 1998 and January 14, 1999, the USPS' responses to interrogatories and questions raised at the hearings in this proceeding, the USPS' weekly and bi-weekly reports on the currently ongoing Mailing Online market test and the PRC's October 7, 1998 decision. My testimony addresses whether or not the USPS' proposed Mailing Online service and the proposed prices that will be charged Mailing Online customers will harm

1 competition. My testimony also addresses certain issues related to the level of costs associated
2 with the Mailing Online service. My analysis and comments regarding Mailing Online are
3 summarized under the following topics:

4 **II. Identification of MASA and PB**

5 **III. Summary and Conclusions**

6 **IV. USPS' Estimates of the Mailing Online Business**

7 **V. Competitive Impacts of Vertical Integration**

8 **VI. Issues on Rates and Costs for Mailing Online**

1 **II. IDENTIFICATION OF MASA AND PB**

2 MASA is a trade association of approximately 670 companies producing mail for First-Class
3 and Standard Rate mailers. MASA has a direct interest in changes concerning First-Class and bulk
4 regular rate Standard (A) mail, the subclasses that will utilize Mailing Online. Many of MASA's
5 members are letter shops, print shops and other mail preparation companies of varying size that
6 could compete for the printing and production of the type of mail to utilize Mailing Online.
7 MASA members provide services that include the design and creation of mail, printing services
8 and preparation of mail for submission to the USPS.

9 PB is a Connecticut-based producer of postage meters, mailing systems, and office supplies.
10 PB is the world's largest supplier of mailing equipment and postage meters. PB utilizes various
11 postal services to carry out its operations, which include a service called DirectNET that provides
12 an electronic service to print postal mail. A specific description of DirectNET was included in
13 the Rebuttal Testimony of PB's Witness Brand dated September 4, 1998 in this proceeding.

14 In summary, as producers of mail, both MASA and PB are extremely concerned about the
15 competitive impact of the Mailing Online service as proposed by the USPS.

III. SUMMARY AND CONCLUSIONS

After a thorough review of the testimony and data presented by the USPS regarding its proposed operation and potential business related to Mailing Online, I conclude that proceeding with the experimental phase of this project will competitively harm MASA and PB. Because of this competitive harm, it is my recommendation that the PRC reject the request for approval of the experimental phase of Mailing Online as proposed by the USPS. If the experimental phase of Mailing Online is put into effect, then the prices charged to the users of Mailing Online should be increased.

My specific conclusions are as follows:

1. Based on the USPS' own data, 62% of Mailing Online pieces would have been mailed even without Mailing Online. Thus, the USPS' Mailing Online service will divert \$121 million worth of business from the marketplace to a USPS controlled operation during the experimental phase of Mailing Online. Based on the USPS' projections for the first five years of operation, the USPS will divert \$521 million worth of current printing business from the marketplace to the USPS' printing subcontractors;
2. Mailing Online integrates the USPS' monopoly mail delivery service with the currently competitive SOHO mail industry. In economic terms, the USPS would be practicing what is called vertical integration. The vertical integration of a monopoly service with a competitive service is widely held to be anti-competitive;
3. Mailing Online provides competitive advantages to the USPS and its selected printers that include: gains in market information, price advantages due to volume discounts on postage rates, potential price advantages due to exemption from sales and income taxes, bidding advantages for the incumbent selected printers and geographic advantages to selected printers.

- 1 4. In Packaging Service,^{1/} Pack and Send^{2/} and E-COM^{3/}, the PRC found that competition
2 must be protected if the USPS expands into competitive areas of business;
- 3 5. If the Mailing Online service is to be continued into the market experimental phase, the
4 mark-up of printing costs should be increased from 25 percent to a range between 47
5 percent and 60 percent in order to provide assurance against harm to competition and to
6 be comparable with other services provided by the USPS;
- 7 6. Because Mailing Online mail will receive the discount postage rates for automation mail
8 and because the USPS' data projects that some current First-Class mail will migrate to
9 Standard (A) mail when moving to Mailing Online, a "revenue leakage" will occur. The
10 revenue leakage will cost the USPS \$43.1 million in revenues during the experimental
11 phase.
- 12 7. The USPS is not limited to 5,000 pieces per job or to the SOHO market and the target
13 market is potentially much larger than the USPS has asserted.
- 14 8. The charges assessed for information systems costs should be increased from 0.1 cents per
15 impression to 0.41 cents per impression. In addition, all appropriate attributable costs
16 should be recognized for Mailing Online, including advertising costs and any credit card
17 service fees.

^{1/} PRC Docket No. MC97-5, Provisional Packaging Service, Opinion and Recommended Decision, March 31, 1998 (Packaging Service).

^{2/} PRC Docket No. C96-1, Complaint of Coalition Against Unfair USPS Competition, Order No. 1145, December 16, 1996 ("Pack and Send").

^{3/} PRC Docket No. R83-1, E-COM Rate and Classification Changes, 1983, Opinion and Recommended Decision, February 24, 1984 ("E-COM").

IV. USPS' ESTIMATES OF THE MAILING ONLINE BUSINESS

The USPS' direct testimony, supplemental testimony and responses to interrogatories, presented its estimate of the level of business for Mailing Online over the 1999 through 2003 time period. These projections identify the volumes (e.g., pages, impressions, mail pieces), printing costs (including information systems costs) and revenues. The years 1999 and 2000 are considered the experimental phase by the USPS. Although the USPS utilized 1999 as the start-up year for the two year experimental phase, USPS' Witness Plunkett recognized that the data "reflect the Year 1 and Year 2 market..." (OCA/USPS-T5-4). For purposes of my testimony I have also assumed that Mailing Online begins in 1999.

Table 1 below separates the basic characteristics of the Mailing Online operations, costs and revenues as presented by the USPS into two time periods. First, Table 1 summarizes the USPS' projected data for the initial 2 years of the Mailing Online program, i.e., the experimental phase. Second, Table 1 summarizes the USPS' projected data for the subsequent 3 years (2001 through 2003).

Table 1
Summary of USPS' Projected Data for Mailing Online
(Values in Millions)

| Item | Experimental Phase | 2001-2003 | Total |
|--|-----------------------|--------------|--------------|
| (1) | 1999-2000 (2) | (3) | (4) |
| 1. Volumes | | | |
| a. Number of pieces ^{1/} | 811.7 | 3,249.8 | 4,061.5 |
| b. Number of pages ^{1/} | 3,391.2 | 13,577.6 | 16,968.8 |
| c. Number of Impressions ^{2/} | 5,505.1 | 22,041.0 | 27,546.1 |
| 2. Aggregate costs ^{2/} | \$194.7 | \$645.7 | \$840.4 |
| 3. USPS Mark-up ^{3/} | <u>48.7</u> | <u>161.4</u> | <u>210.1</u> |
| 4. USPS Mailing Online Revenues (L2 + L3) | \$243.4 | \$807.1 | \$1,050.5 |

^{1/} Attachment to response to OCA/USPS-T5-10 and PB/USPS-T5-5, revised February 4, 1999.

^{2/} USPS-T2, Exhibit A, page 10 of 28.

^{3/} 1999-2000 from Attachment to Response to PB/USPS-T5-5. 2001-2003 from Attachment to Response to OCA/USPS-T5-16. Costs for all years exclude the USPS' variable information systems costs and the costs for 2001-2003 exclude inserter costs.

As shown in Table 1 above, the USPS has projected that during the experimental phase Mailing Online will generate 811.7 million pieces of mail reflecting 3.4 billion pages with 5.5 billion impressions. For the experimental phase, the printing costs, including the USPS information systems cost, are projected to equal \$194.7 million and generate \$243.4 million in revenues. For the entire 5 year projected period, the USPS projects 4.1 billion pieces of mail reflecting 17.0 billion pages and 27.5 billion impressions. The first 5 years of Mailing Online are projected to generate \$840.4 million in costs and \$1,050.5 million in revenues.

In order to place the USPS' proposed Mailing Online operation into perspective, I have developed Table 2 below which compares the Mailing Online projected pieces and revenues for 1999 with the volumes and revenues for some of the USPS' other services. The data for Mailing Online reflects the 1999 portion of the data in Column (2) of Table 1 above. The Table 2 data for the other services is based on the revenue and volume data in Appendix G to the PRC's R97-1 decision.

Table 2
Comparison of Pieces and Revenues
between Mailing Online and Other Services

| <u>Item</u> (1) | <u>Amount (millions)</u> | |
|--|--------------------------|------------------------|
| | <u>Volume</u> (2) | <u>Revenues</u> (3) |
| 1. Mailing Online - 1999 ^{1/} | 295.7 | \$90.0 |
| <u>Other Services</u> ^{2/} | | |
| 2. Mailgrams | 4.8 | \$4.7 |
| 3. Standard Mail (B) - Library Rate | 29.9 | \$49.4 |
| 4. Special Services | | |
| a. Insurance | 30.2 | 68.3 |
| b. C.O.D. | 3.9 | 19.0 |
| c. Bulk Parcel Return Service | 4.8 | 8.4 |
| d. Packaging Service | 2.5 | 43.1 |

^{1/} Attachment to Response to PB/USPS-T5-5.

^{2/} R97-1 decision, Appendix G.

Table 2 shows that the USPS' Mailing Online represents the pursuit of a major new line of business for the USPS. The annual number of pieces of mail and annual revenues for Mailing Online represent a substantially larger business than currently exists for other services such as

1 mailgrams, library rate mail and several special services. In other words, although the USPS
2 states that it is targeting the limited SOHO market, in reality, Mailing Online is a wide-reaching
3 endeavor that represents a major line of business for the USPS.

4 Mailing Online is intended to serve current USPS customers as well as attract new customers.
5 As developed by the USPS, 62 percent of Mailing Online pieces represent existing mail that
6 would have used the USPS without Mailing Online.^{4/} Mailing Online is diverting business from
7 private competitive firms to the USPS' subcontractor. Assuming that the subcontractor costs
8 charged by the USPS are at competitive price levels (Table 1, Line 2), this diversion from private
9 business equals approximately \$121 million^{5/} during the experimental phase and \$521 million^{6/}
10 during the five year period from 1999 to 2003. The magnitude of such a diversion to a limited
11 number of USPS' selected printing companies^{7/} and the potential economic impact on the
12 competitive market for mail preparation services should be taken into consideration prior to
13 proceeding with the experimental phase of Mailing Online.

^{4/} See USPS Witness Plunkett (USPS-T-5), Exhibit D, USPS Witness Rothschild (USPS-T-4), page 33 and Library Reference LR-1, page 38.

^{5/} Table 1, Line 2, Column (2) x .62.

^{6/} Table 1, Line 2, Column (4) x .62.

^{7/} The USPS proposal anticipates 25 print shops would be utilized to perform the production of Mailing Online mail (USPS-T-1, page 2).

1 **V. COMPETITIVE IMPACTS OF VERTICAL INTEGRATION**

2 The USPS' stated intentions for Mailing Online is to provide the SOHO market access to an
3 easy way to create and deliver mail. The USPS has stated that it does not intend for Mailing
4 Online "to replicate a traditional lettershop" and "wish(es) to avoid direct competition with
5 lettershops" (MASA/USPS-T1-15). However, the merger of the USPS' mail delivery function
6 and the actual creation of the mail creates problems for the competitive markets served by MASA
7 and PB.

8 The USPS' proposed Mailing Online service is designed to extend the USPS' mail delivery
9 service backward in the production process to include the creation of the mail. In economic terms,
10 this is called vertical integration. My comments on the impact of the USPS' proposed vertical
11 integration on competitive printing markets are discussed under the following topics:

12 A. Definition of Vertical Integration

13 B. Problems with Vertical Integration

14 C. Past PRC Treatment of USPS' Integration with Competitive Services

15 D. Conclusion

16 **A. DEFINITION OF VERTICAL INTEGRATION**

17 Currently, mail is produced by lettershops or private companies (a competitive industry) and
18 given to the USPS (a monopoly service) for ultimate delivery to the recipient. Although the
19 USPS' pricing structure may provide incentives for the mailer to prepare the mail in a certain way
20 (e.g., rates based on shape or worksharing discounts), the USPS currently has no control over the

1 actual production of the document that is mailed. In other words, the function of producing the
2 mail and the function of delivering the mail are separate.

3 When two (or more) functions in the stages of production are merged together under the
4 control of one company, vertical integration occurs. In generic economic terms, vertical
5 integration:

6 Refers to a firm whose activities extend over more than one successive stage of the
7 production process of transforming raw materials into final goods. Vertical integration
8 can be partitioned into two types: backward integration, where a firm extends itself
9 into a previous stage of the production process and forward integration, where a firm
10 moves into a succeeding stage of activity.^{8/}

11 Backward vertical integration allows a firm at a later stage of production "to incorporate its
12 source of supply..."^{9/}. For Mailing Online, the USPS is integrating backward by controlling the
13 printing stage of the production process through the use of USPS computer software and contract
14 printing services.

15 Specifically, the USPS is developing and paying for the computer hardware and software that
16 the customer utilizes. The Mailing Online customer enters the document to be produced and the
17 list of addresses through the USPS' internet website. Then, the customer submits his payment
18 to the USPS. After receipt of the document and mailing list, the USPS' computer software will
19 distribute the mailing to the appropriate printing company (or companies) that the USPS has

^{8/} The Dictionary of Modern Economics, Revised Edition, David W. Pearce, General Editor, The MIT Press, 1983.

^{9/} Production and operations management. A life cycle approach, Richard B. Chase and Nicholas J. Aquilano, Richard D. Irwin, Inc., 1977.

1 selected as a subcontractor. The printing subcontractor(s) then produces the mail and provides the
2 finished document to the USPS for delivery to the recipient.

3 The two services (production and mail delivery) are clearly formed into one operation because
4 the USPS software and printing contractor(s) must be utilized. Once the product submitted by the
5 customer is printed, it must be mailed and delivered by the USPS, thus, integrating the services
6 provided by the USPS.

7 **B. PROBLEMS WITH**
8 **VERTICAL INTEGRATION**

9 Vertical integration of the production process, in a competitive environment, does not
10 necessarily lead to a decrease in competition. Problems, however, arise when a monopoly
11 function is combined with a competitive function. The following quote summarizes the overall
12 problem when a monopoly vertically integrates:

13 Of course vertical integration loses its innocence if there is an appreciable degree of
14 market control at even one stage of the production process. It becomes a possible
15 weapon for the exclusion of new rivals by increasing the capital requirements for entry
16 into the combined integrated production processes, or it becomes a possible vehicle of
17 price discrimination. In these cases new vertical mergers are not desirable...(footnote
18 omitted) (emphasis added)^{10/}

19 Vertical integration involving a monopoly service can lead to competitors being foreclosed
20 from participation in a market. For the foreclosure to diminish competition, "one or both levels
21 involved must possess some degree of market power"^{11/}. The competitive problem with vertical

^{10/} The Organization of Industry, George J. Stigler, The University of Chicago Press, 1983, page 303.

^{11/} Economics of Regulation and Antitrust, 2nd Edition, W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr., The MIT Press, 1996 ("Regulation and Antitrust"), page 229.

1 integration and the foreclosure created can also be problematic if it "permit(s) an extension of that
2 market power to the other level" (Regulation and Antitrust, page 234).

3 I discuss the specific problems of vertical integration related to Mailing Online under the
4 following two topics:

- 5 1. Advantages for the USPS; and,
- 6 2. Advantages for the USPS Selected Printers.

7 **1. Advantages for the USPS**

8 The integration of the USPS with the services of the selected printing contractor(s) produces
9 several advantages over mail produced by the competitors of Mailing Online. These advantages
10 are present in both informational gains of the USPS and price benefits realized by the USPS.

11 Currently, the USPS has incentives to assist print lettershops and other mail preparation
12 companies in obtaining mail jobs. If a potential SOHO customer is searching for a company to
13 provide mail production services, the USPS has an incentive to help the SOHO customer, if asked.
14 After Mailing Online is operational, the USPS will have a financial incentive to steer the customer
15 to its own mail production service under the USPS' control.

16 Next, the USPS will be in position to gain valuable access regarding mailing habits and
17 distributive networks for the address information gained from customers who submit jobs to
18 Mailing Online. This information will allow the USPS to better target its advertising for Mailing

1 Online or produce its own mailings to solicit business from either SOHO customers or the
2 recipients of Mailing Online mail^{12/}.

3 Under the USPS' proposed Mailing Online Service, the USPS has two additional advantages
4 over other competitors. First, the USPS' proposed postage rates for the experimental phase will
5 reflect the automation discounts even if volumes are not sufficient to qualify for these discounts
6 under current requirements. Because some competitors with Mailing Online printers will not be
7 eligible for discounts, these competitors will be at a price disadvantage. Second, Mailing Online
8 will not charge sales tax and the USPS does not pay corporate income taxes. Thus, the USPS may
9 be able to offer lower prices than its competitors who are subject to sales and income taxes.

10 **2. Advantages for the**
11 **USPS' Selected Printers**

12 The USPS intends to sign contracts with selected printers, initially targeted at up to 25
13 locations, who will be responsible for the production of the Mailing Online documents. These
14 printers are expected, under the USPS' projected operation, to produce over 100,000 pages per
15 day. Thus, a small number of selected printers will have or make the investment in capacity
16 needed to meet the requirements for Mailing Online. The USPS has recognized that "this capacity
17 is also likely to generate new revenue by benefiting their [the Mailing Online printers] ability to
18 satisfy latent and emerging demand from their own or other customers" (MASA/USPS-T1-19(b)).
19 This expansion of business can provide the selected printer with an advantage when the USPS

^{12/} The USPS' periodic survey called the Household Diary Study allows the USPS to gather information on mail received. However, this information does not provide the same marketing opportunities as the Mailing Online data.

1 decides to rebid the initial printing contracts. This issue is another element of the vertical
2 integration problem as shown below:

3 Thus even though there may have been large numbers of qualified bidders at the
4 outset, if the winner of the original bid thereafter enjoys a sunk cost advantage, parity
5 bidding at contract renewal intervals cannot be presumed. Instead, such transactions
6 undergo a "fundamental transformation". What had been an *ex ante* large numbers
7 bidding condition thus becomes a small numbers supply condition thereafter. This
8 transformation is the main factor that is responsible for the decision to remove
9 transactions from markets and organize them internally.^{13/}

10 Finally, the USPS proposes to select printing subcontractors that are geographically dispersed.
11 This prevents true competition for the subcontractors. In other words, the second lowest bid in
12 one geographic area would not receive any USPS business for Mailing Online because a higher
13 bid, in a different geographic area, was selected by the USPS. This is another advantage for the
14 USPS' subcontractors.

15 **C. PAST PRC TREATMENT OF**
16 **USPS' INTEGRATION**
17 **WITH COMPETITIVE SERVICES**

18 Mailing Online is not the USPS' first attempt to enter into a service found in a competitive
19 market. The PRC in the past has instituted protections to make sure that the USPS' entry into a
20 new line of business does not decrease the level of competition. For example, in E-COM, the
21 PRC stated that "it has a responsibility is for preserving or promoting competition" (E-COM, page
22 10). In Packaging Service, the PRC "recommended changes [that] will result in a more level
23 playing field for competition between the Postal Service and private stores" (Packaging Service,

^{13/} The New Palgrave, A Dictionary of Economics, Edited by John Eatwell, Murray Milgate and Peter Newman,
Volume 4, page 810.

1 page 3).^{14/} The PRC's logic employed in the E-COM, Packaging Service and Pack and Send
2 proceedings is relevant to the approach that the PRC should follow with Mailing Online.

3 In E-COM, the USPS proposed to print and mail electronic telegrams. Initially, the USPS
4 proposed to subcontract the data processing operation to Western Union Telegraph Co. but, this
5 was changed later to allow qualified common carrier access to the system (E-COM, pages 4-5).
6 Interveners (including MASA) argued that the USPS' proposed E-COM service would compete
7 with the telecommunication and message preparation industries. The PRC found that the USPS
8 was involved in a competitive product, granted greater access to use the product and instituted a
9 higher coverage ratio (i.e., increased the rates) than proposed by the USPS. The PRC then found
10 its "responsibility is to recommend rates that will prevent such injury..." (E-COM, page 22) and
11 to protect competition.

12 In Packaging Service, the PRC found that the USPS' service consisted "of two components:
13 the sales/acceptance transaction and the packaging operation". (Packaging Service, page 4).
14 This service is postal in nature because the service is performed by USPS employees at USPS
15 facilities. In that proceeding, the PRC evaluated the appropriate costs for the USPS' service and
16 potential for competitive harm. The coverage ratio proposed by the USPS was found to be
17 "inappropriate" and a higher coverage ratio was recommended for two reasons (Packaging
18 Service, page 25-26). First, the higher coverage ratio (based on the estimated costs) provided a
19 contingency in the event that the actual costs are higher. Second, the higher coverage ratio
20 "leveled the playing field" with USPS' competitors.

^{14/} As noted in the PRC decision at page 3, the Packaging Service proceeding is the "successor" to Pack and Send.

1 In Pack and Send, the PRC found that the USPS' service of providing the mailing container
2 and packing service "constitutes mail preparation for a fee" (Pack and Send, page 15). In that
3 proceeding, like Mailing Online, the USPS participated in the creation of the article to be mailed.
4 In Pack and Send, the PRC also found a high correlation between the production of the article to
5 be mailed and the USPS receipt of postage fees for the mail (Pack and Send, page 19). This
6 parallels the USPS' proposal for Mailing Online where the USPS receives postage fees after the
7 mail is created under a USPS contract^{15/}. Ultimately, the PRC concluded that "the level of [USPS]
8 fees have the potential for causing a significant impact on competing stores in the private sector..."
9 (Pack and Send, page 19). The same conclusion is applicable to Mailing Online.

10 D. CONCLUSION

11 Mailing Online service proposed by the USPS will extend its monopoly power backward into
12 the production process. Specifically, the USPS' proposal:

- 13 1. Vertically integrates a competitive service with a monopoly service which can be anti-
14 competitive unless safeguards are instituted;
- 15 2. Provides competitive advantages to the USPS and its selected printers that include: gains
16 in market information, price advantages due to volume discounts on postage rates,
17 potential price advantages due to exemption from sales and income taxes, bidding
18 advantages for the incumbent selected printers, and geographic advantages to selected
19 printers; and,
- 20 3. Contradicts past PRC proceedings which support the protection of competition when the
21 USPS ventures into competitive services.

^{15/} The coverage ratio and contribution discussed here related to Mailing Online do not consider that the USPS also receives a contribution from the postage rates charged for Mailing Online products.

1 For these reasons, the PRC should rigorously examine the terms and conditions on which the
2 USPS proposes to offer Mailing Online in order to safeguard as fully as possible against the
3 realization of the anti-competitive potential of Mailing Online.

1 **VI. ISSUES ON RATES AND COSTS FOR MAILING ONLINE**

2 In the event the USPS proceeds with the experimental phase, several modifications should be
3 made to the Mailing Online rate structure to assure that no competitive harm is caused by the
4 USPS' proposed service during the two-year experimental phase. The specific modifications
5 involve revising the 25 percent mark-up ratio, treatment for revenue "leakage" in the postage
6 rates, revision to recovering the information systems costs, addition of advertising costs to the
7 rates charged customers and the identification of all USPS attributable costs. In addition, I critique
8 the USPS' assertion that the target market is limited to SOHO customers with 5,000 piece
9 mailings. My suggestions and comments on these issues are discussed under the following topics:

10 A. Revised Cost Mark-Up

11 B. Revenue "Leakage"

12 C. Information Systems Costs

13 D. Mailing Online Target Market

14 E. Treatment of Advertising Costs

15 F. Identification of Attributable Costs

16 G. Summary

17 **A. REVISED COST MARK-UP**

18 The USPS has proposed that the price structure for Mailing Online, exclusive of postage
19 costs, should equal printing costs (including a factor of 0.1 cents per impression to recover

1 variable information systems costs) marked-up by 25 percent.^{16/} According to the USPS' Witness
2 Plunkett, the 25 percent mark-up "is reasonable and appropriate". Witness Plunkett further claims
3 that several factors favored "a moderate cost coverage at this time" (USPS-T-5, page 18). The
4 reasons cited by Witness Plunkett to support his arbitrary position include: 1) the price sensitivity
5 of the target customers; 2) the experimental phase is only 2 years; 3) the introduction of new
6 volumes to First-Class and Standard (A) mail; and, 4) the USPS' costs will be lower because of
7 the ability to enter at destination entry. None of Witness Plunkett's reasons support the proposed
8 25 percent mark-up for the experimental phase. A higher mark-up is warranted for several
9 reasons.

10 **1. Precedent for Other Postal Services**

11 Several past and current precedents can be reviewed to assist in determining the appropriate
12 coverage ratio (or mark-up) for Mailing Online. The coverage ratios for the services provided by
13 the USPS for money orders, insurance and packaging are three examples shown below:

14 The USPS currently provides money orders to customers as a service that is outside of the
15 delivery of mail. This service competes with other companies. In R97-1, the PRC found that a
16 coverage ratio of 147 percent (i.e., a mark-up of 47 percent) was warranted. This level of
17 coverage was instituted, in part, to recognize the modest means of the purchasers of money orders
18 (R97-1 Decision, page 595). This reasoning supports a significantly higher mark-up than
19 currently proposed by Witness Plunkett.

^{16/} The 25 percent mark-up represents a coverage ratio of 125 percent.

1 If requested, insurance against the loss or damage of articles of mail (up to a value of \$5,000)
2 is available to USPS customers. In R97-1, the USPS' Witness Plunkett suggested that the
3 proposed "154 percent cost coverage guards against improper competition..." and that "...the
4 proposed fee schedule is fair and equitable for customers, competitors, and the Postal Service,
5 alike" (USPS-T-40, page 7). The same arguments can be made here that a 154 percent coverage
6 ratio for Mailing Online would be fair to the USPS and its competitors.

7 Similarly, in R97-1 the PRC set rates for its packaging service for non-breakable and fragile
8 items shipped via the USPS with a mark-up ratio equalling 55 percent (R97-1 Decision, Appendix
9 G). In Pack and Send where the USPS first requested rates for the packaging service, the USPS
10 proposed a mark-up of 60 percent (Pack and Send, page 20).

11 **2. Fixed Rates for 2 Years**

12 The USPS has stated that the Mailing Online rates would be fixed for 2 years during the
13 experimental phase. For the rates to be set at the USPS proposed level, the PRC must be
14 confident that no competitive harm will occur. Rates in effect for two years (based on a mark-up
15 of 25 percent) may well be sufficient to drive away any current or potential competition. No
16 evidence has been provided to show that individual small lettershops, large printers or other
17 services such as PB's DirectNET will be able to compete successfully with Mailing Online. In
18 light of the \$121 million in revenues that the USPS will be drawing away from current printing
19 companies during the experimental phase of Mailing Online, caution should be exercised and a
20 higher coverage ratio included in the prices charged by the USPS.

1 **3. Uncertainty on Volume**

2 The USPS believes that it will produce 812 million pieces of mail and 5,505 million
3 impressions during the experimental phase of Mailing Online. However, the market research is
4 not definitive and the market test phase of Mailing Online which began in November 1998 has
5 shown extremely low volumes. In order to maximize the possibility that the USPS' start-up costs
6 are recovered,^{17/} Mailing Online should receive the highest mark-up possible.

7 Even considering only the information systems costs incurred of \$22.5 million, the USPS
8 must produce large volumes to cover the costs incurred. If these costs are not covered, then other
9 USPS services must recover the costs. The average mark-up equals 0.88 cents per impression^{18/}.
10 When the 0.1 cent per page additive charged by the USPS is included, the average contribution
11 to recover the USPS' costs equals 0.98 cents per impression. In order to recover the information
12 systems costs of \$22.5 million as shown in the USPS' supplemented testimony during the
13 experimental phase, the USPS will need a volume of 2.3 billion impressions^{19/}. Based on the
14 projected ratio of impressions per page of 1.62, the USPS will need 1.4 billion pages to cover the
15 information systems costs.^{20/}

16 To date, the Mailing Online market test provides no indication that the expanded experimental
17 phase can approach the volumes projected by the USPS. In the twelve weeks of reported data for

^{17/} These costs included \$22.5 million in information systems costs for the experimental phase.

^{18/} Table 1, Line 3 revenue for the mark-up of \$48.7 million divided by Table 1, Line 1c, impressions of 5,505 million.

^{19/} \$22.5 million divided by 0.98 cents per impressions.

^{20/} 2,296 million impressions divided by the ratio of impressions to pages from Table 1, Line 1c ÷ L1b (5,505 million ÷ 3,391.2).

1 the market test,^{21/} Mailing Online had 116 transactions producing 16,666 pages with total revenues
2 (including both printing and postage costs) of \$6,119.01. Mailing Online averaged only 144
3 pieces per transaction. In addition, all 16,666 pieces were mailed First Class, thus, preventing
4 the market test from providing any data regarding Mailing Online products shipped with Standard
5 (A) rates. This indicates a level of uncertainty for the future volumes for Mailing Online. A
6 higher mark-up would help insure that the initial costs are recovered.

7 **4. Other USPS Services**

8 A recent United States General Accounting Office ("GAO") study addressed the profitability
9 of some of the USPS' new products^{22/}. The GAO reviewed the profitability of 19 new USPS
10 products for the 1995 through 1997 time period. The GAO concluded that 18 of the 19 products
11 lost money over the time period studied and the total loss equalled \$84.7 million (New Products,
12 page 19). The potential loss of money or failure to recover money invested in new products
13 further supports a higher mark-up that will recover the costs incurred by the USPS more quickly.

14 **5. Maximizing Contribution**

15 The USPS has not shown that the Mailing Online contribution is maximized with a 25 percent
16 mark-up. USPS' Witness Rothschild speculates that volume will decrease by 31 percent if the
17 mark-up is increased from 25 percent to 50 percent.^{23/} In Table 3 below, I estimate the USPS'
18 contribution from the mark-up during the experimental phase if the mark-up is increased to 50
19 percent and Witness Rothschild's speculation regarding volume decreases is realized.

^{21/} Data has been reported through AP5, Week 2.

^{22/} GAO, U.S. Postal Service, Development and Inventory of New Products, November 1998 ("New Products").

^{23/} USPS-T-4, Table 15 and Table 16.

Table 3
Estimate of USPS Contribution from
Mark-Up Based on Revised
Mark-Up Ratio -- 1999 to 2000

| | Item (1) | Source (2) | Mark-Up Ratio | |
|--|------------------------------|-----------------|---------------|-------------|
| | | | 25% (3) | 50% (4) |
| 1. | Volume - millions | ^{1/} | 811.7 | 560.6 |
| 2. | Aggregate Costs (millions) | ^{2/} | \$194.7 | \$134.5 |
| 3. | Mark-Up Percent | Given | <u>0.25</u> | <u>0.50</u> |
| 4. | USPS Contribution - millions | Line 2 x Line 3 | \$48.7 | \$67.3 |
| ^{1/} Rothschild, USPS-T-4, Table 15 and Table 16. ^{2/} Column (3) equals Table 1 above, Line 2. Column (4) equals Column (3) x [Line 1, Column (4) ÷ Line 1, Column (3)]. | | | | |

As shown in Table 3 above, under Witness Rothschild's scenario volume is decreased from 812 million pieces to 561 million pieces when the mark-up is increased from 25 percent to 50 percent. The decrease in volume also decreases the aggregate costs for printing from \$194.7 million to \$134.5 million.^{24/} However, if the mark-up is increased from 25 percent to 50 percent, the USPS' contribution from the mark-up increases from \$49 million to \$67 million. This further supports the position that the mark-up can be increased above the USPS' proposal and still provide adequate contribution to the USPS.

^{24/} This reflects the assumption that all costs are variable with volume changes. If some costs do not vary with volume, the contribution at the 50 percent mark-up would increase.

1 **6. Summary**

2 As shown above, the 25 percent mark-up should be increased. The appropriate mark-up
3 should range from 47 percent to 60 percent. This increase will prove beneficial to the USPS and
4 protect competition.

5 **B. REVENUE "LEAKAGE"**

6 The USPS believes that Mailing Online will service existing customers as well as attract new
7 customers. From the standpoint of revenues from postage, the discounts provided to Mailing
8 Online will decrease the revenues for the 62 percent of Mailing Online mail that would have used
9 the USPS even if Mailing Online did not exist. Thus, 38 percent of Mailing Online business is
10 new or incremental business which will increase postage revenues.^{25/} In evaluating the revenues
11 for postage realized, USPS' Witness Plunkett stated that:

12 [t]he overall impact of Mailing Online on postage revenue includes this revenue from
13 new pieces, but must account for revenue leakage as a result of making discounted
14 rates available to Mailing Online customers. (Witness Plunkett, page 7) (emphasis
15 added).

16 Witness Plunkett's Exhibit D calculated the amount of this revenue "leakage" associated with the
17 existing mail (i.e., the 62 percent). As shown in his Exhibit D, the revenue "leakage" due to the
18 application of automation rates for existing mail equals \$14.1 million in 1999 and \$20.4 million
19 in 2000^{26/}. The total revenue leakage equals \$34.5 million.

^{25/} This was recognized in USPS Witness Rothschild's response to MASA's interrogatory MASA/USPS-T4-4.

^{26/} My analysis is based on the totals shown in Witness Plunkett's Exhibit D.

1 In addition to the revenue “leakage” associated with current mail receiving the automation
2 discount as referred to by Witness Plunkett, a second type of revenue “leakage” also occurs.
3 USPS' Witness Rothschild acknowledges that some existing First-Class mail will migrate to
4 Standard (A) mail when converting to Mailing Online.^{27/} Because Standard (A) rates are less than
5 First-Class mail, postal revenues will also be lost from this migration.^{28/}

6 Table 4 below summarizes the USPS' lost revenues during the experiment phase of Mailing
7 Online because of the type of revenue “leakage” due to migration of mail from First-Class to
8 Standard (A).

^{27/} Tr 6/1294-1295.

^{28/} The contribution for Standard (A) Regular mail is less than First-Class mail, thus the overall contribution to cover institutional costs also decrease.

| Table 4 | | | | | |
|---|---|---------------|----------------|----------------|----------------|
| <u>Summary of Revenue Leakage Due to Migration</u> | | | | | |
| | <u>Item</u> | <u>Source</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> |
| | (1) | (2) | (3) | (4) | (5) |
| | <u>Difference in Revenue Per Piece</u> | | | | |
| 1. | First-Class | | | | |
| a. | Aggregate Revenue | ^{1/} | \$33,170 | \$63,745 | \$96,915 |
| b. | Aggregate Pieces | ^{1/} | <u>91,899</u> | <u>160,388</u> | <u>252,287</u> |
| c. | Revenue Per Piece | L1a ÷ L1b | xxx | xxx | \$0.384 |
| 2. | Standard (A) | | | | |
| a. | Aggregate Revenue | ^{1/} | \$36,784 | \$63,305 | \$100,089 |
| b. | Aggregate Pieces | ^{1/} | <u>204,263</u> | <u>356,494</u> | <u>560,757</u> |
| c. | Revenue Per Piece | L2a ÷ L2b | xxx | xxx | \$0.178 |
| 3. | Difference Between First-Class and Standard (A) -- Per Piece | L1c - L2c | xxx | xxx | \$0.206 |
| | <u>Number of Pieces Migrating</u> | | | | |
| 4. | Percent of Existing Mail of Total Mail | ^{2/} | xxx | xxx | 0.62 |
| 5. | No. of Existing Pieces in First-Class | L1b x L4 | xxx | xxx | 156,418 |
| 6. | Percent of Mail that Migrates | ^{3/} | xxx | xxx | <u>.267</u> |
| 7. | Total Pieces Migrating - millions | L5 x L6 | xxx | xxx | 41,769 |
| | <u>Revenue "Leakage"</u> | | | | |
| 8. | Revenue "Leakage" due to Migration - millions | L3 x L7 | xxx | xxx | \$8.603 |
| ^{1/} | As shown in USPS-T5-5, Exhibit D. | | | | |
| ^{2/} | MASA/USPS-T4-4. | | | | |
| ^{3/} | PB cross examination exhibit based on LR-2, PB/USPS-T4-CX-1, [(aggregate pieces developed by the study after Mailing Online by 4.086 billion, TR6/1306, divided by existing pieces developed by the study of 5.573 billion, TR6/1309) minus 1]. | | | | |

Witness Plunkett identifies an average difference in rates per piece between First-Class and Standard (A) of 20.6 cents per piece (Table 4, Line 3). Based on Witness Rothschild's data, 41.8

million pieces will migrate (Table 4, Line 7). The USPS will lose an additional \$8.6 million in revenue "leakage" due to migration (Table 4, Line 8).

Table 5 below summarizes the total revenue "leakage".

| Table 5 <u>Summary of Revenue Leakage</u> | | |
|--|-----------------|------------------------------------|
| <u>Item</u> | <u>Source</u> | <u>Amount</u> <u>(millions)</u> |
| (1) | (2) | (3) |
| 1. Revenue "Leakage" due to automation rates | Text | \$34.5 |
| 2. Revenue "Leakage" due to migration | Table 4, Line 8 | <u>8.6</u> |
| 3. Total | L1 + L2 | \$43.1 |

The total revenue leakage applicable to Mailing Online equals \$43.1 million. The issue of revenue leakage is important because the revenue lost adversely affects the contribution to institutional costs. Without some offset to the prices charged Mailing Online customers, the currently mailed portion of Mailing Online (i.e., the 62 percent) will cause a burden on institutional costs. If, as shown by Witness Plunkett, new mail enters the mailstream because of the use of Mailing Online (i.e., the 38 percent new mail calculated by USPS) then overall USPS revenues will increase. However, if the new mail volumes do not materialize, then the USPS will be financially worse off after the Mailing Online program begins.

C. INFORMATION SYSTEMS COSTS

The USPS has proposed that the information systems costs be recovered from a charge of 0.1 cents per impression based on the USPS' original calculation of information systems costs. In the

1 supplemental testimony of USPS' Witness Lim, information systems costs were increased to \$11.1
2 million for one time costs and \$11.4 million for variable costs, or a total of \$22.5 million (USPS-
3 ST-9, page 2). After the USPS' supplemental testimony on January 14, 1999, the USPS' charge
4 for variable information systems costs (0.1 cents per impression) increased to 0.21 cents per
5 impression as shown in Library Reference LR-28. In response to PB's interrogatories, USPS'
6 Witness Plunkett stated that 0.21 cents per impression "could be used" in lieu of the 0.1 cents per
7 piece (PB/USPS-T5-6).

8 Contrary to the USPS' position, the total information systems costs should be charged to
9 Mailing Online. This produces a cost of 0.41 cents per piece.^{29/} Witness Plunkett recognized that
10 the one time information systems costs should not be treated as institutional costs and that Witness
11 Seckar's cost estimates recovered the costs over the first two years of Mailing Online
12 (OCA/USPS-T5-10). Therefore, in order to recover the costs as suggested by Witness Plunkett,
13 the full 0.41 cents per impression should be charged for Mailing Online.

14 **D. MAILING ONLINE TARGET MARKET**

15 The USPS' Mailing Online service is intended to address the market for SOHO mail with less
16 than 5,000 pieces per job. The USPS has claimed that the use of digital printing for Mailing
17 Online products cannot efficiently be used for jobs over 5,000 pieces (OCA/USPS-T-1, page 9).
18 The USPS' Witness Hamm also stated that "5,000 pieces is currently typical of the upper range"
19 (MASA/USPS-T6-9). Contrary to the USPS' position, Mailing Online need not be limited to the
20 SOHO market of short runs of 5,000 pieces or less.

^{29/} \$22.5 million ÷ 5,505 million impressions (Table 1, Line 1c).

1 As noted by the USPS' Witness Hamm, "[o]ne of the keys to digital printing is the ability to
2 personalize the documents" (MASA/USPS-T6-9). The flexibility of digital printing to allow
3 customization and personalization also, according to Witness Hamm, "produces higher response
4 rates" (OCA/USPS-T6-4). Therefore, a customer could choose Mailing Online to utilize this
5 service even if alternative printing methods were less costly. Furthermore, the USPS has
6 acknowledged that the future technological improvements in digital printing occur rapidly (USPS-
7 T1, page 12). Even if the USPS is restricted to the SOHO market, the advantages of the
8 technology and future improvements may well create broader opportunities for the USPS in the
9 future. Any broadening of the market served by Mailing Online will create additional pressures
10 on competition.

11 **E. TREATMENT OF ADVERTISING COSTS**

12 The advertising for Mailing Online will be encompassed in the advertising for the USPS' Post
13 Office Online ("POL"). The USPS' advertising for POL is intended to utilize several advertising
14 media and has a sizeable budget^{30/}. POL is comprised of Mailing Online and another service
15 related to Express Mail and Priority Mail called Shipping Online.^{31/} For Mailing Online, the USPS
16 will utilize "targeted advertising in various media as well as on the internet itself"^{32/}. The USPS'
17 Witness Stirewalt also called the marketing effort "dynamic" and tied changes to the marketing
18 effort, in part, to Mailing Online (MASA/USPS-T3-2).

^{30/} The USPS' marketing plan is incorporated into Library Reference LR-16. Because this document was filed as confidential, I have not identified any specific components of the cost of advertising or the form of the advertising.

^{31/} A summary of POL is shown in Witness Wilcox's interrogatory response OCA/USPS-T7-6.

^{32/} Witness Garvey's revised response to Presiding Officer's Information Request No. 2, Question 4(c).

1 In response to an interrogatory from the Office of Consumer Advocate ("OCA"), Witness
2 Garvey claims "there will be no advertising specific only to Mailing Online..." (OCA/USPS-T1-
3 29). He claims that Mailing Online advertisements will be part of existing programs and if
4 Mailing Online did not exist, the USPS would still incur the advertising costs. For purposes of
5 allocating advertising costs, Witness Garvey's position on advertising misses the point.

6 Mailing Online will benefit from the advertising developed for POL. While no advertising
7 costs may be incremental to Mailing Online^{33/}, no reason exists for Mailing Online not to share
8 in the costs because Mailing Online benefits from the POL cost paid by the USPS.

9 The advertising for POL is designed to attract customers to use the USPS' Mailing Online and
10 Shipping Online services. A potential customer who responds to the USPS' advertisements is not
11 tied to a specific revenue level or size of the transaction that occurs (i.e., number of pieces).
12 Therefore, the advertising is designed to attract transactions and the advertising costs should be
13 allocated on that basis. A transaction would include:

- 14 1. The placing of an order with Mailing Online or Shipping Online;
- 15 2. Use of the help desk for Mailing Online and Shipping Online;
- 16 3. Use of POL website to track Shipping Online packages; and,
- 17 4. Ordering supplies.^{34/}

^{33/} Realistically, in order to design an advertisement including Mailing Online, some of the cost of the design and dissemination of the advertisement is associated with Mailing Online.

^{34/} The functions of POL are graphically shown in OCA/USPS-T7-6.

1 In order to distribute the advertising costs, the number of transactions related to the 4 items
2 discussed above should be tallied. Then, the costs distributed to Mailing Online based on its
3 percentage of the total transactions.

4 **F. IDENTIFICATION OF ATTRIBUTABLE COSTS**

5 In order to avoid burdening other mailers (or subclasses of mail) with the recovery of Mailing
6 Online costs, Mailing Online costs should recover all attributable costs applicable to this function.
7 While institutional costs are incurred by the USPS and unrelated to any type of USPS service,
8 attributable costs are those costs that are distributed to a class, subclass or special service.
9 Attributable costs for a component can, in some cases, be related to more than one class of service
10 (e.g., First-Class and Standard (A)). In R90-1, the USPS recognized that attributable costs include
11 variable costs.^{35/}

12 The USPS has recognized that approximately one-half of the information systems costs (\$11.4
13 million^{36/}) are variable costs. However, all of the information systems costs including the one time
14 costs are tied directly to Mailing Online and should be considered attributable costs. In addition,
15 the advertising costs discussed above should also be considered attributable. To treat these costs
16 otherwise would make the recovery of these costs dependent upon other USPS services or classes
17 of mail. The USPS' Witness Plunkett recognized that "the fixed informational systems costs will
18 not become institutional" (OCA/USPS-T5-52).

^{35/} R90-1, USPS-T-13, page 5.

^{36/} Witness Lim, USPS-ST-9, page 2.

1 In addition to the above, Mailing Online should also recover any specific costs incurred from
2 its operation. This includes credit card service charges which currently are not included in any
3 of the costs (or a reduction in revenues) shown by the USPS' witnesses. The USPS was asked to
4 identify the service charges that USPS will incur resulting from the credit cards utilized by SOHO
5 customers to pay for the Mailing Online jobs submitted. (PB/USPS-T1-1 and PB/USPS-T1-4).

6 USPS has stated that it will pay not more than 3% for bank card service charges.^{37/} This means
7 that based on the USPS projection of revenues for the experimental phase of \$243.4 million (Table
8 1, Line 4), the USPS will pay up to \$7.3 million for bank card service charges (\$243.4 million
9 x 3 percent). These charges, which reduce the USPS' contribution from the mark-up, should be
10 included as attributable costs for Mailing Online.

11 **G. SUMMARY**

12 In summary, the USPS' proposal for the experimental phase for Mailing Online should be
13 modified in several respects to properly reflect the revenues required and costs associated with
14 Mailing Online. These adjustments include:

- 15 1. Increasing the cost mark-up to a range of 47 percent to 60 percent;
- 16 2. Recognize the revenue leakage in postage received by USPS of \$43.1 million;
- 17 3. Recognize that the USPS is not limited to 5,000 pieces per job or solely to the targeted
18 SOHO market;
- 19 4. Increase the charge to recover information systems costs to 0.41 cents per impression;
- 20 5. Distribute advertising costs between Mailing Online and Shipping Online based on the
21 number of transactions for each service; and,

^{37/} The USPS stipulated to this maximum amount at the hearing on February 5, 1999.

- 1 6. Recognize all other appropriate attributable costs that are incurred by the USPS for
- 2 Mailing Online.

STATEMENT OF QUALIFICATIONS

My name is Roger C. Prescott, I am Executive Vice President and an economist with the economic consulting firm of L. E. Peabody & Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314.

I am a graduate of the University of Maine from which I obtained a Bachelor's degree in Economics. Since June 1978 I have been employed by L. E. Peabody & Associates, Inc.

I have previously participated in various Postal Rate Commission ("PRC") proceedings. In Docket No. R90-1, Postal Rate And Fee Changes, 1990, I developed and presented evidence to the PRC which critiqued and restated the direct testimony of the United States Postal Service ("USPS") as it related to the development of the proposed rate structure on behalf of third class business mailers. I submitted rebuttal testimony in PRC Docket No. MC95-1, Mail Classification Schedule, 1995 Classification Reform I, regarding recommendations of intervenors in response to the USPS' proposed reclassification of Third Class Bulk Rate Regular ("TCBRR") rate structure. I also submitted rebuttal testimony in Docket No. 97-1, Postal Rate and Fee Changes, 1997 regarding the development of rates for Standard (A) mail.

The firm of L. E. Peabody & Associates, Inc., specializes in solving economic, marketing and transportation problems. As an economic consultant, I have participated in the direction and organization of economic studies and prepared reports for railroads, shippers, for shipper associations and for state governments and other public bodies dealing with transportation and related economic problems. Examples of studies which I have participated in organizing and

directing include traffic, operational and cost analyses in connection with the transcontinental movement of major commodity groups. I have also been involved with analyzing multiple car movements, unit train operations, divisions of through rail rates and switching operations throughout the United States. The nature of these studies enabled me to become familiar with the operating and accounting procedures utilized by railroads in the normal course of business.

In the course of my work, I have become familiar with the various formulas employed by the Interstate Commerce Commission ("ICC") (now the Surface Transportation Board ("STB")) in the development of variable costs for common carriers with particular emphasis on the basis and use of Rail Form A and its successor, the Uniform Railroad Costing System ("URCS"). In addition, I have participated in the development and analysis of costs for various short-line railroads.

Over the course of the past twenty years, I have participated in the development of cost of service analyses for the movement of coal over the major eastern, southern and western coal-hauling railroads. I have conducted on-site studies of switching, detention and line-haul activities relating to the handling of coal. I developed the carrier's variable cost of handling various commodities, including coal, in numerous proceedings before the ICC/STB. As part of the variable cost evidence I have developed and presented to the ICC/STB, I have calculated line specific maintenance of way costs based on the Speed Factored Gross Ton ("SFGT") formula.

In October 1993, I presented the history and use of the SFGT formula at a conference attended by shippers, railroads, association members and Commission staff. The conference, titled "Maintaining Railway Track-Determining Cost and Allocating Resources," examined the methodologies used to determine maintenance of way costs over freight and passenger rail lines.

I have developed and presented evidence to the ICC/STB related to maximum rates, and "Long-Cannon" factors in several proceedings. I have also submitted evidence on numerous occasions in Ex Parte No. 290 (Sub-No. 2), Railroad Cost Recovery Procedures related to the proper determination of the Rail Cost Adjustment Factor.

In the two recent Western rail mergers, Finance Docket No. 32549, Burlington Northern, et al. -- Control and Merger -- Santa Fe Pacific Corporation, et al. and Finance Docket No. 32760, Union Pacific Corporation, et al. -- Control and Merger -- Southern Pacific Rail Corporation et al., I reviewed the railroads' applications including their supporting traffic, cost and operating data and provided detailed evidence supporting requests for conditions designed to maintain the competitive rail environment that existed before the proposed mergers.

CERTIFICATE OF SERVICE

I hereby certify that I have on this date served this document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

DATE: February 8, 1999

Ian D. Volner fw
Ian D. Volner