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Official Transcript of Proceedings

Before the

UNITED STATES POSTAL RATE COMMISSION

In the Matter of: MAILING ONLINE SERVICE

Docket No. MC98-1

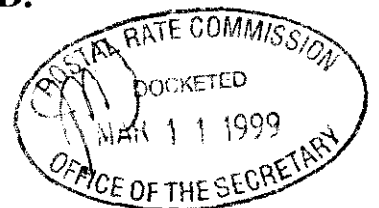
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BEFORE THE

POSTAL RATE COMMISSION

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In the Matter of: : Docket No. MC98-1.
MAILING ONLINE SERVICE :
----- X

Third Floor Hearing Room
Postal Rate Commission
1333 H Street, N.W.
Washington, D.C. 20268

Wednesday, March 10, 1999

The above matter came on for hearing, pursuant to
notice, at 9:31 a.m.

BEFORE: EDWARD J. GLEIMAN, Chairman
W. H. "TREY" LeBLANC, III, Commissioner
DANA COVINGTON, Commissioner
GEORGE OMAS, Commissioner
RUTH GOLDWAY, Commissioner



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C O N T E N T S

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2	WITNESS	DIRECT	CROSS	REDIRECT	RE CROSS
3	ROGER C. PRESCOTT				
4	BY MR. WIGGINS	2100			
5	BY MR. RUBIN		2175		

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7	DOCUMENTS TRANSCRIBED INTO THE RECORD:				PAGE
8	Direct Testimony and Exhibits of C. Scott Schuh				2049
9	Designation of Written Cross-Examination and				
10	Declaration of C. Scott Schuh				2067
11	Direct Testimony and Exhibits of Richard Jurgena				2077
12	Designation of Written Cross-Examination and				
13	Declaration of Richard Jurgena				2091
14	Direct Testimony and Exhibits of Roger C. Prescott				2102
15	Designation of Written Cross-Examination of				
16	Roger C. Prescott				2143
17	Designation of Additional Written Cross-Examination				
18	of Roger C. Prescott				2175

E X H I B I T S

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21	EXHIBITS AND/OR TESTIMONY		IDENTIFIED		RECEIVED
22	Direct Testimony and Exhibits of				
23	C. Scott Schuh		2049		2049
24	Designation of Written Cross-Examination				
25	and Declaration of C. Scott Schuh		2067		2067

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3	Direct Testimony and Exhibits of	
4	Richard Jurgena	2077 2077
5	Designation of Written Cross-Examination	
6	and Declaration of Richard Jurgena	2091 2091
7	Direct Testimony and Exhibits of	
8	Roger C. Prescott	2102 2102
9	Designation of Written Cross-Examination	
10	of Roger C. Prescott	2143 2143
11	Designation of Additional Written	
12	Cross-Examination of Roger C. Prescott	2175 2175
13		
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17		
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PROCEEDINGS

[9:31 a.m.]

COMMISSIONER LeBLANC: The hearing will come to order this morning. Before we get started, I do want to thank everybody with the inclement weather for making the effort to get here, and hope it wasn't too much of an inconvenience, but we do believe in carrying on, as they say.

The hearing will come to order this morning. Today we resume hearings in Docket No. MC98-1, considering the Postal Service's request to initiate Mailing Online service.

Originally three witnesses were scheduled to appear today. As there is no interest in cross-examination of the Mail Advertising Service Association witnesses, and I apologize on the names, I guess it's Schuh --

MR. BUSH: Perfect.

COMMISSIONER LeBLANC: S-c-h-u-h, and Jurenga -- boy, I blew that one, I'm sure.

MR. BUSH: Jurgena.

COMMISSIONER LeBLANC: Who is it?

MR. BUSH: Jurgena.

COMMISSIONER LeBLANC: Jurgena. So for you, Mr. Reporter, that's J-u-r-g-e-n-a.

The testimony of those witnesses can be entered

1 into the record using sworn statements for authenticity.
2 Considering yesterday's weather, I think it's just as well
3 that Witness Schuh did not have to fly to Washington from
4 Arkansas. However, there will be cross-examination of
5 Witness Prescott, who appears on behalf of both the Mail
6 Advertising Service Association and Pitney Bowes.

7 During the last set of hearings I announced that
8 participants could designate for incorporation into the
9 record during this round of hearings discovery responses and
10 answers to questions from the bench. One set of
11 designations has been filed, and I will enter those
12 materials into the record at tomorrow's hearing.

13 I believe, Mr. Rubin, since you will have the
14 lead, I have one additional housekeeping matter to raise
15 with you. The Postal Service has provided a report showing
16 Mailing Online usage. Have these reports been served on
17 participants?

18 MR. HOLLIES: Can I ask which reports you're
19 referring to?

20 COMMISSIONER LeBLANC: The usage ones.

21 MR. HOLLIES: The usage reports.

22 COMMISSIONER LeBLANC: Yes. Biweekly reports.

23 MR. HOLLIES: Thank you. The biweekly is the
24 label I'm looking for.

25 COMMISSIONER LeBLANC: Oh, I'm sorry. Okay.

1 MR. HOLLIES: Those are generally served on
2 participants. All of the reports have been treated by us as
3 pleadings. In addition, we filed some additional reports
4 this morning. Indeed, three of them consist of the
5 long-missing AP reports, as well as one additional weekly
6 report, I think it's AP-6, week 3. And we have some copies
7 available at our table over here, inasmuch as the small
8 table usually behind us is not present this morning.

9 COMMISSIONER LeBLANC: Okay. The weather seems to
10 have ruined a lot of things today.

11 Thank you, Mr. Hollies. But these reports have
12 been submitted to the Commission only in hard copy. It
13 strikes me that the participants and the Commission might be
14 able to use this information more readily if it could be
15 downloaded from an electronic version wired to the
16 Commission's docket room. Would it be possible to file
17 electronic versions of these reports as well?

18 MR. HOLLIES: I am not sure. We can check into
19 it. At least in some measure it exists in electronic form,
20 but the ones filed today, for example, we received via fax,
21 and it's not clear what we could do. We'll check that out
22 and we'll have an answer certainly for you by tomorrow
23 morning.

24 COMMISSIONER LeBLANC: That will be fine. Thank
25 you very much.

1 I want to apologize again for my voice this
2 morning. I've got a big frog in my throat, so I do
3 apologize again.

4 My ruling number 26 scheduled oral arguments on
5 the Office of Consumer Advocate motion to suspend the
6 procedural schedule indefinitely. After cross-examination
7 is completed tomorrow, I will allow a brief recess and
8 proceed directly to hearing arguments.

9 The Office of the Consumer Advocate will speak
10 first. Then I will ask for arguments from any participant
11 supporting the OCA motion. I will then allow the Postal
12 Service and any participants opposing the OCA motion to
13 respond. I will not -- again, I will not -- limit the time
14 for presentations. Because of the seriousness of this
15 matter, however, it is my intention to certify this issue to
16 the full Commission and allow Commissioners to ask questions
17 of counsel. The Commission will consider written and oral
18 arguments promptly, and we hope to issue a ruling
19 expeditiously.

20 Does any participant have a procedural issue to
21 raise before we begin this morning?

22 Mr. Wiggins.

23 MR. WIGGINS: It's sort of procedural, I think,
24 Mr. Presiding Officer. I served yesterday but wasn't able
25 to file until today owing to the early closing of the Docket

1 Room yesterday Mr. Prescott's answer to Interrogatory 28
2 from the Postal Service, and I have copies of that here if
3 anyone would like them.

4 COMMISSIONER LeBLANC: I'm sorry, I didn't hear
5 the last part.

6 MR. WIGGINS: I have copies of that document here
7 if anyone would like to have a hard copy of it. The Postal
8 Service has it.

9 COMMISSIONER LeBLANC: I understand. I'm looking
10 around to see if anybody raised -- okay. And that's all you
11 have then, Mr. Wiggins?

12 MR. WIGGINS: Yes.

13 COMMISSIONER LeBLANC: Does any other participant
14 have a procedural issue at this time?

15 If no participant has filed a request for
16 cross-examination of Witness Schuh and -- give me one more
17 time, Mr. Bush.

18 MR. BUSH: Schuh and Jurgena.

19 COMMISSIONER LeBLANC: Jurgena. Okay. We will
20 accept their testimony into the record at this point.

21 Mr. Bush, are you prepared to offer the direct
22 testimony and written cross-examination of Witness C. Scott
23 Schuh?

24 MR. BUSH: I am, Mr. Presiding Officer, and I have
25 a declaration from Mr. Schuh -- it is a faxed copy, because

1 we were unable to get the original here -- certifying that
2 the testimony is as he would give it if he were here today.

3 COMMISSIONER LeBLANC: Could you please provide
4 the reporter two copies of the corrected testimony and
5 exhibits of Witness C. Scott Schuh, accompanied by the
6 declaration attesting to the authenticity of that document?

7 MR. BUSH: I can.

8 COMMISSIONER LeBLANC: Please do. You have the
9 declaration with that, right, Mr. Bush?

10 MR. BUSH: Yes, I do, Mr. Presiding Officer. I
11 have handed it to the reporter.

12 COMMISSIONER LeBLANC: And you do want that
13 admitted into evidence, is that correct?

14 MR. BUSH: I would like it admitted into evidence.

15 COMMISSIONER LeBLANC: Any objections?

16 [No response.]

17 COMMISSIONER LeBLANC: So be it. Hearing no
18 objections, the testimony, as I said, and exhibits of C.
19 Scott Schuh are received into evidence and I direct that
20 they be transcribed into the record of this proceeding.

21 [Direct Testimony and Exhibits of
22 C. Scott Schuh were received into
23 evidence and transcribed into the
24 record.]

25

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MAILING ONLINE SERVICE

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

MAILING ONLINE SERVICE

Docket No. MC98-1

ERRATA FOR
REPLACEMENT DIRECT TESTIMONY
OF
C. SCOTT SCHUH

On Behalf Of
MAIL ADVERTISING SERVICE ASSOCIATION INTERNATIONAL

This is an errata to replace the cover page of Replacement Direct Testimony of C. Scott Schuh filed on February 9, 1999.

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TABLE OF CONTENTS

1
2
3
4
5
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7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
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27
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29
30
31
32

		<u>Page</u>
I.	PURPOSE OF THE TESTIMONY	2
II.	USPS AS A COMPETITOR	2
III.	THE MARKET TARGETED BY MAILING ONLINE	4
IV.	USPS'S UNFAIR COMPETITIVE ADVANTAGES	5
	A. Access to Superior Advertising and Promotional Activities	5
	B. Access to Sensitive Business Information	6
	C. Postage Rate Structure	7
	D. USPS Pricing Assumptions	8
	E. USPS Pricing Structure	8
	F. Exemption from State Sales Tax	9
V.	CONCLUSION	9

LIST OF EXHIBITS

<u>ITEM</u>	<u>TITLE</u>
(A)	USPS Mailing Online Business Partner Statistics
(B)	Lloyd Schuh Company Pricing Comparison on USPS Detailed Calculation of Costs - Example 1

1 Replacement Direct Testimony

2 Of

3 C. Scott Schuh

4 My name is Scott Schuh. I am President of the Lloyd Schuh Company, Inc.
5 ("Schuh"), a 51-year old direct mail production company founded by my father in 1948.
6 My firm offers data processing, laser printing, lettershop, and fulfillment services to our
7 clients. Our services include, among other things, the production and preparation of
8 materials for direct mail advertising and communications. The company employs 36
9 people and is headquartered in a 24,000 square foot facility in Little Rock, Arkansas.
10 Schuh is a member of Mail Advertising Service Association ("MASA").

11 I hold a B.A. in marketing from the University of Arkansas at Little Rock. I have
12 been employed at Schuh and active in the mailing services industry for 21 years. I was
13 elected to the Board of Directors of MASA in 1997, and I remain on the Board today. I
14 am also an active member of the Sales and Marketing Executives of Arkansas, the
15 state chapter of an international association of sales and marketing executives, as well
16 as the International Association of Business Communicators, an international business
17 association.

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I. Purpose of Testimony

I have become familiar with United States Postal Service ("USPS") plans to offer a new service, Mailing Online. Mailing Online will permit direct mail end users to submit data to USPS over the Internet, after which USPS contractors will produce and assemble the mailings and USPS will deliver them through the mail stream. I am extremely concerned about USPS's attempt to compete with my company and the many others like it, and I know that many MASA members share this concern. The purpose of my testimony is to describe the ways in which Mailing Online will interfere with fair competition, and the resulting effect that Mailing Online will have on private companies like mine.

II. USPS as a Competitor

For as many years as I have been in the business, we have depended on USPS to provide the essential final step necessary for us to serve our clients: the delivery of the mail. While USPS's services have been essential for us, our efforts have at the same time conferred substantial benefits on USPS.

My company provides its clients a full range of mailing and related services, from data processing and production services to delivery to USPS for placement in the mail stream. In performing those services, we act as a non-commissioned sales agent for USPS. We obtain business through the substantial efforts of five sales people and myself. We generate in excess of one million dollars annually in postage expenses for our clients through their use of stamps, metered postage, and permit accounts for their direct mail programs.

1 At Schuh, and at other companies in our business, we make every effort to
2 maintain a cooperative working relationship with USPS. Among other things, we deliver
3 mail to USPS in accordance with its requirements, we provide information USPS
4 requires for its operations, and we exchange suggestions concerning ways to improve
5 our respective operations.

6 USPS has, until recently, fully embraced this cooperative approach. It promoted
7 in recent years a "Business Partners" program through which USPS sought to enhance
8 its ability to offer services and programs to the private mailing industry, creating a
9 "partnership" of sorts between USPS and the industry. USPS employees participate
10 with lettershops, others who provide mailing services, and end users in Postal
11 Customer Councils, which are designed to facilitate communication concerning matters
12 of mutual interest. In these and other respects, USPS has recognized the value of
13 fostering a positive relationship with the companies that support it.

14 Mailing Online is a radical departure from this approach. USPS, on whom our
15 industry depends for mail delivery, now proposes to compete with us on an uneven
16 playing field that favors USPS in many respects. The mere fact that USPS is now a
17 competitor would in any other circumstance cause us to discontinue our relationship; if
18 it were possible, I would engage a different delivery service to see that our mail reaches
19 its final destination. Of course, since USPS has a monopoly, there are no other mail
20 delivery services to which we can turn.

1 Online during the two year experiment period will come from existing users of direct
2 mail. This represents a shifting of millions of dollars of revenue from mailing service
3 companies to USPS. These Mailing Online customers will be current clients of my
4 company and others that service this market. While these accounts and their mailings
5 may be "small" for USPS, they are the bread and butter of my business.

6 I have personally spoken with many mailers who share my concerns about this
7 program. I recently requested information from mailers concerning the percentage of
8 their jobs that are under 5,000 and the percentage of their total revenues that comes
9 from such jobs. I have attached as Exhibit A a summary of the responses I received,
10 from 14 mailers, together with the corresponding information for Schuh. For the group
11 as a whole, an average of 58% of their jobs accounting for 35% of their total revenue
12 are small mailings

13 **IV. USPS's Unfair Competitive Advantages**

14 In competing for these direct mail customers, USPS enjoys many competitive
15 advantages that are a direct result of its monopoly. These advantages are discussed
16 below.

17 **A. Access to Superior Advertising and Promotional Activities**

18 Because of its sheer size, USPS is able to advertise on a scale that companies
19 like mine cannot even contemplate. It runs periodic national television advertising
20 campaigns; takes out full page ads in newspapers, some of them prominent national
21 papers; sends notices to users of the mails, who are potential users of Mailing Online;
22 and conducts a variety of expensive promotional campaigns. USPS will have the ability

1 to engage in such advertising and promotional activity for Mailing Online, and to
2 incorporate promotion of Mailing Online in ads and promotions for other products.

3 It is simply impossible for my company to compete effectively with a competitor
4 who, by virtue of its national monopoly and resulting size, can advertise on such a
5 grand scale. While my company markets aggressively, it uses such means as direct
6 mail, yellow pages, trade shows and business publications. In 1998 we mailed a series
7 of eight self-promotions to 4,500 customers and prospects in Arkansas. Our target list
8 consisted of numerous small and mid-size companies we felt were either direct mail
9 users or potential users, including companies on our client database. We choose these
10 means of promotion because they are targeted and cost-effective. Our marketing
11 budget is limited, and we cannot support television, radio or newspaper advertising of
12 the sort available to USPS.

13 **B. Access to Sensitive Business Information**

14 USPS's ability to compete is further enhanced by its access to invaluable
15 competitive information. USPS knows the identity of each permit holder and collects
16 data reflecting their usage patterns, such as the type of direct mail they use, the typical
17 quantities and the frequency of use. Moreover, each time we place a mailing in the
18 mailstream using our own permit we are required to complete a form 3602, which
19 identifies the end user. With this information, USPS can assemble the same sort of
20 information for end users without permits.

21 Such information is not available to private businesses. I recently requested a
22 copy of the mailing list of my local Postal Customer Council chapter, in which I am an
23 active participant. Although this list would not have included the sort of data concerning

1 usage patterns that is available to USPS, it would nevertheless have been a valuable
2 marketing tool. The USPS representative on the Postal Customer Council, who
3 maintains a copy of this list on a USPS computer system, advised me that the list could
4 not be shared, due to headquarters directives. He further stated his belief that no
5 private customer of any Postal Customer Council across the country could receive
6 access to this list.

7 USPS appears to be increasing its efforts to maintain such information. For the
8 last few months the USPS mail acceptance clerk in our facilities has been logging the
9 name and address information of our end users in the USPS proprietary database
10 system. USPS is therefore accumulating in a readily usable form information
11 concerning the valued clients that mail on our company's postal permits. It would be a
12 simple matter for USPS to send a direct mail solicitation for Mailing Online to my
13 company's accounts offering printing and production rates as well as postage costs that
14 are below our costs.

15 **C. Postage Rate Structure**

16 The proposed charges for the postage portion of Mailing Online confer several
17 benefits to Mailing Online customers that are not available to the rest of us. USPS
18 proposes to make available to all Mailing Online customers basic presort automation
19 rates, irrespective of the size of their mailings. For all other users of the mails, there is
20 a 200 piece minimum for Standard "A" mailings and a 500 piece minimum for First
21 Class mailings to obtain such discounts.

1 **D. USPS Pricing Assumptions**

2 A significant part of the cost of any job we perform, excluding postage, is the
3 cost of the labor associated with our interaction with our client. When we receive data
4 files from a client, it is invariably necessary to interact with the client regarding problems
5 in the data, the review of proofs, and a broad range of other production and design
6 issues. The effort required for a small job is often as great as for a large job, and the
7 effect of these efforts on the cost per piece is therefore greatest for small jobs.

8 It appears to me from USPS's pricing of four typical mailings, which I discuss
9 below, that USPS has priced Mailing Online as if data will be received in a consistent
10 and highly accurate form and there will be little need for direct interaction with the
11 customer. Once again, in my experience it is entirely unrealistic to disregard the real
12 cost of providing service to the customer. Questions frequently arise concerning
13 matters ranging from layout and content to the appropriate prefixes to be used in the
14 salutation of letters. A help desk that is not directly involved in production will simply
15 not be able to address the many issues that do arise.

16 **E. USPS Pricing Structure**

17 I have reviewed USPS's sample Mailing Online prices for four examples,
18 provided in the updated response of witness Plunkett to OCA/USPS-T5-28 using
19 USPS's actual printer contract prices. Attached as Exhibit B is a spreadsheet for
20 Example 1, reflecting my company's costs per piece based on 1,000, 2,500 and 5,000
21 pieces. My company's selling costs, excluding postage, run from 50% above Mailing
22 Online on larger quantities to 250% above Mailing Online on small quantities. Mailing

1 Online pricing structure is so far below my costs, let alone my prices, that it would be
2 impossible for me to compete with USPS if prices were calculated as proposed.

3 **F. Exemption from State Sales Tax**

4 One of USPS's most obvious advantages is its exemption from state and local
5 sales taxes. In Arkansas, I am required to collect a state and county tax from my clients
6 of 6.25% of the non-labor portion of each order, which includes paper, printing and
7 direct addressing, a substantial portion of many mailing projects.

8 The mere fact that USPS is exempt from state sales tax therefore gives it what
9 would be a substantial cost advantage even if all other costs were equal. USPS plans
10 to undercut my costs in other respects, and the sales tax exemption merely
11 exacerbates an already insurmountable pricing structure.

12 **V. Conclusion**

13 My firm welcomes competition from other private sector companies facing the
14 same business challenges as we face, and seeking to make a return on investment for
15 their shareholders. If a non-monopolistic, private sector company with which I do
16 business chose to compete with me, I would have the opportunity to go elsewhere in
17 order to avoid supporting my competitor's efforts through the revenue I generate for the
18 competitor. Under USPS's current system, the efforts of my company and hundreds of
19 others like mine generate substantial revenue to feed the monopolistic services of what
20 could become our ex-partner and new competitor. Yet we have no realistic alternatives
21 to USPS to get our mail delivered.

22 The proposed Mailing Online service, if approved, threatens to drive a stake
23 through the heart of my business, and will have a similar impact on many others. The

1 service that my company and my industry provides is outstanding and the costs are fair.
2 USPS, if it becomes our competitor, will have the ability to leverage its monopoly on
3 mail service into many unfair competitive advantages. It will exacerbate the problem by
4 pricing its service at a level that does not take into account all of the costs it will incur,
5 shifting those costs to other customers. The inevitable result will be that my company
6 and many others will lose significant portions of our business to USPS, which until now
7 we viewed as our business "partner" rather than our business "predator." The mailing
8 industry will be dramatically effected and business relationships shattered if Mailing
9 Online is allowed to go forward.

DECLARATION

I, C. Scott Schuh, declare under penalty of perjury that foregoing testimony is true and correct, to the best of my knowledge, information and belief.

Dated: 2/6/99

C. Scott Schuh

CERTIFICATE OF SERVICE

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The undersigned hereby certifies that the foregoing Replacement Direct

4

Testimony of C. Scott Schuh was served upon all participants of record in this

5

proceeding in accordance with Section 12 of the Rules of Practice and POR No. MC98-

6

1/4 this 9th day of February, 1999.

7

8



9

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Normal L. Eisen

USPS MAILING ONLINE BUSINESS PARTNER STATISTICS

COMPANY NAME	STATE	% JOBS UNDER 5,000	% TOTAL REVENUE
Colorado Data Mail	CO	52%	23%
Mailmedia, Inc.	WA	59%	24%
The Mail Room	CO	0-40%	15-20%
Publisher's Mail Service, Inc.	WI	45%	16.5%
Lone Oak Mailing Services ¹	MN	80%	65%
First Class Direct, Inc.	CO	80%	35%
Quality Letter Service, Inc.	NY	70%	45%
Mailtech Enterprises, Inc.	IL	12%	2%
K/P Corporation	CA	N/R	20-25%
The Lloyd Schuh Company	AR	60%	30%
Confidential ²	CA	74%	35%
Advertising Mail Corporation	TX	42%	34%
Post Haste Mailing Services	CA	79%	35%
Burke's Mail Service	NE	100%	100%
Hopkins Mailing Services	IL	24%	N/R
Average Percentages		58%	35%

¹ This respondent's provided the percentage of its jobs that are under 6,000 pieces.

² One respondent asked that its name be kept confidential if possible. If necessary, its name can be provided to the Commission

Lloyd Schuh Company Pricing Comparison on USPS Detailed Calculation of Costs for Exhibit A - Example 1
 2 Page, 8.5x11, Simplex, Black & White, First-Class

	A	B	C	D	E	F	G	H	I	J
Impression Costs	\$ 0.0398	\$ 0.0094	\$ 0.0150	\$ 0.0336	\$ 0.0016	\$ 0.0992	\$ 0.0248	\$ 0.1240	\$ 0.2700	\$ 0.3940
Paper Costs	\$ 0.0870	\$ 0.0300	\$ 0.0250	\$ 0.0790	\$ 0.0965	\$ 0.3175	N/A	\$ 0.3175	\$ 0.2700	\$ 0.5875
Envelope Costs	\$ 0.0210	\$ 0.0250	\$ 0.0210	\$ 0.0580	\$ 0.0670	\$ 0.2350	N/A	\$ 0.2350	\$ 0.2700	\$ 0.5050
Folding & Insertion	\$ 0.0510	\$ 0.0190	\$ 0.0510	\$ 0.0510	\$ 0.0570	\$ 0.2050	N/A	\$ 0.2050	\$ 0.2700	\$ 0.4750
Information Systems										
Subtotal										
Contribution										
Fee										
Postage										
Total Postage & Fee										

Percent LSC Fee higher than USPS Fee (H) for 1,000 mailing 256%
 Percent LSC Fee higher than USPS Fee (H) for 2,500 mailing 190%
 Percent LSC Fee higher than USPS Fee (H) for 5,000 mailing 165%

Production notations:

- * Print two 8.5 x 11 sheets black ink one side on 20# white stock
- * Provide #10 white non-window stock with no print copy
- * Load client file from email, standardize, & postal code
- * Presort client file for lowest possible automation rates
- * Fold each 8.5 x 11 sheet to letterize (tri-fold)
- * Insert into #10 envelope, seal (assumes permit indicia pre-printed)
- * Inkjet address #10 envelope and prepare for USPS entry

Cost assumptions

- * Presort rate assumes 100% postal qualification and no residual mail pieces
- * Assumes high speed inkjet addressing service
- * Assumes letter copy above is generic with no in-letter personalization or variables
- * Information Systems above include customer file preparation and inkjet address output

MAR 9 '99 15:15 FROM 4103320444 TO ZUCK-6TH
03/09/99 12:33 THE LLOYD SCHUH COMPANY, INC. + 14106590436401
MAR 9 '99 14:32 FROM 4103320444 TO 15013726570

PAGE.002/003
PAGE.004/005

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0061

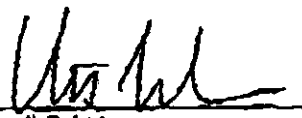
MAILING ONLINE SERVICE

Docket No. MC98-1

DECLARATION OF C. SCOTT SCHUH
REGARDING TESTIMONY

I, C. Scott Schuh, declare under penalty of perjury that the testimony attached as Exhibit A (NASA-T-1) is a copy of my direct testimony, and that it was prepared by me or under my direction and control. If I were to testify orally before the Postal Rate Commission, my testimony would be the same. There are no errors or errata in my testimony.

Date: 3/9/99


C. Scott Schuh

1 COMMISSIONER LeBLANC: Mr. Bush, do you have a
2 declaration applicable to the designated written cross
3 examination of Witness Schuh?

4 MR. BUSH: Yes, I do, Mr. Presiding Officer.

5 COMMISSIONER LeBLANC: Could you hand the reporter
6 two copies of the corrected written cross examination of
7 Witness Schuh and I direct that it be transcribed at this
8 point along with the applicable declaration and that it be
9 received into evidence.

10 THE REPORTER: And copied in?

11 COMMISSIONER LeBLANC: Yes, please.

12 [Designation of Written
13 Cross-Examination and Declaration
14 of C. Scott Schuh were received
15 into evidence and transcribed into
16 the record.]

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Mailing Online Service

Docket No. MC98-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL
WITNESS C. SCOTT SCHUH
(MASA-T1)

Party

Office of the Consumer Advocate

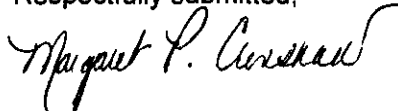
United States Postal Service

Interrogatories

USPS/MASA-T1-1-5

USPS/MASA-T1-6

Respectfully submitted,



Margaret P. Crenshaw
Secretary

INTERROGATORY RESPONSES OF
MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL
WITNESS C. SCOTT SCHUH (T1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory:

USPS/MASA-T1-1
USPS/MASA-T1-2
USPS/MASA-T1-3
USPS/MASA-T1-4
USPS/MASA-T1-5
USPS/MASA-T1-6

Designating Parties:

OCA
OCA
OCA
OCA
OCA
USPS

**RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL WITNESS SCHUH TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/MASA-T1-1. Do your company's capabilities include varying each copy of a document to contained [sic] personalized information (e.g., mail merge)?

USPS/MASA-T1-1 Response:

Yes.

USPS/MASA-T1-2. Please refer to your discussion at page 3 of your testimony concerning your company's relationship with the Postal Service.

- (a) Please cite specific examples of any change you feel has taken place.**
- (b) Please specifically address whether the Postal Service has stopped or curtailed its efforts you mention, including the "Business Partners" program and participation in Postal Customer Councils.**

USPS/MASA-T1-2 Response:

(a) Mailing Online is not yet available in my area. Nevertheless, there have been a number of developments, which may be a result of Mailing Online or may simply reflect the Postal Service's changing attitude, that show the Postal Service's increasing willingness to compete rather than cooperate with our industry. As I described at page 7 of my testimony, USPS is now logging information concerning actual end users who mail Standard A mail under my company's mailing permit. To my knowledge, this has never been done before. In addition, I was not given access to the Postal Customer Council chapter mailing list recently, although I had been given access to this list the year before. I am also aware of the Postal Service's welcome kit program, as part of which the Postal Service, through a contractor, sells advertising and uses a mailing list that is not available to private companies. On my end, as a result of the possible implementation and expansion of Mailing Online, I find it necessary to consider more carefully and to be more guarded in responding to USPS requests for information in light of the potential competitive use of the information.

(b) See response to part (a). In addition, it appears that USPS has either stopped or reduced its support of the Business Partners program, at least in my area. There used to be a directory published by USPS of participants in the program, and USPS actively promoted the program. During the period USPS has been developing Mailing Online, I have not seen a directory or any Business Partners promotion of any kind in the area I serve. I am not aware of any activity during the past year in connection with the Business Partners program.

USPS/MASA-T1-3. Does your company prepare materials for its customers that are disseminated other than by the Postal Service?

USPS/MASA-T1-3 Response:

Yes, for a few clients. We do not disseminate materials by carriers other than USPS if they can be sent using First Class or Standard A mail.

USPS/MASA-T1-4. On page 4 of your testimony you refer to the "basic production criteria" for Mailing Online. Please define specifically what you mean by these criteria and explain whether they include digital printing and desktop software for document production.

USPS/MASA-T1-4 Response:

My reference to "jobs of 5,000 pieces or fewer that met the basic production criteria for the Mailing Online program" was intended to refer to all mailings of the specified number of pieces that could have been prepared through Mailing Online. I did not mean to limit such mailings to those that were prepared using digital printing or desktop software, but rather to mailings that could have been prepared by Mailing Online using its production capabilities.

USPS/MASA-T1-5. You state that the 62 percent of Mailing Online volume that is estimated to come from existing users of direct mail will come from "current clients of my company and others that service this market."

- (a) On what basis do you believe that the mailers of this 62 percent are current clients of your company and similar companies?
- (b) Please refer to the testimony of witnesses Wilcox and Campanelli, filed on behalf of the Postal Service, where they indicate that before Mailing Online, they prepared and mailed direct mailings themselves. How do you reconcile their testimony with your statement that direct mailing which migrates to Mailing Online will come from your company or similar companies?

USPS/MASA-T1-5 Response:

- (a) I do not believe that the entire portion of Mailing Online that comes from existing users of direct mail will come from current clients of my company and similar companies. This business will come from current and potential clients of my company and other similar companies.
- (b) These witnesses are perfect prospects for companies like mine. The services they were performing for themselves are some of the very services that we perform for our clients.

USPS/MASA-T1-6. Please refer to your testimony at page 5, regarding the information you solicited from other firms concerning the percentage of their jobs that are less than 5,000 pieces.

- (a) Are all of these pieces mailed? If not, what percentage is mailed?**
- (b) Do you project that all of this volume will shift to Mailing Online? If not, what percentage do you believe will shift and what is the basis for your estimate?**
- (c) Do you believe volume will shift to Mailing Online in cases where the basic automation postage rate charged by Mailing Online is higher than the deeper discounts available to you and your customers? How does this affect your estimate provided in part (b) above?**

USPS/MASA-T1-6 RESPONSE:

- (a) Yes.**
- (b) No. I have not attempted to project the percentage of this volume that will shift to Mailing Online, but I believe that if the program is effectively promoted and operated, the percentage will be significant.**
- (c) I do not believe that any postage savings I might be able to offer customers in some cases will affect the volume shift to Mailing Online. Any savings I might conceivably be able to obtain in postage rates through deeper discounts will be exceeded by the substantially lower fees charged by USPS.**

MAR 9 '99 15:15 FROM 4103320444 TO ZUCK-6TH
03/09/99 12:33 THE LLOYD SCHUH COMPANY, INC. → 14106590436401
MAR 9 '99 14:33 FROM 4103320444 TO 15013726570

PAGE. 003/003
PAGE. 005/005

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

MAILING ONLINE SERVICE

Docket No. M098-1

DECLARATION OF C. SCOTT SCHUH
REGARDING INTERROGATORY ANSWERS

I, C. Scott Schuh, declare under penalty of perjury that the Response Of Mail Advertising Service Association International Witness Schuh to Interrogatories Of the United States Postal Service (USPS/MASA-T1-1-6), attached as Exhibit A, is a copy of my answers to interrogatories, and that it was prepared by me or under my direction and control. If I were to testify orally before the Postal Rate Commission, my answers to these interrogatories would be the same. There are no errors or errata in my interrogatory answers.

Date: 3/9/99


C. Scott Schuh

MAR 9 '99 14:37

5013726570 ** TOTAL PAGE. 003 **
PAGE. 003

** TOTAL PAGE. 003 **

1 COMMISSIONER LeBLANC: Mr. Bush, are you also
2 prepared to offer the direct testimony and written cross
3 examination of Witness Richard -- here it goes again -- I am
4 going to learn it --

5 MR. BUSH: Jurgena.

6 COMMISSIONER LeBLANC: Jurgena. Okay.

7 MR. BUSH: Yes, I am, Mr. Presiding Officer.

8 COMMISSIONER LeBLANC: Can you provide the
9 reporter with two copies, as we talked about earlier, of the
10 corrected testimony and exhibits of the witness accompanied
11 by the declaration attesting to the authenticity of the
12 document?

13 MR. BUSH: Yes, I have, Mr. Presiding Officer.

14 COMMISSIONER LeBLANC: And again you do want this
15 into evidence, is that correct?

16 MR. BUSH: I would ask that this be accepted into
17 evidence, Mr. Presiding Officer.

18 COMMISSIONER LeBLANC: Any objections?

19 [No response.]

20 COMMISSIONER LeBLANC: Hearing none, the testimony
21 and exhibits of the witness are received into evidence and I
22 direct that they be transcribed into the record of this
23 proceeding.

24 [Direct Testimony and Exhibits of
25 Richard Jurgena was received into



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evidence and transcribed into the
record.]

Feb 11 3 11 PM '99

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

MAILING ONLINE SERVICE

Docket No. MC98-1

**ERRATA FOR
REPLACEMENT DIRECT TESTIMONY
OF
RICHARD JURGENA**

**On Behalf Of
MAIL ADVERTISING SERVICE ASSOCIATION INTERNATIONAL**

This is an errata to replace the cover page of Replacement Direct Testimony of Richard Jurgena filed on February 9, 1999.

Communications with respect to this document may be sent to:

Graeme W. Bush
Martin S. Himeles, Jr.
Zuckerman, Spaeder, Goldstein,
Taylor & Kolker, L.L.P.
1201 Connecticut Avenue, N.W.
Washington, D.C. 20036
202/778-1801

Counsel for Mail Advertising Service
Association International

Due Date: February 11, 1999



TABLE OF CONTENTS

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21

	<u>Page</u>
I. PURPOSE OF THE TESTIMONY	2
II. THE IMPORTANCE OF MAILING ONLINE'S TARGET MARKET TO MY COMPANY	2
III. USPS'S COMPETITIVE ADVANTAGES	3
A. Postage Costs	3
B. Advertising	4
C. Customer Support	5
D. The Importance of Smaller Mailings	6
E. The Loss of Business Referred by USPS	6
F. Potential Damage to the Industry if Mailing Online Fails	7
IV. CONCLUSION	8

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
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19
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Replacement Direct Testimony

Of

Richard L. Jurgena

My name is Richard L. Jurgena. I am President and owner of Mail Advertising Services, Inc. ("Mail Advertising") in Rockville, Maryland. Mail Advertising is a direct mail production company that offers services including maintenance of mailing lists, conversion of lists from multiple formats, personalization of letters, labeling of envelopes and other mail-related functions. We do not provide printing services, as many of our best customers are printers. The company has 15 full-time and 6 or 7 part-time employees. We have a 13,000 square foot plant at our headquarters in Rockville and a 5,000 square foot plant in Frederick, Maryland. Our annual sales are approximately \$900,000.

I have been in the direct mail business since 1970, when I became an employee of Mail Advertising. I purchased the company in 1976, and have been its President since then. In addition to having spent the past 29 years in the business, I am active in Mail Advertising Service Association ("MASA"), and Mail Advertising is a member of MASA. I served on the MASA Board of Directors from 1990 through 1994. Mail Advertising also belongs to the Direct Marketing Association of Washington and the Chambers of Commerce of Montgomery and Frederick Counties, Maryland.

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I. Purpose of Testimony

Over the years, I have regularly followed developments in the industry that may affect my company, including in particular developments in products and services offered by the United States Postal Service ("USPS"). I have followed USPS's recent attempts to introduce a new Mailing Online service, and this service is of great concern to me. The purpose of my testimony is to describe the impact Mailing Online will have on my business and the unfairness of USPS's proposal to compete with us.

II. The Importance of Mailing Online's Target Market to My Company

I understand that Mailing Online is intended to target relatively small mailings of 5,000 or fewer pieces. The nature of Mail Advertising's business is such that mailings of that approximate size are critical to our business.

The average size of our jobs is approximately 7,000 to 8,000 pieces. In a typical year, approximately 65 percent of our jobs are under 5,000 pieces. We recently completed a 329 piece job for a large and important customer. The potential loss of such jobs would be of considerable concern, both because we would lose the revenue from those jobs and because our relationships with customers who provide us substantial other business would be jeopardized.

What is of even greater concern to me is that we frequently handle larger jobs that are by design split into multiple jobs of fewer than 5,000 pieces to test different approaches or to time solicitations in accordance with events occurring at different times in different areas. A job we just completed is a good example. Microsoft hired us to produce a 50,000 piece mailing consisting of five drops over a period of 45 days. Each drop was split into two parts, one sent in the form of an envelope and letter and

1 the other delivered in the form of a self-mailer, in order to compare these different forms
2 of mailing. Thus, although one might describe the job as a 50,000 piece job, it actually
3 consisted of 10 mailings totaling 50,000 pieces. Jobs of this sort are a large part of our
4 business. I would estimate that approximately 30 percent of our revenues come from
5 jobs that are either under 5,000 pieces or divided into mailings under 5,000 pieces.

6 **III. USPS's Competitive Advantages**

7 **A. Postage Costs**

8 First and foremost among USPS's advantages in competing with Mail
9 Advertising is the preferential pricing it will provide to its own Mailing Online customers.
10 The Postal Service requires 200 pieces in a mailing in order to provide an automation
11 discount. USPS, on the other hand, proposes to give all of its Mailing Online customers
12 automation discounts, no matter how small their mailings. The effect of this pricing
13 structure will be to provide Mailing Online customers less expensive postage rates for
14 all mailings under these quantities.

15 The only reason USPS can give itself, but not others, preferential pricing is
16 because it has no competition in the delivery of the mail. It sets the rates, subject to
17 regulatory approval, and the effect of Mailing Online, if it is permitted, will be to give
18 lower rates to users of Mailing Online than to others who use mail service firms.
19 Because there is no alternative means of mail delivery, we will have no choice but to
20 attempt to compete with Mailing Online notwithstanding the higher postage costs we will
21 incur.

22 I believe that this lower postage rate alone will be sufficient to cause us to lose a
23 significant portion of our business. Many of our customers for mailings that are under

1 5,000 pieces are large and sophisticated corporations. While USPS says that it is
2 attempting to target small offices and home offices, these large corporations often send
3 small mailings, and they have sufficient sophistication and technical ability to provide
4 their mailings directly to USPS electronically without difficulty. If USPS will accept their
5 mail directly at lower postage rates than are available if we produce their mail, it will be
6 difficult for us to persuade them to continue using our services.

7 **B. Advertising**

8 USPS's ability to advertise on a large scale is yet another advantage it has. My
9 company advertises by sending newsletters that include inserts promoting our services
10 to our current customers and prospects. We do not have the resources to run ads on
11 national television, or even on local television, or to advertise extensively in the print
12 media. Our funds are limited, and we rely on targeted direct mail advertising of the sort
13 we provide our customers. While I believe that this form of advertising is the most cost-
14 effective, its reach is limited to prospects we are able to identify.

15 USPS has immeasurably greater resources than we do, and it has the additional
16 advantage of being able to promote Mailing Online in tandem with other products at no
17 incremental cost. Mailing Online will be a new service for USPS, and it can only
18 succeed if potential customers become aware of it. USPS's ability to advertise
19 extensively, which is a result of its monopoly over the delivery of mail and its resulting
20 size and other advertising needs, will permit it to create the visibility that is essential to
21 the success of Mailing Online.

1 **C. Customer Support**

2 Mailing Online is designed on the premise that most of the interaction between
3 USPS and the customer can occur over the Internet. From my experience in the
4 industry, I believe that far more customer interaction will be necessary than USPS
5 seems to believe. It is not practical for a customer to submit data over the Internet,
6 USPS to distribute it to the appropriate contract printers, and the printers to print the
7 mailings and address labels, prepare them for mailing, and deliver them to a BMC, all
8 with little or no direct interaction. Address lists invariably include addresses with cities
9 that do not match states, zip codes that are wrong, and other such problems. Our
10 typical practice is to identify bad addresses using USPS-approved software and notify
11 the customer that these items can only be mailed first class and probably will not be
12 delivered. It is also frequently necessary to communicate with the customer about other
13 matters, such as whether the addresses are upper or lower case, the use of prefixes,
14 and other questions and problems that arise. The need for such guidance will be
15 particularly acute in Mailing Online if, as USPS projects, the users are in large part
16 small offices and home offices that have not used direct mail previously.

17 Particularly in light of the projected prices for Mailing Online, I believe USPS has
18 underestimated these costs associated with Mailing Online. While USPS may well be
19 able to adapt to needs that exceed its expectations, it will incur additional costs that are
20 not reflected in its prices. Its proposed prices are unfairly low, and will make it
21 impossible for us to compete with Mailing Online.

1 **D. The Importance of Small Mailings**

2 USPS minimizes the significance of mailings under 5,000 pieces. I can state
3 unequivocally that such mailings are not insignificant to my company. We rely on them,
4 and if we were to lose them the consequences would be severe. Only in the context of
5 an entity the size of USPS are such mailings of minimal significance -- and if that is truly
6 the case, I do not understand why USPS insists on proceeding with Mailing Online.

7 **E. The Loss of Business Referred by USPS**

8 Yet another casualty of Mailing Online will be a stark change in our relationship
9 with USPS, and with that change a corresponding loss of business. USPS has in
10 recent years presented itself as a partner of the direct mail industry. Every year USPS
11 holds a course to teach members of the industry about various aspects of its products
12 and pricing. I have attended these courses for each of the last three years. On each
13 occasion USPS has made an effort to provide information that facilitates our ability to
14 carry out our business, and we have in turn attempted to work with USPS. Likewise, I
15 have readily provided to USPS information concerning my customers, including
16 telephone numbers that lead directly to the contacts for direct mail advertising, although
17 I would never make a customer list available to a competitor.

18 The competition with USPS that will accompany Mailing Online can only interfere
19 with this relationship. We will no longer be willing to provide to USPS information that
20 will allow it to construct our customer list, and we will have to make every effort to limit
21 the information we provide, to the extent we can do so without preventing delivery of
22 the mail. I am concerned about USPS's competitive use of the information we have

1 already provided. More generally, our cooperative relationship with USPS can only
2 deteriorate when they begin to take business from us.

3 In addition, because USPS is the only provider of mail delivery service, it
4 receives inquiries from potential clients who want to send direct mailings in a particular
5 area. In Maryland, USPS has responded to these inquiries by providing a list of its
6 "business partners" in the area -- companies like mine, which have worked together
7 with USPS to further our mutual interests. These referrals have been a source of
8 considerable business over the years. Just as USPS does not send Express Mail
9 customers to Federal Express, it is inevitable that, once Mailing Online is available,
10 USPS will respond to inquiries by referring potential customers to Mailing Online. It is
11 only because of its monopoly on mail delivery that USPS receives these inquiries in the
12 first instance, and Mailing Online will cost us the business associated with them.

13 **F. Potential Damage to the Industry if Mailing Online Fails**

14 I have discussed above my concerns about the impact on our business if Mailing
15 Online is successful. It is also possible that, notwithstanding USPS's enormous
16 advantages, it will be unable to provide even a minimally acceptable level of service,
17 and Mailing Online will be unable to retain customers. The failure of Mailing Online
18 would also cause serious damage to the industry.

19 We are constantly attempting to protect the image and reputation of the industry,
20 and to educate our customers and potential customers about the value of direct mail as
21 compared with other methods of advertising. Some of the customers of Mailing Online
22 will be using direct mail for the first time; others will be prior users, but in some
23 instances they too will be relatively new to direct mail. If Mailing Online is unable to

1 provide the quality of service that the private sector provides, these potential customers
2 -- who might otherwise have contacted my company or another like it for their first direct
3 mailing -- may well conclude that other advertising methods are superior to direct mail.
4 I have no doubt that Mailing Online will attract significant numbers of my customers and
5 potential customers. If Mailing Online is successful, it will retain those customers; if it
6 fails, they may be lost forever to direct mailing.

7 **IV. Conclusion**

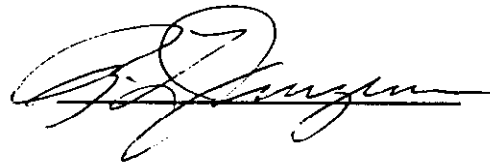
8 USPS does well for all of us when it provides economical and efficient mail
9 delivery services. I rely on those services every day in my business, and I do
10 everything I can to facilitate USPS's efforts.

11 At the same time, USPS's position as the sole provider of such services confer
12 on it enormous competitive advantages in other areas. If USPS is permitted to become
13 my competitor rather than my partner, I have grave concerns about the impact on my
14 business. I respectfully submit that the USPS's proposed Mailing Online program will
15 spell the end of fair competition in the direct mail business.

DECLARATION

I, Richard Jurgena, declare under penalty of perjury that foregoing testimony is true and correct, to the best of my knowledge, information and belief.

Dated: 2/8/99



A handwritten signature in cursive script, appearing to read "Richard Jurgena", written over a horizontal line.

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

MAILING ONLINE SERVICE

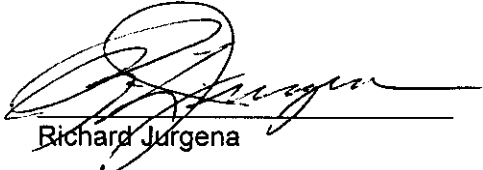
Docket No. MC98-1

DECLARATION OF RICHARD JURGENA
REGARDING TESTIMONY

I, Richard Jurgena, declare under penalty of perjury that the testimony attached as Exhibit A (MASA-T-2) is a copy of my direct testimony, and that it was prepared by me or under my direction and control. If I were to testify orally before the Postal Rate Commission, my testimony would be the same. There are no errors or errata in my testimony.

Date:

March 8, 1999


Richard Jurgena

1 COMMISSIONER LeBLANC: Do you have a declaration
2 also applicable to the designated written cross examination
3 of the witness, Mr. Bush.

4 MR. BUSH: Yes, I do, Mr. Presiding Officer.

5 COMMISSIONER LeBLANC: Could you please hand the
6 reporter two copies of the corrected written cross
7 examination of Witness Jurgena and I direct that it be
8 transcribed at this point along with the applicable
9 declaration and that it be received into evidence.

10 [Designation of Written
11 Cross-Examination and Declaration
12 of Richard Jurgena were received
13 into evidence and transcribed into
14 the record.]

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Mailing Online Service

Docket No. MC98-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL
WITNESS RICHARD JURGENA
(MASA-T2)

Party

Office of the Consumer Advocate

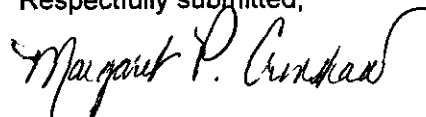
United States Postal Service

Interrogatories

USPS/MASA-T2-1, 5

USPS/MASA-T2-2-4

Respectfully submitted,



Margaret P. Crenshaw
Secretary

INTERROGATORY RESPONSES OF
MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL
WITNESS RICHARD JURGENA (T2)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory:

USPS/MASA-T2-1
USPS/MASA-T2-2
USPS/MASA-T2-3
USPS/MASA-T2-4
USPS/MASA-T2-5

Designating Parties:

OCA
USPS
USPS
USPS
OCA

**ERRATA
RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL WITNESS JURGENA TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/MASA-T2-1. Please refer to your testimony at page 2, where you state that your firm "recently completed a 329 piece job for a large and important customer." Please describe in detail the nature of that job, including, but not limited to: the size of the pieces; the nature of the pieces, including the use of color and the paper or stock type; the type of printing or other process used to produce the pieces; and the specific work your firm performed.

USPS/MASA-T2-1 Response:

The nature of this particular job for this customer was the printing and mailing of 329 personalized letters. Specifically, we printed personalized letters in black on 8 1/2 by 11 inch white customer-provided letterhead. The letterhead contained the customer's logo and typical letterhead information printed in black. The customer provided an electronic copy of an address list, as well as a faxed copy of the list with annotations by hand to indicate to which of the addresses on the list the letter should be mailed. Our employees then sorted the selected addresses alphabetically by company and split them in half. The letters were printed on a laser printer and half of the addresses were printed by inkjet printer in black ink on white envelopes that matched the customer's letterhead. The corresponding letters were inserted in these envelopes and the envelopes were sealed and sent by First Class Mail. For the other half of the addresses, we prepared UPS shipping documents using the customer's account and sent the letters in UPS second day air letter packs. On approximately four subsequent occasions, the customer sent by e-mail several additional addresses to which we sent personalized letters.

USPS/MASA-T2-2. What percentage of your customers' mailpieces pay single-piece rates?

USPS/MASA-T2-2 Response:

I do not know the precise percentage of our customers' mailpieces that pay single-piece rates. I believe the percentage is less than fifty percent but not insignificant.

USPS/MASA-T2-3. Are any of your customers' mailpieces entered at discounted postage rates? If so, what discount levels are used and what proportion of pieces your firm prepares are entered at each discount rate? If not, at what rates is your customers' mail entered?

USPS/MASA-T2-3 Response:

Some of our customers' mailpieces are entered at discounted postage rates. The discount levels range from the single piece basic rates (i.e., no discount) to carrier route/DDU, and include all or most discounted rates in between. I do not know the proportion of the pieces we prepare that are entered at each discount rate.

USPS/MASA-T2-4. Would you, or your customers, be willing to forego possible higher discounts for which your mailings might qualify if entered into the mail in the traditional way, in return to access to the mail categories (including waiver of the volume minimums) now applicable to Mailing Online?

USPS/MASA-T2-4 Response:

The portion of the question beginning with "in return" is ambiguous; I assume that you intend to ask whether my company or my customers would be willing to forego possible higher discounts in order to use Mailing Online. I believe that some of my customers would be willing to forego possible higher discounts to use Mailing Online. My company would not use Mailing Online as long as it is in direct competition with us.

USPS/MASA-T2-5. At page 4 you state that many of your customers are large corporations that "often send small mailings, and they have sufficient sophistication and technical ability to provide their mailings directly to USPS electronically without difficulty." Do these customers' mailpieces typically qualify for discounts deeper than automation basic? If so, would such customers be prepared to forgo the deeper discounts for which they generally qualify to use Mailing Online?

USPS/MASA-T2-5 Response:

The quoted testimony at page 4 referred to many of our customers "for mailings that are under 5,000 pieces." These customers' mailings that are under 5,000 pieces occasionally, but infrequently, qualify for discounts deeper than automation basic. I believe that some of my customers would forego deeper discounts, in the infrequent instances when they are available, to use Mailing Online.

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

MAILING ONLINE SERVICE

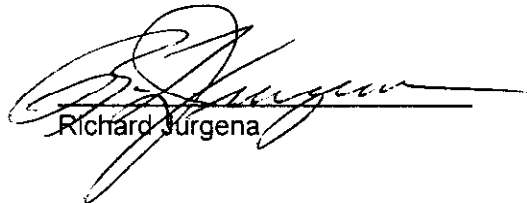
Docket No. MC98-1

DECLARATION OF RICHARD JURGENA
REGARDING INTERROGATORY ANSWERS

I, Richard Jurgena, declare under penalty of perjury that the Response Of Mail Advertising Service Association International Witness Jurgena to Interrogatories Of the United States Postal Service (USPS/MASA-T2-1-8), attached as Exhibit A, is a copy of my answers to interrogatories, and that it was prepared by me or under my direction and control. If I were to testify orally before the Postal Rate Commission, my answers to these interrogatories would be the same. There are no errors or errata in my interrogatory answers.

Date:

March 8, 1999


Richard Jurgena

1 COMMISSIONER LeBLANC: Mr. Bush, will you
2 identify, or I guess it will be Mr. Wiggins this time, your
3 witness so that we can swear him in, please.

4 MR. WIGGINS: Pitney Bowes, which I represent, and
5 the Mail Advertising Service Association International,
6 represented by Mr. Bush and Mr. Himeles, call Roger C.
7 Prescott.

8 MR. BUSH: Mr. Prescott, could you stand and raise
9 your right hand, please.

10 Whereupon,

11 ROGER C. PRESCOTT,
12 a witness, was called for examination by counsel on behalf
13 of Pitney Bowes and the Mail Advertising Service Association
14 International, and having been first duly sworn, was
15 examined and testified as follows:

16 COMMISSIONER LeBLANC: Will you proceed.

17 DIRECT EXAMINATION

18 BY MR. WIGGINS:

19 Q Mr. Prescott, do you have in front of you a
20 document that has been marked as MASA/PB-T-1, which is
21 captioned, "Direct Testimony of Roger C. Prescott"?

22 A Yes, I do.

23 Q Was that document prepared by you or under your
24 supervision?

25 A Yes, it was.

1 Q Do you care to make any corrections to it?

2 A There are four typographical changes to the
3 testimony.

4 Q Would you note those for the record, please?

5 A At page 8 of my testimony in Table 1, line 2 of
6 Table 1 states "aggregate costs, Footnote 2" -- that should
7 be "aggregate costs, Footnote 3".

8 Also in Table 1 in Footnote 3 to Table 1 on the
9 second line, there is a sentence that starts, "Cost for all
10 years exclude" -- that should be "Cost for all years
11 include".

12 Next, on page 30 on line 9 of page 30 next to
13 Footnote 29 the word "piece" should be changed to
14 "impression".

15 Last, on page 31, line 17, the beginning of the
16 line starts, "Witness Stirwalt" -- that should be "Witness
17 Garvey".

18 Q And that is the extent of your corrections?

19 A Yes, sir.

20 Q With those corrections, Roger, do you adopt this
21 document as your sworn testimony in this proceeding?

22 A Yes, I do.

23 MR. WIGGINS: Mr. Presiding Officer, I have
24 provided the reporter with two copies of the document with
25 the corrections that have been noted by Mr. Prescott, and I

1 would ask that it be transcribed into the record and
2 admitted into evidence as Mr. Prescott's testimony in this
3 proceeding.

4 COMMISSIONER LeBLANC: Are there any objections?

5 [No response.]

6 COMMISSIONER LeBLANC: Hearing none, Mr.

7 Prescott's testimony and exhibits are received into evidence
8 and I direct that they be transcribed into the record at
9 this point.

10 [Direct Testimony and Exhibits of
11 Roger C. Prescott was received into
12 evidence and transcribed into the
13 record.]

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MASA/PB-T-1

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

MAILING ONLINE SERVICE

Docket No. MC98-1

DIRECT TESTIMONY
OF
ROGER C. PRESCOTT
Executive Vice President
L. E. Peabody & Associates, Inc.

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

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Due Date: February 8, 1999

TABLE OF CONTENTS

	<u>Page</u>
I. PURPOSE OF THE TESTIMONY	2
II. IDENTIFICATION OF MASA AND PB	4
III. SUMMARY AND CONCLUSIONS	5
IV. USPS' ESTIMATES OF THE MAILING ONLINE BUSINESS	7
V. COMPETITIVE IMPACTS OF VERTICAL INTEGRATION	11
A. Definition of Vertical Integration	11
B. Problems with Vertical Integration	13
1. Advantages for the USPS	14
2. Advantages for the USPS Selected Printers	16
C. Past PRC Treatment of USPS' Integration with Competitive Services	16
D. Conclusion	18
VI. ISSUES ON RATES AND COSTS FOR MAILING ONLINE	19
A. Revised Cost Mark-Up	19
1. Precedent for Other Postal Services	21
2. Fixed Rates for 2 Years	22
3. Uncertainty on Volume	23
4. Other USPS Services	24
5. Maximizing Contribution	24
6. Summary	26
B. Revenue "Leakage"	26
C. Information Systems Costs	29
D. Mailing Online Target Market	30
E. Treatment of Advertising Costs	31
F. Identification of Attributable Costs	33
G. Summary	34

LIST OF EXHIBITS

<u>ITEM</u>	<u>TITLE</u>
(1)	(2)
Appendix A	Statement of Qualifications

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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.

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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

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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.

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III. SUMMARY AND CONCLUSIONS

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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.

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My specific conclusions are as follows:

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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;

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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;

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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").

1 **IV. USPS' ESTIMATES OF THE MAILING ONLINE BUSINESS**

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

10 Table 1 below separates the basic characteristics of the Mailing Online operations, costs and
11 revenues as presented by the USPS into two time periods. First, Table 1 summarizes the USPS'
12 projected data for the initial 2 years of the Mailing Online program, i.e., the experimental phase.
13 Second, Table 1 summarizes the USPS' projected data for the subsequent 3 years (2001 through
14 2003).

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<u>Item</u> (1)	Experimental Phase <u>1999-2000</u> (2)	<u>2001-2003</u> (3)	<u>Total</u> (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 ^{3/}	\$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 include the USPS' variable information systems costs and the costs for 2001-2003 exclude inserter costs.			

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

1 In order to place the USPS' proposed Mailing Online operation into perspective, I have
 2 developed Table 2 below which compares the Mailing Online projected pieces and revenues for
 3 1999 with the volumes and revenues for some of the USPS' other services. The data for Mailing
 4 Online reflects the 1999 portion of the data in Column (2) of Table 1 above. The Table 2 data for
 5 the other services is based on the revenue and volume data in Appendix G to the PRC's R97-1
 6 decision.

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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.		

24 Table 2 shows that the USPS' Mailing Online represents the pursuit of a major new line of
 25 business for the USPS. The annual number of pieces of mail and annual revenues for Mailing
 26 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 and
6 the actual creation of the mail creates problems for the competitive markets served by MASA and
7 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
7 the production process of transforming raw materials into final goods. Vertical
8 integration can be partitioned into two types: backward integration, where a firm
9 extends itself into a previous stage of the production process and forward
10 integration, where a firm 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
14 of market control at even one stage of the production process. It becomes a
15 possible weapon for the exclusion of new rivals by increasing the capital
16 requirements for entry into the combined integrated production processes, or it
17 becomes a possible vehicle of price discrimination. In these cases new vertical
18 mergers are not desirable...(footnote 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,
5 parity bidding at contract renewal intervals cannot be presumed. Instead, such
6 transactions undergo a "fundamental transformation". What had been an *ex ante*
7 large numbers bidding condition thus becomes a small numbers supply condition
8 thereafter. This transformation is the main factor that is responsible for the
9 decision to remove 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 rates,
6 revision to recovering the information systems costs, addition of advertising costs to the rates
7 charged customers and the identification of all USPS attributable costs. In addition, I critique the
8 USPS' assertion that the target market is limited to SOHO customers with 5,000 piece mailings.
9 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.

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

<u>Item</u> (1)	<u>Source</u> (2)	<u>Mark-Up Ratio</u>	
		<u>25%</u> (3)	<u>50%</u> (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)].

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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
13 from new pieces, but must account for revenue leakage as a result of making
14 discounted rates available to Mailing Online customers. (Witness Plunkett, page
15 7) (emphasis 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.

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Table 4 <u>Summary of Revenue Leakage Due to Migration</u>				
Item (1)	Source (2)	1999 (3)	2000 (4)	Total (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].				

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

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

3 Table 5 below summarizes the total revenue "leakage".

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Table 5		
<u>Summary of Revenue Leakage</u>		
<u>Item</u>	<u>Source</u>	<u>Amount</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

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

19 **C. INFORMATION SYSTEMS COSTS**

20 The USPS has proposed that the information systems costs be recovered from a charge of 0.1
21 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 impression.^{29/} Witness Plunkett
10 recognized that the one time information systems costs should not be treated as institutional costs
11 and that Witness Seckar's cost estimates recovered the costs over the first two years of Mailing
12 Online (OCA/USPS-T5-10). Therefore, in order to recover the costs as suggested by Witness
13 Plunkett, 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 Garvey 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
2

6. Recognize all other appropriate attributable costs that are incurred by the USPS for 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.

1 MR. WIGGINS: With that I tender the witness for
2 examination.

3
4 COMMISSIONER LeBLANC: Mr. Prescott, have you had
5 an opportunity to examine the packet of designated written
6 cross examination that was made available to you earlier
7 this morning?

8 THE WITNESS: Yes, I have.

9 COMMISSIONER LeBLANC: If these questions were
10 asked of you today, would your answers be the same as those
11 previously provided in writing?

12 THE WITNESS: Yes, they would.

13 COMMISSIONER LeBLANC: Two copies of the corrected
14 designated written cross examination of Witness Prescott
15 will be given to the reporter. I believe -- Mr. Wiggins, do
16 you have those?

17 MR. WIGGINS: I do.

18 COMMISSIONER LeBLANC: Thank you, sir. I direct
19 that they be accepted into evidence and transcribed into the
20 record at this point.

21 [Designation of Written
22 Cross-Examination of Roger C.
23 Prescott was received into evidence
24 and transcribed into the record.]

25

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Mailing Online Service

Docket No. MC98-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF MAIL ADVERTISING SERVICE ASSN. INTL. AND
PITNEY BOWES, INC.
WITNESS ROGER PRESCOTT
(MASA/PB-T1)

Party

Office of the Consumer Advocate

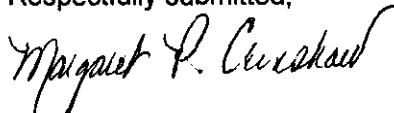
Interrogatories

USPS/MASA/PB-T1-7

United States Postal Service

OCA/MASA/PB-T1-1
USPS/MASA/PB-T1-1-6, 9-17, 19-27

Respectfully submitted,



Margaret P. Crenshaw
Secretary

INTERROGATORY RESPONSES OF
MAIL ADVERTISING SERVICE ASSN. INTL. AND PITNEY
BOWES, INC.
WITNESS ROGER PRESCOTT (T1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory:

Designating Parties:

OCA/MASA/PB-T1-1	USPS
USPS/MASA/PB-T1-1	USPS
USPS/MASA/PB-T1-2	USPS
USPS/MASA/PB-T1-3	USPS
USPS/MASA/PB-T1-4	USPS
USPS/MASA/PB-T1-5	USPS
USPS/MASA/PB-T1-6	USPS
USPS/MASA/PB-T1-7	OCA
USPS/MASA/PB-T1-9	USPS
USPS/MASA/PB-T1-10	USPS
USPS/MASA/PB-T1-11	USPS
USPS/MASA/PB-T1-12	USPS
USPS/MASA/PB-T1-13	USPS
USPS/MASA/PB-T1-14	USPS
USPS/MASA/PB-T1-15	USPS
USPS/MASA/PB-T1-16	USPS
USPS/MASA/PB-T1-17	USPS
USPS/MASA/PB-T1-19	USPS
USPS/MASA/PB-T1-20	USPS
USPS/MASA/PB-T1-21	USPS
USPS/MASA/PB-T1-22	USPS
USPS/MASA/PB-T1-23	USPS
USPS/MASA/PB-T1-24	USPS
USPS/MASA/PB-T1-25	USPS
USPS/MASA/PB-T1-26	USPS
USPS/MASA/PB-T1-27	USPS

RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL/PITNEY BOWES
WITNESS PRESCOTT TO INTERROGATORIES
OF THE OFFICE OF THE CONSUMER ADVOCATE

OCA/MASA/PB-T1-1. Please refer to your testimony at page 10, lines 5-13.

- (a) Please define "mail preparation services."
- (b) Please define the "competitive market for mail preparation services."
- (c) Please confirm that some of the 62 percent of business diverted from "private competitive firms to the USPS' subcontractors" could be diverted from firms that prepare mail in-house as an adjunct to major business activities, such as insurance company policy statements. If you do not confirm, please explain.
- (d) Please provide any studies, reports or other evidence showing the proportion of the \$121 million of business during the experiment diverted from firms that prepare mail in-house.

OCA/MASA/PB-T1-1 Response:

- (a) The phrase "Mail preparation services" in my testimony refers to the physical production of documents to be mailed including any or all of the following: composition, printing, stapling, enveloping, selection of recipients, addressing, sorting, and placement of postage on the mailable item.
- (b) The phrase "competitive market for mail preparation services" in my testimony refers to those private companies that could compete for any of the services provided by Mailing Online.
- (c) Confirmed.
- (d) My analysis was based on data presented by the USPS. I am unaware of any data presented by the USPS that identifies the proportion of mail diverted from firms that prepare mail in-house.

**RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL/PITNEY BOWES
WITNESS PRESCOTT TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE**

USPS/MASAPB-T1-1. On page 4, lines through 6, you state that:

Many of MASA's members are letter shops, print shops and other mail preparation companies of varying sizes that could compete for the printing and production of the type of mail to utilize Mailing Online.

Please confirm that some MASA members could compete to become a Mailing Online printer under contract to the Postal Service. If you do not confirm, please explain.

USPS/MASAPB-T1-1 Response:

Confirmed.

USPS/MASAPB-T1-2. Please provide the source of the Aggregate Costs figures in your Table 1, on page 8 of your testimony. The listed source of Exhibit USPS-2A, page 10 provides only volume numbers.

USPS/MASAPB-T1-2 Response:

The Aggregate Cost figures are developed from the sources shown in footnote 3. The reference to footnote 2 on Line 2 of Table 1 should be changed to footnote 3.

USPS/MASAPB-T1-3. Please refer to your Table 2, on page 9 of your testimony. Please confirm that Mailing Online revenues of \$90 million would be less than 0.2 percent of total Postal Service revenues of about \$60 billion. If you do not confirm, please explain.

USPS/MASAPB-T1-3 Response:

Confirmed.

USPS/MASAPB-T1-4. On page 10, lines 7 to 10, you estimate a diversion from private business of \$121 million during the Mailing Online experiment. Please confirm that the \$121 million estimate assumes that all existing mail which uses Mailing Online is currently using the mail preparation services of private businesses. If you do not confirm, please explain why. If you do confirm, please explain the basis for this assumption.

USPS/MASAPB-T1-4 Response:

Confirmed. Existing mail that uses Mailing Online is currently prepared either by a company that provides mail preparation services or in-house by a private business that is a potential customer of the companies that provide mail preparation services.

USPS/MASAPB-T1-5. On page 10, lines 11 to 12, you refer to the "potential economic impact on the competitive market for mail preparation services".

- (a) How do you define the "competitive market for mail preparation services?" Please specify how it corresponds to the approximately 670 companies that belong to MASA?
- (b) Please provide an estimate of the total amount spent per year on private mail preparation services. Please indicate whether your response is limited to MASA members.

USPS/MASAPB-T1-5 Response:

- (a) The phrase "competitive market for mail preparation services" is defined in my response to OCA/MASA/PB-T1-1. The 670 companies that are members of MASA consist of part, but not all, of the competitive market for mail preparation services.
- (b) The total amount spent per year on private mail preparation services was not needed for my analysis and, therefore, I have not developed that value.

USPS/MASAPB-T1-6. Please refer to page 12, line 3 of your testimony, where you state "when two (or more) functions in the stages of production are merged together under the control of one company, vertical integration occurs."

- (a) Please confirm that private printing companies will supply MOL services under contract to the Postal Service, rather than being merged with the Postal Service. If you do not confirm, please explain.
- (b) By the use of the word "control", do you mean that the Postal Service will forbid Mailing Online contractors from obtaining other printing and mailing business on their own? Please explain any affirmative response.

USPS/MASAPB-T1-6 Response:

- (a) Not confirmed. Because the private printing companies are under contract to the USPS and all of the Mailing Online jobs come through the USPS, the printing and mail production function is merged through vertical integration with the USPS' mail delivery function.
- (b) No.

USPS/MASAPB-T1-7. Please refer to page 15, lines 7-9 of your testimony, where you argue that:

Mailing Online will not charge sales tax and the USPS does not pay corporate income taxes. Thus, the USPS may be able to offer lower prices than its competitors who are subject to sales and income taxes.

- (a) Please confirm that the Postal Service's fee proposal for Mailing Online calls for marking up the costs of private printers. If you do not confirm, please explain.
- (b) Please confirm that these private contractors are subject to sales and corporate income taxes. If you do not confirm, please explain.
- (c) Would you agree that in preparing bids for provision of MOL services, potential printing contractors would include sales and corporate income taxes in estimating their costs? Please explain any negative answer.
- (d) Do you believe that any sales taxes currently apply to the sale of products and services over the Internet? Please explain any affirmative answer.

USPS/MASAPB-T1-7 Response:

- (a) Not confirmed. The USPS will mark-up the price charged by the private printer contracting with the USPS.
- (b) Not confirmed. Whether or not the private contractor pays sales or corporate income tax is a function of several factors, including the tax regulations of the state where the printer is located, the profitability of the company and, with respect to sales, the nature of purchasing entity.
- (c) Not necessarily, as discussed in my response to part (b).
- (d) Yes. For example, the popular website called Amazon.com that sells books, music and videos states that "Washington State and Nevada State laws require that we charge a sales tax on the full amount of the order."

USPS/MASAPB-T1-9. Please refer to Table 4 on page 28 of your testimony. In estimating the amount of revenue leakage due to migration of volume from First-Class Mail to Standard Mail (A), did you consider cost savings resulting from this migration? Please explain any affirmative response.

USPS/MASAPB-T1-9 Response:

No. Table 4 only calculates revenues. However, as noted in footnote 28 on page 27 of my testimony, the contribution for Standard (A) Regular mail is less than First Class Mail.

USPS/MASAPB-T1-10. Please refer to page 32, line 6 of your testimony, where you state that "Mailing Online will benefit from the advertising developed for POL."

- (a) In your view, does the fact that a product benefits from an expenditure justify distributing at least part of that expenditure to the product. Please explain your answer.
- (b) To the extent that Mailing Online makes it easier to use First-Class Mail and Standard Mail (A), and increases First-Class Mail and Standard Mail (A) volumes, will First-Class Mail and Standard Mail (A) "benefit from" the advertising of POL? Please explain any negative response.

USPS/MASAPB-T1-10 Response:

- (a) In my testimony I used the word "benefit" to mean an expenditure intended to increase demand for Mailing Online. The fact that a product benefits in the sense of experiencing increased demand as a result of an expenditure justifies distributing at least some part of the expenditure, however large or small, to the product.
- (b) Yes.

USPS/MASAPB-T1-11. Please fully define the term "incremental" as you use it on page 32, line 7 of your testimony.

USPS/MASAPB-T1-11 Response:

The sentence in my testimony states that "...while no advertising costs may be incremental to Mailing Online, no reason exists for Mailing Online not to share in the costs..." (footnote omitted).

The term incremental refers to any specific advertising costs that would not have been incurred but for the addition of the Mailing Online service.

USPS/MASAPB-T1-12. Please refer to page 32, line 9 through page 33, line 3 of your testimony. Please assume that POL offers two services, MOL and POL [sic], and that over a given time period there are 60 MOL transactions and 40 SOL transactions, as you defined transaction in this section of your testimony. Please further assume that over that same period, advertising costs for POL total \$100. Please confirm that the distribution approach described on page 33, lines 1 to 3 would distribute \$60 of advertising costs to MOL and \$40 to SOL. If you do not confirm, please explain.

USPS/MASAPB-T1-12 Response:

Confirmed.

USPS/MASAPB-T1-13. Please refer to your testimony at page 24, lines 15 to 16, where you claim that the Postal Service "has not shown that the Mailing Online contribution is maximized with a 25 percent mark-up."

- (a) Do you consider contribution maximization to be a relevant criterion in establishment of rates and fees under the Postal Reorganization Act? Please explain your answer.
- (b) Please confirm that the aggregate cost figure of \$194.7 million you use in your Table 4 excludes those costs characterized as "fixed" by the Postal Service. If you do not confirm, please explain.
- (c) Please confirm that your Table 4 assumes that aggregate costs drop in proportion to the drop in volume when moving from a 25 percent to a 50 percent mark-up ratio. If you do not confirm, please explain.
- (d) Please reconcile your assumption about the relationship between volumes and aggregate costs with the evidence that high-cost options, such as documents over 10 pages, 11 x 17 inch documents, and spot color documents, decrease disproportionately when moving from a 25 percent to a 50 percent markup. See Tables 15 and 16 of witness Rothschild's testimony (USPS-T-4), and Tables 1, 2, and 3 of witness Seckar's testimony (USPS-T-2).

USPS/MASAPB-T1-13 Response:

- (a) No. Maximization of contribution is not a criterion of the Postal Reorganization Act.
- (b) Confirmed, if the correct reference in the question is to Table 3 of my testimony.
- (c) Confirmed, if the correct reference in the question is to Table 3 of my testimony.
- (d) The change in costs in Table 3 was based on the average costs for simplicity. The data required to perform the analysis shown in witness Seckar's exhibit, and utilized by the USPS' witness Plunkett, are not available in the USPS' data for projected volumes with the 50 percent mark-up.

**RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL/PITNEY BOWES
WITNESS PRESCOTT TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE**

USPS/MASAPB-T1-14. Please refer to your testimony at page 23, lines 5 to 15, and footnote 17. On line 5 you refer to "USPS start-up costs", and in footnote 17 you state that "[t]hese costs included \$22.5 million in information systems costs for the experimental phase."

- (a) Please confirm that the information systems costs of \$22.5 million consists of \$11.1 million of "one-time" costs, and \$11.4 million of "variable" costs, as presented by witness Seckar at Tr. 8/1882. If you do not confirm, please explain.
- (b) Please confirm that witnesses Seckar and Lim consider the \$11.1 million of "one-time" costs to be "start-up" costs for Mailing Online. See Tr. 5/1050-51 (witness Seckar considers information systems fixed costs to be "one-time start up costs for the experimental period"); Tr. 8/1913 (Witness Lim states that he "share[s] Witness Seckar's views that one-time costs are essentially the start-up costs for MOL."). If you do not confirm, please explain.
- (c) Do you consider the \$11.4 million of "variable" information systems costs to be start-up costs for Mailing Online? Please explain any affirmative response.
- (d) Do you consider the \$11.4 million of "variable" information systems costs to be fixed costs regardless of the volume of Mailing Online? Please explain any affirmative response.
- (e) On page 23, line 9 of your testimony, you state that "[t]he average mark-up equals 0.88 cents per impression." Please confirm that the mark-up for Mailing Online is based on all printing costs, including paper, envelope, and insertion costs, as well as impression costs. If you do not confirm, please explain.

USPS/MASAPB-T1-14 Response:

- (a) Confirmed.
- (b) Confirmed.
- (c) I have not made an assessment as to whether or not the "variable" information systems costs should be considered start-up costs. However, the \$11.4 million quantified by the USPS' Witness Lim is a cost incurred by Mailing Online volume during the proposed experimental phase and should be recovered by Mailing Online.

(d) No.

(e) Not confirmed. The mark-up for Mailing Online is based on the printing prices charged by the USPS' subcontractor and the USPS' charge for information systems.

**RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL/PITNEY BOWES
WITNESS PRESCOTT TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE**

USPS/MASAPB-T1-15. On page 23, lines 5 to 6, you state that "In order to maximize the possibility that the USPS' start-up costs are recovered, Mailing Online should receive the highest mark-up possible." On page 24, lines 5 to 6, you state that a "higher mark-up would help insure that the initial costs are recovered."

- (a) Would you support a higher mark-up even if it resulted in decreased contribution for Mailing Online, because of lost volume?
- (b) Please confirm that, compared to the Postal Service's proposal, you are proposing to both increase the costs attributed to Mailing Online, and increase the cost coverage for Mailing Online.
- (c) Are you confident that these changes, in conjunction with each other, will not decrease volume so much that contribution would be reduced? Please explain your response.

USPS/MASAPB-T1-15 Response:

- (a) Yes.
- (b) Confirmed.
- (c) Based on the data available, I am unable to determine the impact to contribution. The extent to which contribution may change is a function of both volume and the mark-up ratio. Even if contribution is reduced, the mark-up should be increased during the experimental phase in order to avoid competitive harm to MASA members, Pitney Bowes, Inc. and similarly situated businesses.

USPS/MASAPB-T1-16. Please refer to page 30, line 9 of your testimony. Please confirm that the cost of 0.41 cents is per impression, rather than per piece. If you do not confirm, please explain.

USPS/MASAPB-T1-16 Response:

Confirmed.

USPS/MASAPB-T1-17. Please refer to page 31, lines 17 to 18 of your testimony. Please confirm that you intended to refer to witness Garvey, rather than witness Stirewalt.

USPS/MASAPB-T1-17 Response:

Confirmed.

USPS/MASAPB-T1-19. Please refer to your response to OCA/MASA/PB-T1-1(b), where you define the competitive market for mail preparation services as "those private companies that could compete for any of the services provided by Mailing Online." Does this market include firms that prepare mail in-house as an adjunct to major business activities, such as insurance companies preparing policy statements for mailing? Please explain.

USPS/MASAPB-T1-19 Response:

It might. If Mailing Online solicits business for mail preparation services provided in-house then the USPS is competing in the market to obtain that business.

USPS/MASAPB-T1-20. Please refer to your response to USPS/MASAPB-T1-10, where you state that "the fact that a product benefits in the sense of experiencing increased demand as a result of an expenditure justifies distributing at least some part of the expenditure, however large or small, to the product."

Consider a hypothetical in which the Postal Service designs and runs advertisements promoting Priority Mail. These advertisements address Priority Mail only, and make no mention of other Postal Service products. Assume, however, that the advertisements are effective in raising the image of the Postal Service in the public's mind, and that this improved image in turn leads to increased purchases of other products, such as First-Class letter mail and various special services. Please confirm that, consistent with your response to USPS/MASAPB-T1-10, these other products that benefitted from this advertising should be assigned a portion of its costs. If you do not confirm, please explain.

USPS/MASAPB-T1-20 Response:

Not confirmed. Attributable or variable costs are associated with a product (or products) because a quantifiable causative relationship is shown between the cost and the product. The hypothetical does not provide sufficient information to determine whether an increase in volume related to improved image due to Priority Mail advertising represents a quantifiable causative relationship because of the numerous other factors that could have impacted volumes.

**RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL/PITNEY BOWES
WITNESS PRESCOTT TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE**

USPS/MASAPB-T1-21. Please refer to your testimony at page 15, lines 12 to 13.

- (a) Do you understand the Postal Service plans to be limited to one printing company per location?
- (b) Could the Postal Service requirements set forth in its printer statement of work (USPS-LR-11) be accommodated by a group of printers within a geographic area? Why or why not?

USPS/MASAPB-T1-21 Response:

- (a) No. The USPS states that the "commercial print sites will be geographically situated according to demand..." (USPS-T1, page 2). If demand warranted, more than one printing company could be at a given location.
- (b) The use of a group of printers within a geographic area is possible, however, the USPS has stated that it "presume[s] that a single printer will receive all volume for a given area" (OCA/USPS-T1-5).

USPS/MASAPB-T1-22. On page 16 of your testimony you include a quotation from *A Dictionary of Economics*, which states in part, "if the winner of the original bid thereafter enjoys a sunk cost advantage, parity bidding at contract renewal intervals cannot be presumed."

- (a) What is your understanding of how this applies to Mailing Online?
- (b) What "sunk cost advantage" would inhere to original bid winners? Please explain fully.
- (c) What is your understanding of the pace of change in the printing industry today?
- (d) How long does printing equipment last?
- (e) What is the expected lifespan of the print-on-demand equipment necessary for Mailing Online?
- (f) If equipment necessary for a successful bidder to perform printing and related services for Mailing Online is available on a lease basis, with no up front capital cost reduction fee, would that bidder have a "sunk cost advantage" during subsequent bidding cycles? Please explain fully.

USPS/MASAPB-T1-22 Response:

- (a) When contracts are rebid, the USPS' current subcontractor may have an advantage over other potential bidders equal to its sunk cost.
- (b) The sunk cost advantage includes the acquisition of equipment and facilities plus the operational expertise that are already in place for the original bidder.
- (c) If the term in the question "the pace of change in the printing industry" refers to technological innovation for printing, then the changes will depend on numerous factors including the type of printing, the willingness of the industry to change, and the incentives provided by customers, governments and companies that supply goods to the printing industry.
- (d)-(e) The useful life of printing equipment depends on numerous factors including the type of equipment, the level of utilization, maintenance and technological change.
- (f) The bidder may have a sunk cost advantage depending on the operational experience of the incumbent bidder and the ability of other bidders to obtain the same lease terms as the successful bidder.

USPS/MASAPB-T1-23. On page 16, line 11 of your testimony, you use the term "true competition". Please define this term and provide an appropriate reference supporting your definition.

- (a) Does "true competition" apply at the national, state and other levels to the same extent? Please explain your response.
- (b) What role, if any, does the necessity for printing contractors to meet performance deadlines that require entry of Mailing Online pieces to specific, geographically dispersed postal facilities play in your analysis of "true competition".
- (c) Do you believe that a printer bidding to become a Mailing Online contractor could have its physical plant located in New Mexico yet meet the performance deadlines in Florida?
 - i. If so, how could the printer expect to be competitive given the need to account for substantial transportation costs that printers in Florida would not need to incur?
 - ii. If not, how do you reconcile this with the statement, also on page 16 of your testimony, that "the second lowest bid in one geographic area would not receive any USPS business for Mailing Online because a higher bid, in a different geographic area, was selected by the USPS"?
- (d) What is your background and experience in government procurement regulations. Please explain in detail.

USPS/MASAPB-T1-23 Response:

The reasons that the USPS' proposed Mailing Online line service "prevents true competition for the subcontractors" are explained in my text, namely that the USPS' requirement that the winning bidder(s) be geographically dispersed presents a barrier to competition for other bidders. This condition results in a constraints on competition that otherwise would not occur in the market.

- (a)-(c) For purposes of the text referenced in this interrogatory, the competition discussed relates to the geographic areas^m which the USPS is utilizing to choose its anticipated 25 subcontractors. The geographic locations for the printing contractors is driven by the

USPS' design of Mailing Online. Therefore, the USPS has placed limitations on the ability of some companies to compete for Mailing Online contracts.

In a competitive environment, the potential bidder evaluates the revenues, costs and profits associated with entering the market. Each component of cost, including transportation, to supply the regional service would be evaluated. A potential bidder with a plant in New Mexico might have problems with performance deadlines in Florida but the ability to compete would be evaluated by the printer in New Mexico. The printer in New Mexico might be able to overcome problems with performance deadlines with added transportation costs, which might result in the New Mexico printer still providing service at a lower cost than other printers closer to the ultimate destination.

- (d) Since 1956, L.E. Peabody & Associates, Inc. submit bids for consulting services to state, local and federal governments. As part of assisting with the preparation of bids and administration of contracts, I am generally familiar with the regulations required for the contracts relevant to our company. For purposes of this proceeding I have reviewed the contract between the USPS and Vestcom International Inc. shown in USPS-LR-11 but my testimony does not attempt to address the competitive environment in which this contract was negotiated.

USPS/MASAPB-T1-24. On page 15 of your testimony you state, "a small number of printers will have or make the investment in capacity needed to meet the requirements for Mailing Online."

- (a) Do you mean that only successful Mailing Online bidders will have that incentive, or will unsuccessful or non-bidders have such an incentive. Please address the chapter that appears at Tr. 6/1489-1503 as part of your response.
- (b) In qualitative or quantitative terms, or both, what proportion of the entire capacity of the print-on-demand industry do you believe Mailing Online contractors will generate purely to provide Mailing Online services?
- (c) In qualitative or quantitative terms, or both, what proportion of the print-on-demand industry capacity do you believe Mailing Online contractors will generate to provide service other than for Mailing Online?

USPS/MASAPB-T1-24 Response:

- (a) Bidders that are not successful in obtaining a contract for the production of Mailing Online documents will not have any incentive to make investments in capacity related to Mailing Online. As noted in Attachment No. 1 to Presiding Officer's Information Request No. 2, Question No. 5, digital printing offers several advantages. (Tr. 6/1500-1502). These advantages are independent of the USPS providing the Mailing Online service.
- (b)-(c) For my analysis, the entire capacity of the print-on-demand industry is not required. However, my testimony does calculate the diversion of business from current printing businesses to Mailing Online to range between \$121 million for the first 2 years and \$521 million over the 5 year period is shown by the USPS.

USPS/MASAPB-T1-25. Please confirm that the equipment required to prepare documents in accordance with the Mailing Online specifications is widely available.

USPS/MASAPB-T1-25 Response:

Confirmed.

USPS/MASAPB-T1-26. Do you contend that Mailing Online will lead to the development of proprietary printing technology that will constitute an entry barrier for would-be Mailing Online printers? Please explain fully any affirmative response.

USPS/MASAPB-T1-26 Response:

The impact on printing technology due to Mailing Online is not known to me, but it is certainly conceivable that technology changes could produce entry barriers .

USPS/MASAPB-T1.27. Please refer to your testimony at page 15, lines 7 to 9, where you state that "the USPS may be able to offer lower prices than its competitors who are subject to sales and income taxes."

- (a) Prior to filing your testimony, did you read the testimonies of witness Tayman, USPS-T-9, in Docket No. R97-1, or the Commission's Opinion in Docket No. R97-1, at pages 21 to 23, concerning the Postal Service's need to recover prior years' losses?
- (b) Confirm that a private firm subject to federal income taxation can carry forward its net operating losses for the past 15 years and apply them against profits earned in subsequent years. If not confirmed, please explain.
- (c) Confirm that a firm subject to federal income taxation can carry back operating losses and offset them against profits earned in previous years. If so, what are the general rules governing the extent to which a private firm subject to federal income taxation may do so? If not confirmed, please explain.
- (d) Assume for this subpart that the Postal Service were subject to federal income taxation since its inception.
 - i. Do you believe the Postal Service would have incurred tax liability for any of the years of its existence since 1971? If so, please state the fiscal year(s) in which you believe the Postal Service would have incurred tax liability, what income you believe would be subject to taxation, and the total tax liability. For each year in which you believe that the Postal Service would have incurred tax liability, please also state whether such liability would have been subject to any refunds due to carry back losses. Please show all calculations, and provide sources for your figures.
 - ii. Assume that the Postal Service does not retire its entire Prior Years' Loss by the end of the experimental period. Do you believe that the Postal Service would pay federal income taxes during the experimental period? If so, please explain why the Postal Service would have any taxable net income.

USPS/MASAPB-T1-27 Response:

- (a) No.
- (b)-(d) I have not analyzed the impact of carry forward, carry back or recovery of prior years' losses based on the USPS being subject to income tax because that calculation is not required for my testimony. The calculation of the hypothetical taxes that the USPS would have paid (and any potential impact on postal rates) would require an in-

depth study of the USPS' accounting data. Any attempt to calculate the income taxes that the USPS would have paid requires data not available such as the proportion of the USPS' net income attributable to each state or locality and the consideration that the USPS' decisions for investment acquisition might change if the USPS' was a taxable entity.

1 COMMISSIONER LeBLANC: Does any participant have
2 additional written cross examination for Witness Prescott?

3 MR. RUBIN: Yes. The Postal Service does.

4 COMMISSIONER LeBLANC: Mr. Rubin.

5 CROSS EXAMINATION

6 BY MR. RUBIN:

7 Q Mr. Prescott, we are providing you with two copies
8 of your response to Postal Service Interrogatory T1-28.
9 Have you been able to review those responses?

10 A Yes.

11 Q And if you were to testify orally here today,
12 would those responses be the same?

13 A Yes, they would.

14 Q Then I would ask that those responses be entered
15 into the record.

16 COMMISSIONER LeBLANC: Any objections?

17 MR. WIGGINS: None.

18 COMMISSIONER LeBLANC: So ruled.

19 [Designation of Additional Written
20 Cross-Examination of Roger C.
21 Prescott was received into evidence
22 and transcribed into the record.]

23

24

25

Postal Service
Add it written
cross

**RESPONSE OF MAIL ADVERTISING SERVICE ASSOCIATION
INTERNATIONAL/PITNEY BOWES
WITNESS PRESCOTT TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE**

USPS/MASAPB-T1-28. Please refer to page 32, line 12 to page 33, line 3 of your testimony, where you state that the advertising costs for PostOffice Online should be distributed based on the percentage of transactions for PostOffice Online, Mailing Online, and Shipping Online. Consider a hypothetical in which POL provides only two services, Shipping Online (SOL) and Mailing Online (MOL). During year 1, SOL had 25 transactions, and MOL had 50 transactions. During year 2, SOL has 50 transactions and MOL has 50 transactions. Based on your approach, which of the following methods should be used to distribute the advertising cost to SOL and MOL, for each of the scenarios (a), (b), (c), and (d) presented below?

- (1) 25/75 to SOL, and 50/75 to MOL, based on year 1 transactions?
- (2) 50/100 to SOL, and 50/100 to MOL, based on year 2 transactions?
- (3) all to SOL, based on the changes in transactions from year 1 to year 2 for SOL and MOL, respectively?
- (4) Another alternative?

Please explain your choice.

- (a) During year 1 the Postal Service spent \$1 million on a POL advertising campaign conducted during year 1;
- (b) During year 1 the Postal Service spent \$1 million on a POL advertising campaign that was conducted half during year 1 and half during year 2, at no additional expense in year 2.
- (c) During year 1 the Postal Service spent \$600,000 on POL advertising conducted during year 1, and during year 2 the Postal Service spent \$400,000 on POL advertising conducted during year 2.
- (d) During year 2 the Postal Service spent \$1 million on POL advertising conducted during year 2.

USPS/MASAPB-T1-28 Response

I assume based on the example that the \$1 million for advertising for the two services is determined to be the attributable advertising costs, then the distribution of advertising costs between the two services in each hypothetical example is as follows:

- (a) 25/75 to SOL and 50/75 to MOL;
- (b) 25/75 to SOL and 50/75 to MOL, although it appears illogical that the USPS would prepay for services to be incurred in a subsequent time period;
- (c) For the \$600,000 spent in year 1, 25/75 to SOL and 50/75 to MOL. For the \$400,000 spent in year 2, 50/100 to SOL and 50/100 to MOL; and,
- (d) 50/100 to SOL and 50/100 to MOL.

1 COMMISSIONER LeBLANC: Is that all you have, Mr.
2 Rubin?

3 MR. RUBIN: Yes.

4 COMMISSIONER LeBLANC: Okay. Only one
5 participant -- the United States Postal Service -- has
6 requested oral cross examination of Witness Prescott.

7 Does any other participant have oral cross
8 examination for Witness Prescott?

9 [No response.]

10 COMMISSIONER LeBLANC: Mr. Rubin, will you please
11 begin?

12 MR. RUBIN: Thank you.

13 CROSS EXAMINATION [cont.]

14 BY MR. RUBIN:

15 Q I am David Rubin for the Postal Service. Mr.
16 Prescott, would you turn to your response to Postal Service
17 Interrogatory T1-19.

18 A Yes, I have it.

19 Q Thank you. You were asked whether the market for
20 mail preparation services includes firms that prepare mail
21 in-house as an adjunct to major business activities, and you
22 respond that it might and continue, "If Mailing Online
23 solicits business for mail preparation services provided
24 in-house then U.S. is competing in the market to obtain that
25 business."

1 Now if Mailing Online does not solicit business
2 for in-house mail preparation work, is that in-house work
3 thereby excluded from the market for mail preparation
4 services?

5 A If Mailing Online is set up in such a way that
6 in-house preparation of mail were excluded from being able
7 to utilize the services of Mailing Online then, yes, it
8 would be excluded from that market.

9 Q Now if Mailing Online provides services for
10 individuals, would those individuals be part of the market
11 for mail preparation services?

12 A Yes.

13 Q And let's consider a firm that uses radio
14 advertising but does not use direct mail at all. Would that
15 firm be part of the market for mail preparation services?

16 A If your question refers to the production of a
17 document that is going to be provided to the Postal Service
18 for delivery in hard-copy form, then that's part of the
19 Mailing Online market --

20 Q Right.

21 A Or the market that Mailing Online is searching
22 for.

23 Q And what I'm starting with here is a firm that
24 doesn't use -- isn't preparing mail or doesn't have mail for
25 advertising purposes but instead does its advertising on the

1 radio. Wouldn't that be outside of the market for mail
2 preparation services?

3 A The market for Mailing Online is restricted to
4 hard-copy documents that are sent through the Postal
5 Service. So if a firm is not producing a document that can
6 be given to the Postal Service, then that would be excluded
7 from the market.

8 Q Now let's say that Mailing Online -- this firm
9 that does radio advertising becomes aware of Mailing Online
10 and then decides to start using direct mail using Mailing
11 Online. Would that make this firm become part of the market
12 for mail preparation services?

13 A It would become part of the market; yes.

14 Q Okay. Would you please turn to page 20 of your
15 testimony.

16 A Yes.

17 Q In the first sentence you suggest that several
18 modifications should be made to the Mailing Online rate
19 structure to assure that no competitive harm is caused by
20 the Mailing Online experiment. What do you mean by "no
21 competitive harm"?

22 A The term "no competitive harm" means that any mail
23 preparation firm would not be hindered in the marketplace
24 because of Mailing Online providing this service.

25 Q So does that mean that Mailing Online should have

1 no effect at all on the business of competitors in the mail
2 preparation market?

3 A It means at a minimum that Mailing Online should
4 not be competing with any advantages over firms that are
5 already in that market.

6 Q If there were a level playing field so there were
7 no competitive advantages, would it then be okay for Mailing
8 Online to have an impact on the business of these companies?

9 A Well, when you get to that point, I think you get
10 into an issue of the priorities of the postal system and
11 what the strategic plan ought to be and what the core
12 business ought to be, and whether there is harm due to the
13 vertical integration of a monopoly service with a
14 competitive service.

15 There are concerns that have to be considered
16 whenever you merge these two type of operations together,
17 and then it gets to an issue of policy as to whether you do
18 it or not.

19 Q A lot of the modifications to the Mailing Online
20 rate structure you propose would raise the price for Mailing
21 Online; is that correct?

22 A Some of them would; yes.

23 Q Is there a risk that Mailing Online's price would
24 be raised so high that it would get no business at all?

25 A As an economist, theoretically you could raise the

1 price to a level where you did no business, yes.

2 Q Should there be an attempt to keep the price of
3 Mailing Online as low as possible once you reach a point at
4 which it produces no competitive harm?

5 A I am not sure I understand the question.

6 Q Well, I am hypothesizing a situation in which the
7 modifications you suggest are made so that there is no
8 competitive harm to mail preparation companies, private
9 companies.

10 Is there also a goal to keep the Mailing Online
11 price as low as possible once you meet that other goal?

12 A Well, my testimony is broken into two distinct
13 areas. The first area is one of what happens to competition
14 when you have a monopoly service merging with a competitive
15 service.

16 The second portion of my testimony assumes that
17 the policy issue of whether you should be performing that
18 function has been resolved and you are going to perform the
19 function, then how should you price that.

20 What I have suggested is at a minimum you have to
21 make certain adjustments to the pricing structure.

22 I have not gone to the extent of saying that with
23 the changes that I am proposing at pages 20 to pages 35 of
24 my testimony would eliminate all the competitive harm. I
25 don't think there is a total assessment as to what the

1 competitive harm would be or what possible competitive harm
2 could occur if this service went forward. Bits and pieces
3 have been looked at.

4 So I am not sure how to answer the questions in
5 terms of placing the pricing for Mailing Online at a level
6 that assures that there is no competitive harm.

7 Q Okay. That's fair. If rate structure
8 modifications are made to raise the price for Mailing Online
9 in order to prevent competitive harm, what would be the
10 impact on Mailing Online customers?

11 A Traditionally if you raise the price the Mailing
12 Online customers would pay more and there may be or may not
13 be a change in volume, from a theoretical standpoint.

14 Q Thank you. Would you turn to your response to
15 Postal Service Interrogatory T1-10.

16 A Yes, I have it.

17 Q You were asked whether the fact that a product
18 benefits from an expenditure justifies distributing at least
19 part of that expenditure to the product.

20 In your answer you state that you use the word
21 "benefit" to mean an expenditure intended to increase demand
22 for Mailing Online.

23 Would you say that intent to increase demand is a
24 necessary condition that must be met in deciding to
25 distribute advertising costs to a particular product?

1 A We are talking about the distribution of costs
2 between products?

3 Q Yes.

4 A No. I don't think intent is a requirement.

5 Q It is not a necessary condition?

6 A It's not an absolute, no.

7 Q Please turn to your response to Postal Service
8 Interrogatory T1-20.

9 A Yes, I have it.

10 Q There you are asked a hypothetical question about
11 an advertising campaign and how you would assign the
12 advertising costs.

13 In this hypothetical campaign the Postal Service
14 designs and runs advertisements promoting Priority Mail.
15 These advertisements address Priority Mail only and do not
16 mention any other Postal Service product.

17 The advertisements, however, raise the image of
18 the Postal Service in the public's mind and as a result
19 other products, such as First Class letter mail, experience
20 an increase in demand.

21 You were asked whether the other products that
22 benefitted from the campaign such as First Class letter mail
23 should receive a portion of the advertising costs, and you
24 responded that the hypothetical does not provide sufficient
25 information to determine the answer because of the numerous

1 other factors that could have impacted volume. Is that
2 correct?

3 A Yes.

4 Q And would it be necessary to know whether the
5 Postal Service in this hypothetical intended to increase the
6 demand for products other than Priority Mail?

7 A In Postal Service costing, where you take total
8 costs, determine attributable costs, and then distribute
9 attributable costs over the functions, no, intent is not a
10 criteria that is used as a distribution factor of those
11 costs.

12 Q Let's assume that the advertising can be shown to
13 represent, in your words, a "quantifiable causative
14 relationship with increased First Class letter mail
15 volume" -- would you still say that you do not have enough
16 information to answer the question?

17 A I don't think you can isolate one specific factor
18 like this. I think there would be other generic types of
19 factors which can have an impact on volume. I am not sure
20 how you would get a definitive quantitative answer related
21 to the impact on volume for a cost item which was not shown
22 to be a factor with that specific product, so I -- I don't
23 know how that would be done.

24 Q Are you able to identify any other factors
25 specifically?

1 A Well, the Postal Service has numerous procedures
2 for distributing cost between products, relating to time, to
3 pieces, to miles, to weight, cubes, things of those nature.

4 Those are all concrete distribution factors that
5 you can quantify and you can assign to a specific product.

6 MR. RUBIN: Thank you. That's all I have.

7 COMMISSIONER LeBLANC: You make this an easy day,
8 Mr. Rubin.

9 Is there any follow-up cross?

10 MR. BUSH: Can we have a second, please, to
11 determine if there is any follow-up cross?

12 COMMISSIONER LeBLANC: Certainly -- I'm sorry.
13 It's already a long day. I had to dig my car out this
14 morning.

15 Off the record, Mr. Reporter.

16 [Pause.]

17 MR. WIGGINS: There will be no redirect, Mr.
18 Presiding Officer.

19 COMMISSIONER LeBLANC: Well, no redirect. We
20 can't go back to you, Mr. Rubin, so this will be a short day
21 then.

22 Before we do that there are no questions from the
23 bench here

24 [No response.]

25 COMMISSIONER LeBLANC: Good. Well, since

1 everybody is just about finished up, this will be a short
2 day. Thank you, Mr. Rubin. I like this one --

3 MR. RUBIN: You might thank the witness, Mr.
4 Presiding Officer.

5 COMMISSIONER LeBLANC: Mr. Prescott, we do
6 appreciate your appearance here today and your contributions
7 to our record, and if there is nothing further you are
8 excused, sir.

9 THE WITNESS: Thank you, sir.

10 COMMISSIONER LeBLANC: Ladies and gentlemen, I'd
11 like to tell you this one, but the hearing is adjourned
12 until tomorrow morning at 9:30 when we will receive the
13 testimony of the Office of the Consumer Advocate, the
14 witnesses Callow and Collins.

15 Thank you very much. Drive carefully, as they
16 say. Off the record, Mr. Reporter.

17 [Whereupon, at 10:03 a.m., the hearing was
18 recessed, to reconvene at 9:30 a.m., Thursday, March 11,
19 1999.]

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