

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

POSTAL RATE AND FEE CHANGES, 2006

:
:
:
Docket No. R2006-1

REPLY BRIEF OF THE
UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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CONCLUSION

I. DMA ET AL.'S ARGUMENTS DO NOT SUPPORT ANY REDUCTION IN THE POSTAL SERVICE'S REVENUE REQUIREMENT

None of the arguments made by DMA et al. in their brief regarding the revenue requirement¹ support their attempts to reduce the Postal Service's revenue requirement. As explained below, the scalpel they wield in search of "fat" in the USPS revenue stream² would instead slash muscle, tendons, and nerves. The Commission is urged to provide a rational "second opinion" that recognizes the conservative scope of the Postal Service's revenue request and forgoes the unnecessary surgery suggested by DMA et al.

A. The Postal Service's Proposed Revenue Requirement Satisfies the Act's "Break-Even" Requirement

The first argument in the brief of DMA et al. on the revenue requirement inscrutably perpetuates the tempest in a teapot created by witness Buc in his testimony regarding the requirement of § 3621 that total estimated revenues must equal total estimates expenses "as nearly as practicable." DMA et al. express surprise that the Postal Service has challenged their contention that rates need to be reduced by the Commission "so that there is no surplus in TYAR."³

DMA's surprise is itself surprising. First, and most fundamentally, the Act simply does not require that there be "no surplus." To the contrary, it speaks explicitly of break even "as nearly as practicable," which clearly allows for an unspecified degree of approximation. Not surprisingly, DMA et al.'s brief can provide no legal argument or

¹ Joint Brief Concerning the Revenue Requirement of DMA et al. (hereinafter "DMA RR Brief").

² DMA RR Brief at 18.

³ DMA RR Brief at 2, citing DMA-T-1, at 10.

citation to support witness Buc's misinterpretation. They are apparently satisfied to put forth a layman's novel opinion as a settled proposition of law without further elaboration.

Equally surprising is their citation of witness Buc's Table 1 as "showing that the Commission has come quite close to break-even in the rate recommendations it has made over 35 years"⁴ The table, in fact, is witness Buc's analysis of break-even amounts underlying the *Postal Service's requested rates* over the years,⁵ not those resulting from the rates actually recommended by the Commission. Despite this error, the past "break-evens" that DMA et al. so approvingly cite range in absolute value from near break-even (0.001 and 0.004 percent of the total estimated revenue requirement) to slightly less near break-even (0.111 and 0.154 percent). These statistics contravene DMA et al.'s argument that the current 0.125 percent fails to represent break-even "as nearly as practicable."

With respect to the 0.154 percent, witness Buc and DMA et al. attempt to impeach reliance on it, on the ground that it is from Docket No. R2005-1. The recommended decision in that case was based on a settlement among the parties for an across-the-board rate increase that was designed to generate revenue allowing the Postal Service to fulfill the escrow requirement of P.L. 108-18, rather than to fund increased operating costs. Witness Buc argued that the 0.154 percent should be disregarded as a "function of the Across-the-Board nature of the case."⁶ Nevertheless, while admittedly the particular recommendations in Docket No. R2005-1 do not stand as binding precedent, in evaluating their conformance with the Act, the Commission was

⁴ DMA RR Brief at 10.

⁵ DMA-T-1, at 9-10 and Table 1.

⁶ DMA-T-1, at 9.

obligated, as it always is, to recommended rates so that revenues would equal costs “as nearly as practicable.”⁷ Moreover, according to the Commission’s costing and other methodologies, the net surplus estimated to result from the its recommended rates and fees in that docket was 0.254 percent, twice the percentage difference at issue here.⁸

DMA et al. have, in their own words, “raised more controversy in this proceeding than is typical” with witness Buc’s exhortation to the Commission to “reduce rates by enough so that there is no surplus in TYAR.”⁹ Interestingly, Table 1 in Witness Buc’s testimony shows that, in six out of eleven past rate cases, the Postal Service requested rates and fees that were estimated to produce a projected test year net *loss*. Despite their call for flawless break-even in the instant docket, the Postal Service does not recall arguments from DMA et al. in those previous cases that the rates needed to be *raised* by enough so that there would be no *loss* in TYAR in order to satisfy the break-even requirement.

Lest the reader be numbed by the multi-digit decimals cited above, it is worth remembering that the 0.125 percent at issue here is just above one-tenth of one percent, which is one one-thousandth! Put another way, break even in this case is .99875 accurate.¹⁰ There is simply no plausibility to the argument that Congress intended to impose a greater degree of precision upon the Postal Service, the Commission, and the Governors.

⁷ See PRC Op., R2005-1, at 15; see also PRC Op., R2001-1, at 22.

⁸ See PRC Op., R2005-1, App. C (\$184.7 million over a revenue requirement of \$72,712.4 million).

⁹ DMA-T-1, at 10, cited in DMA RR Brief at 2.

¹⁰ Even Ivory soap claims only .9944 purity. See http://www.ivory.com/YourIvoryProducts_ClassicIvoryBarSoap.htm.

Tellingly, DMA et al.'s argument does not explicitly state that it would be unlawful for the Commission to recommend the rates and fees requested by the Postal Service and projected on the record to yield a \$97 million net surplus. Indeed, it would be perfectly consistent with the PRA for the Commission to do so, based on the settled interpretation of § 3621 and the need to balance all the relevant policies of the Act in the iterative process by which rates and fees are developed.

B. DMA et al.'s Argument that the Postal Service Underestimates Savings in Supervisory Costs Is Based on Nonexpert Speculation and Is Contravened by the Record

DMA et al. argue that the Postal Service has underestimated supervisory savings and that the Commission should instead rely on witness Buc's "consistent methods supported by record evidence."¹¹ Unfortunately, witness Buc's "methods" and DMA et al.'s arguments rely on blind consistency and ignore record evidence and expert testimony.

DMA et al. first argue that the Postal Service's approach to estimating supervisor cost reduction savings is inconsistent with its "rollforward method." What DMA et al. refer to as the "rollforward method" is the assumption that changes in craft employee resources caused by changes in mail-volume workload result in proportional changes in supervisors. The notion that this "method" should be automatically applied to cost reduction programs is simplistic and is contradicted by the record.

A workload reduction provides an opportunity to capture craft labor resources and supervisors in the same proportion. Employees do not automatically disappear

¹¹ DMA RR Brief at 5-8.

when volume declines; management has to take steps to reduce employee resources—whether craft labor or supervisors—to match the lower level of workload. A cost reduction program is not the same as, and does not operate in the same manner as, a workload reduction. Rather, a cost reduction program is an attempt to handle the same amount of workload in a new and more efficient way. The introduction of a new method or a new piece of equipment does not reduce workload, as is reflected by the “rollforward method.” Rather, it changes the work environment to handle the same workload more efficiently. As witness Loutsch testified: “Most cost reduction programs result in changes in the work environment”¹² Supervisors are still required to manage the new process, the new equipment, and the new mail flow, even if one or two fewer craft employees are needed. Witness Oronzio’s testimony explains why the “theoretical” elimination of 0.09 supervisors that would result from witness Buc’s and DMA et al.’s blind insistence on consistency is, in reality, balanced against changes in the environment and in supervisory responsibilities in the context of the entire operations of a facility. He explains how, in fact, this happens in the budget process, and explains that any supervisory savings that can be hoped to be achieved are reflected in the budget and are already deducted from rate case cost estimates through the breakthrough productivity initiative (BPI).¹³ As explained by witness Oronzio, this process has at its base the “specific circumstances” of each plant. DMA et al. ignore this evidence on the record in their apparent attempt to malign the Postal Service’s approach as “simply ask[ing] around Headquarters as to what the relevant program

¹² USPS-T-6, at 31.

¹³ USPS-RT-15, at 5-7.

office believed the cost changes should be.”¹⁴ Rather, testimony from postal experts, as well as common sense, demonstrate why the hypothetical reduction of 0.09 supervisors will not occur.

DMA et al. allege that the Postal Service provides no evidence to support its experts’ opinion that cost reduction programs result in changes in the work environment.¹⁵ One wonders on what basis DMA et al. challenge postal experts’ statements that should be of no surprise even to non-expert observers of postal operations. How could the introduction of new equipment, for instance, *not* change the work environment? The only support DMA et al. provide is witness Buc’s belief that there are two programs, out of the many presented, that do not appear to him to change the work environment. Witness Buc is not presented as an expert on postal operations and his testimony makes no claim to such expertise. He provides no explanation or analysis to support either his “reading” of the other cost reduction programs or his conclusion that “many do not” change the work environment.

Nor does his superficial analysis of the job descriptions provided for the record by the Postal Service¹⁶ provide any insight concerning the relative amount of supervisory effort devoted to any one of the responsibilities. He merely noted that the primary responsibility was to supervise and pointed to five of the ten responsibilities in the first “analysis” and one responsibility in the second “analysis.” But he did not study or address what portion of the supervisor’s time is spent in supervisory versus the other defined functions or provide any basis for determining the relationship between

¹⁴ DMA RR Brief at 6.

¹⁵ *Id.*

¹⁶ *See id.*, citing DMA-T-1, at 5.

supervisory time and reductions in craft positions related to equipment programs. There is no reason that his lay beliefs should supervene the judgment of postal managers in the process of actually budgeting for the needs of postal operations, including supervisors, as described by witness Oronzio.¹⁷

It bears emphasizing that it is not the Postal Service's position that cost reduction programs present no opportunity to reduce supervisor resources. Rather, the Postal Service's position is that those savings opportunities are not exactly proportional to reductions in craft resources and that the supervisor savings reductions are incorporated into the BPI cost reductions. This mechanism, as described by witnesses Loutsch, Oronzio, and Lyons, allows supervisory costs to be reduced appropriately, rather than arbitrarily and contrary to reality, as DMA et al.'s argument would have it.

As witness Lyons testified, to impose DMA et al.'s proposal would be akin to double counting and would overstate expected savings.¹⁸ The Commission is urged not to make this unfounded and damaging reduction. In an environment in which capturing cost savings has become more and more challenging and has not been fully achieved in the past two years,¹⁹ double counting savings estimated for the test year would be a serious mistake.

C. DMA et al.'s Arguments that There Be No Provision for Contingencies Are Inconsistent with the Act, the Record, Commission Precedent, and the Financial Stability of the Postal Service

DMA et al. argue that there should be no provision for contingencies in this case, despite the clear statutory requirement and years of precedent. As an initial matter,

¹⁷ USPS-RT-15, at 5-7.

¹⁸ USPS-RT-3, at 5.

DMA et al.'s brief erects a strawman argument concerning the Act's division of ratemaking responsibilities with regard to the provision for contingencies.²⁰ Their brief takes Postal Service testimony explaining how postal management determined one percent as the appropriate contingency provision to include in its rate request and twists it into an argument that the provision is immune from review in this proceeding. DMA et al. misuse witness Lyons's historical statement that the Commission recommended the amount requested by the Postal Service in all but two cases—with citations to them and their subsequent history—as a basis for rehashing settled issues that the Postal Service has not raised.²¹

In fact, the long quotation from the Commission's Opinion in R2000-1, which DMA et al. include in their brief,²² acknowledges the respective roles of the Board, the Commission, and the Governors in the ratemaking process. It includes the Commission's acknowledgement that its on-the-record review of the revenue requirement, including the contingency, is not final, and is subject to a determination by the Governors of the ultimate revenue sufficiency of its recommendations, including the amount allotted for contingencies.²³

¹⁹ *Id.* at 6.

²⁰ DMR RR Brief at 9-10.

²¹ DMA et al. gratuitously exhort the Commission “not [to] lose sight of the fact that it is an *independent* regulatory agency.” DMA RR Brief at 12 n. 35. DMA et al. provide no citation to a lapse in this regard; neither is the Postal Service aware of any.

²² DMA RR Brief at 10.

²³ The debate that DMA et al. attempt to push to the forefront of the facts in the current case arises out of a long history of judicial and agency interpretation. While the Postal Service continues to assert its interpretation of the law in this regard, it bears noting that it does not contend that the Commission has no role in evaluating the contingency provision. For a complete explanation, see the lengthy discussion in the Decision of the Governors of the United States Postal Service on the Recommended Decision in

Apparently, DMA et al. see benefit in deflecting attention away from the actual substance of the Postal Service's testimony explaining how the request was formulated, and redirecting it toward an imagined challenge to the Commission. The Postal Service's argument is simply that the Commission, once it reviews the entire record, should reject the proposals put forth in the testimony of DMA et al. And, as set forth below, it should do so on substantive grounds, in favor of the Board's judgment, explained on the record by witnesses Loutsch and Lyons, that a contingency provision of one percent is needed.

1. The test year cash balance will not provide a sufficient cushion against adverse financial outcomes.

In their brief, DMA et al. inexplicably continue to pretend that witness Buc was correct in asserting that the Postal Service will have \$3.8 billion in cash at the end of the test year.²⁴ This \$3.8 billion, however, was corrected in witness Buc's revised testimony dated October 26, 2006, to \$5.587 billion. DMA-T-1, at 15. This is apparently a typo, since that page cites Tab 8 of DMA-LR-1, which shows \$4.587 billion. Witness Buc agreed during oral cross-examination that to determine the amount of cash at the *end* of the test year, it would have been appropriate to subtract the escrow amount of \$3.6 billion for that year from \$4.587 billion.²⁵ This leaves \$1 billion, which is the amount of cash the Postal Service estimates it will have at the end of the test year.²⁶ DMA et al.'s brief blithely ignores these facts, relying on an original mistaken amount.

Further Reconsideration of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R2000-1, at 29-55 (May 7, 2001).

²⁴ DMA RR Brief at 14, citing DMA-LR-1, Tab 8. On the stand, however, witness Buc indicated that the source was Tab 9. Tr. 22/8036.

²⁵ Tr. 22/ 8039-40.

²⁶ USPS-LR-50, at 271 (intincExp_06.xls).

As explained by witness Lyons, the Postal Service will be out of cash at the end of the test year. The Postal Service will have to borrow \$3.563 billion over the period FY 2006-2008 in order to maintain a bare minimum of \$1 billion in cash at the end of the test year. This level of cash represents less than one payroll.²⁷ This borrowed cash does not satisfy the contingency provision's purpose of providing a cushion against adverse outcomes. It should be noted, moreover, that the \$3.6 billion escrow amount, along with other expenses described below which DMA et al. ignore in their reliance on witness Buc's incomplete calculations has, in the interim, been replaced, as a result of the Postal Accountability and Enhancement Act of 2006 (PAEA), by an even bigger payment—in the amount of \$5.6 billion—to fund health benefits.²⁸

Even if the Postal Service did project a significant cash balance at the end of the test year, that projection would not support the reduction of the contingency provision to zero that DMA et al. propose. It is well settled that the contingency is intended to protect against the unforeseen occurrence of a loss in the test year, as DMA et al. themselves state in their brief.²⁹ While large cash balances can provide a short-term cushion in managing day-to-day finances, they do not protect against the occurrence of a loss in the test year and a worsening of the Postal Service's financial position due to conditions and events that could not be predicted with certainty, which is the primary purpose of the contingency provision.

²⁷ USPS-RT-3, at 12.

²⁸ 39 U.S.C. § 8909a(d)(2)(B), as added by P.L. 109-435. Further effects of the PAEA on test year postal finances are discussed below.

²⁹ DMA RR Brief at 16.

2. Equity does not provide the required cushion against loss in the test year.

Although DMA et al. also cite positive equity as a reason for reducing the contingency provision to nothing,³⁰ equity is even less effective as a cushion than cash in the bank. Equity will not prevent a loss in the test year, nor can it be used as a temporary cushion like cash. Similarly, the components of equity, such as buildings and equipment, do not provide an adequate cushion, since they first would have to be converted to cash. Accordingly, an assumed “fire sale” on Postal Service assets cannot be relied upon as providing a way to cushion against adverse financial events.

DMA et al. argue that because the after-rates test-year equity is higher than the estimated test-year equity balance in Docket No. R97-1—when the Postal Service’s contingency provision was also one percent—no contingency provision is needed now.³¹ This argument is based on two faulty premises: that the Postal Service’s financial position at that time was strong, and that the Postal Service used a one-percent contingency in that case was because of its strong financial position. The record is otherwise. Witness Tayman explained that the one-percent contingency provision was a policy decision based on management’s “desire to keep rate increases as low as possible and below the level of growth in general inflation.”³²

The estimated test year equity balance of \$2.3 billion is the lowest level of equity since FY 2003 and only moderately higher than the Postal Service’s beginning level of equity of \$1.686 billion in FY 1971.³³ That level of equity was 19.2 percent of FY 1971

³⁰ *Id.* at 13-14.

³¹ *Id.*

³² Docket No. R97-1, USPS-T-9, at 38.

³³ Annual Report of the Postmaster General, 1971-1972, at 35.

revenue, which stood at \$8.751 billion.³⁴ A comparable level of equity in FY 2008 would be \$14.9 billion. DMA's argument that the current level of equity provides a cushion against unforeseen costs is unpersuasive.

3. Real estate is no substitute for a contingency provision.

The arguments made by DMA et al. regarding the effect of the Postal Service's real estate holdings on the Postal Service's financial condition were refuted by witness Lyons.³⁵ In their brief, DMA et al. stretch the record far and wide, yet the acres are not so green as DMA et al. portray. They cite the ratio of market value of book value of real estate *sold* from 2001 to 2006 and argue that "there is no reason to believe that this relationship does not hold for all Postal Service real estate."³⁶ But there is no evidence on the record and no reason to believe that this ratio necessarily does hold. Regardless, the fact remains that the vast majority of these buildings are held because they are an essential part of the network.³⁷ Speculation that they might be sold for more than their book value does nothing to protect against a loss in the test year.

DMA et al. also argue there is value to be captured from postal real estate without its sale by virtue of air rights. This argument ignores the fact that any revenue from air rights would already be included in the Postal Service's estimate of miscellaneous revenue. Put in perspective, the suggestion that such small sources of potential revenue, even if actuated, would be enough to negate the need for a contingency is completely implausible.

³⁴ *Id.*

³⁵ USPS-RT-3, at 12-13.

³⁶ DMA RR Brief at 15.

³⁷ USPS-RT-3, at 13.

4. Variance analysis must not be a fair-weather friend.

As the Commission is aware, the Postal Service has maintained the position over the years that analysis of past variances between projected and actual revenue and expenses should not be used exclusively or as the main factor to the exclusion of management judgment in determining the appropriate size of a future provision for contingencies. The Commission, however, has considered variance analysis as one factor in its examination of the record on the provision for contingencies in past rate cases.

Not surprisingly, therefore, in Docket No. R2000-1, witness Buc devoted considerable attention to variance analysis in his revenue requirement testimony. But his testimony in the instant case contains nary a word about variance analysis, pro or con. In attempting to analyze this phenomenon, one cannot help but observe that the variance analysis witness Loutsch presented—to satisfy the Commission’s requirement that the Postal Service do so as part of its rate case requests—would indicate a contingency in the range of 1.6 to 3.2 percent. Nevertheless, the Board of Governors exercised their judgment to determine that a lower contingency provision—one percent—was the appropriate amount to include in the revenue requirement underlying the request for changes in rates and fees in this docket.

When asked to explain the lack of discussion about variance analysis in his testimony, in contrast to his extensive discussion of it in Docket No. R2000-1, witness Buc equivocated, first stating that he “did not spend very much time at all looking at the variance analysis,”³⁸ and then stating that it was “just not within the work that I did in this

³⁸ Tr. 22/8052

particular case.”³⁹ In the wake of witness Buc’s inartful dodging, DMA et al. apparently falter—no doubt as a result of repetition of a longstanding refrain—by urging the Commission to consider variance analysis as one of the important factors:

Thus, the Commission has looked to objective criteria such as a variance analysis, the financial condition of the Postal Service and its ability to weather adverse outcomes, and the general state of the economy to assess a proposed contingency. While none of these individual factors is dispositive, each has an important role in informing the Commission’s exercise of its discretion.⁴⁰

Consideration of variance analysis, however, would repudiate DMA’s proposal for no contingency provision and could support inclusion of a contingency provision as large as 3.2 percent.⁴¹

5. Actual events support the need for a contingency provision.

DMA et al.’s contention that no contingency provision is needed is belied by actual events with regard to the enumerated “unknowns” originally set forth in witness Loutsch’s testimony⁴² and the analysis provided by witness Lyons of FY 2006 financial results and the Postal Service’s Integrated Financial Plan for FY 2007.⁴³ It is now known that the Postal Service will not be receiving interest on the escrow amounts

³⁹ Tr. 22/8054. Witness Buc testified that he looked only at “[h]ow able is the Postal Service to cope with any possible adverse outcome, not what size the adverse outcome might actually be.” *Id.* at 8053. Witness Buc sounds like a financial adviser who assures a client that because the client has \$10,000 (borrowed) dollars in the bank and a residence with lots of equity, the client need not worry about paying next year’s credit card bills, even though the financial adviser does not know whether the bills are going to total \$1,000 or \$100,000.

⁴⁰ DMA RR Brief at 13.

⁴¹ In the unlikely event that further clarification is needed in this regard, the Postal Service is advocating neither reliance on variance analysis nor a higher contingency provision than it proposed. This argument is intended to point out the inconsistencies, both internal and historical, in the argument put forth by DMA et al. in the instant case.

⁴² USPS-T-6, at 62.

⁴³ USPS-RT-3, at 6-9.

required under P.L. 108-18, since escrow funds will be paid to the newly established Postal Service Retiree Health Benefits Fund.⁴⁴ The full amounts of projected cost reductions for FYs 2005 and 2006 were not realized.⁴⁵ Fuel and energy costs caused FY 2006 expenses to be higher than expected.⁴⁶ Workers' compensation expense in FY 2006 was \$163 million more than expected.⁴⁷ The September 2006 COLA was \$400 million more than expected.⁴⁸ The Postal Service's Integrated Financial Plan (IFP) for FY 2007 indicates that postal finances will be \$400 million worse than is estimated in the revenue requirement.⁴⁹ And the risk of adverse effects from further unknowns remains; a reasonable contingency is therefore both appropriate and necessary under the terms of § 3621, which remain in effect at least for the instant case.

D. The Effect of the PAEA on Test Year Estimates Is Financially Challenging, Rather Than Enriching, as DMA et al. Speculate

DMA et al. make some creative, yet unsubstantiated, arguments about the effect of the just-enacted Postal Accountability and Enhancement Act of 2006, P.L. 109-435.⁵⁰ While the Commission certainly may take official notice of the Act, its provisions, and their explicit effect, much of the rumination in DMA et al.'s brief regarding its effects is speculative at best. Relying on the myth that the PRA contemplates a three-year rate cycle, DMA et al. argue that "any financial cushion incorporated into this case ... will

⁴⁴ P.L. 109-435, section 804.

⁴⁵ USPS-RT-3, at 6.

⁴⁶ *Id.* at 6-7.

⁴⁷ *Id.*

⁴⁸ *Id.* at 8.

⁴⁹ *Id.* at 7.

⁵⁰ DMA RR Brief at 16-19.

remain in USPS bank accounts” due to the asserted operation of the PAEA.⁵¹ This argument assumes that all estimates on which this case are based end up being identical to actual results and no unknown adverse events occur. As shown above, this is already known not to be the case. Moreover, DMA et al.’s logic, taken in the other direction, should lead to the equally, if not more, troublesome conclusion that any shortfall in the test year in this case might never be recovered, to the permanent detriment of the Postal Service and thereby to those who depend on the mail, and on the availability of quality postal services, such as DMA et al. The contingency provision is intended to provide a cushion against a shortfall and is no less necessary in this case than it has been in the past.

DMA et al.’s argument that “the PAEA makes it virtually certain that the impact of any adverse financial developments ... in the test year, FY 2008, will be very short-lived” is a non sequitur. The provision for contingencies is designed to provide a cushion against adverse financial outcomes *in the test year*. The test year will only last a year, postal reform notwithstanding. And the contingency provision is only one percent, too small to fuel the longer rate cycle that has occurred during certain periods in the past. Given the timeframes in the PAEA, with a year for a final case under the current system and with 18 months of rulemaking to define the new system, one can reasonably expect that rates from the new ratemaking system are unlikely to go into effect before FY 2010. By then, the revenue generated by the one percent contingency provision will be long gone.

⁵¹ *Id.* at 18.

In fact, the known effect of the PAEA on test year finances, as shown in the table below, has nearly consumed the entire contingency amount before the test year even begins and before consideration of the negative financial trends discussed by witness Lyons.⁵² Even with a one percent contingency provision, the Postal Service is much more likely to end up in the red in the test year than to have the bulging bank accounts that DMA et al. posit.

Test Year Impact of PAEA ⁵³ (\$ in millions)	
Eliminate CSRS Employer Contribution	1,357 ^a
Eliminate Escrow Amount	3,588 ^b
Eliminate CSRS Supplemental Liability	290 ^b
Eliminate Escrow Interest	-297 ^c
<hr/>	
Total Items Eliminated	4,938
Payment to Pre Fund Health Benefits	-5,600 ^d
<hr/> <hr/>	
Impact on Net Income	-662

The final argument made by DMA et al., that “any adverse developments that will have occurred in the Test Year in this case, and their financial impact, will be clear to the Commission by the time it issues its Recommended Decision” in the (optional) next rate case under the current ratemaking system,⁵⁴ does not bear scrutiny. The latest

⁵² USPS-RT-3, at 6-9.

⁵³ Sources:

^a Exhibit USPS 6O (\$811 million CSRS cost increase of 10.4% factored up to 17.4%).

^b Exhibit USPS 6O.

^c Exhibit USPS 6G.

^d Section 8909a(d)(2)(B).

⁵⁴ DMA RR Brief at 19.

such a final omnibus case could be filed is December 20, 2007.⁵⁵ The Commission would therefore have until October 20, 2008 to issue its Recommended Decision. There would not be sufficient time for audited final results for FY 2008 to be produced, let alone considered by the Commission on the record. Accordingly, DMA et al.'s arguments about the PAEA fail to have any bearing on the legal and financial necessity, under the currently applicable system and in accordance with well-established precedent, for a contingency provision.

⁵⁵ New section 3622(f).

II. THE POSTAL SERVICE ONGOING DATA COLLECTION SYSTEMS PROVIDE ACCURATE ESTIMATES OF COSTS ON WHICH ITS PROPOSED CLASSIFICATIONS, RATES AND FEES ARE PROPERLY BASED.

The National Newspaper Association (NNA) continues to participate in Commission ratemaking proceedings on behalf of largely successful small community newspapers that enter significant portions of their circulation at Within-County Periodicals rates. Inevitably, NNA argues the cost estimates are too high and volume estimates are too low, thereby assailing the two primary input values necessary to calculate unit costs. NNA's most significant focus in this docket is upon mail processing and in-office city carrier costs derived from the In-Office Cost System (IOCS), whose data collection instrument (questionnaire) was recently revised after a prolonged period of close examination.

Postal Service witnesses Dr. Martin Czigler (USPS-T-1) and Dr. A. Thomas Bozzo (USPS-T-46) testified about IOCS. Dr. Czigler's focus was upon the estimates and CVs produced by IOCS for mail processing costs (Table 1), city carrier in-office costs (Table 2), and Supervisor costs (Table 3). He also briefly addresses changes in city carrier and supervisor costs driven by the IOCS redesign.

Dr. Bozzo's direct testimony lays out the context within and processes utilized to redesign the IOCS data collection instrument, necessary data elements, major changes in approach, and testing and validation. Dr. Bozzo also provided rebuttal testimony (USPS-RT-1) that responds to challenges of IOCS results by NNA's witnesses. Both witnesses testimonies are addressed in the Postal Service Initial Brief section II(A) at 15-26.

NNA has been claiming since the mid 1990s that Postal Service data collection systems do not accurately reflect volumes or costs incurred by Within-County Periodicals mailers. Since Within-County volumes are modest when compared to other subclasses, NNA finds support in the fact that the data systems correspondingly show larger CVs than do larger subclasses.

Below, this reply brief addresses arguments made largely by NNA, some supported by Newspaper Association of America (NAA), in initial briefs regarding IOCS and the Revenue, Pieces and Weight (RPW) system. It also addresses the claim by Major Mailers Association (MMA) that the Postal Service has not been responsive regarding First-Class Presort costs.

A. IOCS Cost Data: NNA's Claim That The BY 2005 IOCS Cost Data for Within-County Periodicals Are Unreliable and Overstated Lacks Evidentiary Support on the Record

At the heart of NNA's argument that the IOCS estimates of Within-County Periodicals costs are too high is an inversion of Dr. Bozzo's conclusions, which are based on extensive testing of the redesigned IOCS data collection instrument, that BY 2005 estimates of subclass costs (including those of Within-County Periodicals) have been improved. NNA asserts that the Postal Service has offered no evidence that previous Within-County Periodicals costs were in error, and, moreover, has neither explained the causes of the previous errors nor shown how the redesigned IOCS data collection instrument remediates the situation. Thus, NNA claims, the absence of significant errors in the prior IOCS instrument "must" lead the Postal Service to "conclude that the new IOCS instrument overstates the costs of Within-County

Periodicals.”¹ NNA witness Siwek claims that the cost increase results from deficiencies in the “processes and data used by the USPS to estimate the volume variable costs of the Within-County Periodical [sic] subclass.”² The record shows otherwise.

First, NNA’s contention that the Postal Service failed to identify problems with the old IOCS instrument is false. Dr. Bozzo indicates how Within-County Periodicals costs previously were understated, how the redesigned IOCS instrument remedies the issue, and that the fix was successful.³ By the same token, Dr. Czigler describes improvements in the recordation of mailpiece markings leading to better identification of sampled pieces.⁴ NNA’s false predicate regarding the old IOCS instrument notwithstanding, NNA’s claim that the Postal Service procedures overstate Within-County Periodicals costs fails because no source of an overstatement has been demonstrated; despite its myriad attempts, NNA is unable to challenge the accuracy of even one Within-County IOCS tally.

Witness Siwek’s contention that the increase in measured Within-County Periodicals costs can be traced to “deficiencies” in the Postal Service “processes and data” likewise fails. While changes in IOCS methods are identified as the cause of the Within-County Periodicals increase, the relevant changes are not specific to Within-County Periodicals and involve no demonstrated deficiency. Additionally, the data elements and processes specific to Within-County Periodicals are unchanged and therefore cannot have caused the shift.

¹ NNA Initial Brief at 8, emphases in original.

² NNA Initial Brief at 3.

³ USPS-T-46 at 35-37.

⁴ USPS-T-1 at 12.

1. NNA cannot show material overstatement of Within-County Periodicals costs resulting from IOCS methods.
 - a. The redesigned IOCS instrument accurately identifies Periodicals tallies.

For NNA's claim that the BY 2005 IOCS data lead to a material overstatement of Within-County Periodicals costs relative to BY 2004 to be true, IOCS must misidentify mail of other classes as Periodicals and/or misidentify Outside-County Periodicals as Within-County Periodicals. The record clearly shows that IOCS does not over-identify Periodicals in general, and that the possibilities for misidentifying Outside-County Periodicals as Within-County do not point to quantitatively or qualitatively significant issues with the Within-County Periodicals tallies.

Dr. Bozzo identifies efforts to improve the identification of obscure Periodicals titles – some of which had been implemented for BY 2004 while the redesigned IOCS instrument was still undergoing testing – as the major cause of the Within-County Periodicals cost increase.⁵ Dr. Bozzo describes a new IOCS data collection model incorporating a questionnaire branch tailored for pieces without indicia, of which Periodicals are a major component, that reduces the previous instrument's need for data collectors and respondents to pre-identify pieces as Periodicals prior to entering the title and other information used to validate Periodicals tallies in subsequent data processing.⁶

The evidence shows that the Postal Service's data collection methods are successful at identifying but not over-identifying Periodicals. Dr. Bozzo notes that

⁵ See, e.g., USPS-T-46 at 36.

⁶ USPS-T-46 at 35; Tr. 9/2334.

testing of the IOCS redesign showed no overstatement of Periodicals.⁷ While NNA seeks to place stock in the fact that the IOCS testing was not specific to Within-County Periodicals,⁸ it is important to note that the IOCS data collection methods for Periodicals also are not specific to Within-County Periodicals. Rather, data collectors record observable characteristics that are used in subsequent processing to validate tallies as belonging to Periodicals and to identify the subclass.⁹

The IOCS methodology changes affect a larger proportion of Within-County Periodicals, but data provided by Dr. Bozzo show that the methodology changes affect much larger absolute amounts of Outside-County Periodicals costs – \$173.5 million (Outside-County) vs. \$3.8 million (Within-County) for titles added to the Periodicals lookup list, \$30 million vs. \$5.7 million for titles not on the lookup list.¹⁰ The Postal Service testing, while not specific to Within-County Periodicals, is relevant because problems with the IOCS methodology applicable to both Within-County and Outside-County Periodicals subclasses would have been observable in the aggregate Periodicals data. Yet, as noted above, no such problems were observed.

- b. The record shows that the Within-County Periodicals identification issues raised by NNA do not lead to material problems for the tally editing processes.

The bulk of NNA's case for overstatement of Within-County Periodicals costs stands on assertions that the Postal Service tally editing processes may mistake Outside-County Periodicals pieces for Within-County Periodicals. While NNA restates

⁷ USPS-T-46 at 36.

⁸ NNA Initial Brief at 7.

⁹ Tr. 9/2336, 2346.

¹⁰ USPS-T-46 at 37.

the alleged problems,¹¹ they conveniently ignore the bulk of the evidence on the magnitudes of the problems raised by the NNA witnesses.

NNA restates witness Heath's incorrect assertions that, for certain categories of non-subscriber pieces, the edit checks "would fail to accurately identify the [rate category for the] piece."¹² However, witness Heath misstated the applicable regulations, which permit non-subscriber pieces to be mailed at Within-County rates within limits.¹³ Witness Heath amended his argument to suggest that mailers would reserve their ability to mail non-subscriber pieces at Within-County rates, but he admits that mailers within the limits would employ Within-County rates on eligible pieces.¹⁴ Dr. Bozzo notes that the extent of the potential problem depends on the extent to which mailers exceed the limits on non-subscriber pieces allowable at Within-County rates, and shows that to be a trivial 0.1 percent.¹⁵

The matter of "wandering routes", likewise, does not lead to a significant data quality issue in practice. This concern arises because the destination data recorded in IOCS and used in the edit process identify a "main" county for the delivery route (based on the 5-digit ZIP Code), but some route segments may cross into adjacent counties. However, each 9-digit ZIP Code route segment resides entirely within one county. For the delivery ZIP Codes underlying the BY 2005 Within-County Periodicals tallies, only 1.5 percent of route segments, and likely fewer addresses, are located outside the primary county; the problem, as described by witness Heath, could be addressed by collecting the 9-digit delivery ZIP Code and incorporating that additional information into

¹¹ NNA Initial Brief at 9-10.

¹² Id.

¹³ USPS-RT-1 at 7-8.

¹⁴ Tr. 29/9648, 9771.

¹⁵ USPS-RT-1 at 9-10.

the determination of destination county.¹⁶ As the Postal Service noted in its Initial Brief, the Postal Accountability and Enhancement Act appears to have changed the rate eligibility for at least some such pieces, though the exact data requirements under the new law have yet to be determined.¹⁷ Regardless of the final disposition, the problem described by witness Heath is minor, amenable to a ready fix, and cannot be associated with any supposedly erroneous tallies.

NNA argues that the Postal Service is unable to observe issue-to-issue variations in circulation, or the rate paid for specific pieces,¹⁸ without addressing whether the absence of such observations is meaningful. Again, the evidence suggests that they are not. NNA witness Heath cannot identify any examples of a title losing and then regaining eligibility to mail at Within-County rates.¹⁹

NNA's witnesses agree that mailers have strong financial incentives to claim the much lower Within-County rates for eligible pieces, and do not identify any circumstances that might be exceptions.²⁰ Indeed, witness Siwek had narrowed his critiques of the ability to infer Within-County rates to the limited non-subscriber piece situations raised by witness Heath.²¹ As a result, there is no reason to believe that eligibility – which is mostly determined through the actual use of Within-County rates – is insufficient to infer use of the rates.²²

¹⁶ USPS-RT-1 at 11-13.

¹⁷ Postal Service Initial Brief at 23.

¹⁸ NNA Initial Brief at 10.

¹⁹ Tr. 29/9594.

²⁰ Tr. 29/9595, 9673.

²¹ *Id.*

²² USPS-RT-1 at 3, 6.

- c. Regardless of their practical import, none of the "deficiencies" claimed by NNA witnesses are responsible for the Within-County Periodicals cost increase.

The record shows that the inferences employed in the Postal Service edit procedures are valid, and the effects of the issues raised by the NNA witnesses are far too small to contribute to the Within-County Periodicals cost increase. Regardless, the factors raised by NNA cannot account for the increase because they involve data elements and processes that are unchanged from BY 2004.²³ NNA's critiques, broadly, deal with cases in which the observed characteristics of pieces may not be fully dispositive of the rate category in the absence of a specific rate marking. Since the old and redesigned IOCS instruments collect the same data elements,²⁴ the NNA critiques would apply to BY 2004 as well – though there is no reason to believe that the problems shown to be minor in the BY 2005 sample would be significantly worse in other samples.

Given that IOCS records publication titles on the tallies, that most Within-County Periodicals tallies are linked with *PostalOne!* data showing that the mailers actually used Within-County rates, that the remaining tallies are individually reviewed for evidence of Within-County rate eligibility, the undisputed fact that mailers will claim Within-County rates for eligible pieces, and finally the evidence that categories of ineligible pieces that may appear eligible to the edit processes are too small to account for any material source of cost increase, NNA's claim that the BY 2005 Within-County Periodicals costs are significantly overstated faces long odds.²⁵ Indeed, NNA

²³ Compare, e.g., USPS-LR-L-9, Appendix D, with Docket No. R2005-1, USPS-LR-K-9, Appendix D.

²⁴ See USPS-T-46 at 4.

²⁵ USPS-T-46 at 36; USPS-RT-1 at 6, 18.

demonstrates no specific errors in the IOCS Within-County Periodicals tallies, and no significant reason to overturn the inferences used to assign activity codes.

2. Postal Service witnesses Bozzo and Czigler accurately describe the sampling CVs of Within-County Periodicals costs; reduced CVs are possible but not costless.

NNA criticizes Dr. Czigler and Dr. Bozzo for "seem[ing] to argue that a higher CV should be accepted for a small subclass like Within-County Periodicals."²⁶ However, the Postal Service witnesses were simply describing how, given the sample size, small categories of mail will have relatively high CVs, or that the IOCS sample size must be increased very dramatically to reduce the CVs to the current levels observed for large categories.²⁷ In effect, NNA is "stuck" with the mathematical properties of sample-based estimators.

Newspaper Association of America (NAA) follows NNA's lead and suggests that Within-County mailers suffer because of 'the thinness of sampling tallies'.²⁸ However, as shown by witness Siwek, the increase in costs in BY 2005 is statistically significant and is not due to sampling variation.²⁹ In any event, a small sample size does not imply any bias in estimates.

What is clear is that reduction of CVs for Within-County Periodicals is not free. Expanding the IOCS sample several fold, to reduce the sampling CV for Within-County Periodicals to levels presently experienced by larger subclasses, would be very expensive. Dr. Bozzo notes that the properties of Within-County Periodicals are not

²⁶ NNA Initial Brief at 11.

²⁷ Tr. 10/2437-2438.

²⁸ NAA Initial Brief at 46.

²⁹ NNA-T-3 at 12.

such that targeted increases in sampling rates could materially improve estimates' sampling properties at low cost.³⁰ Certainly, any special study that could be used to augment the sample-based data also would not be costless, and a reduction of supposed "risk" from sampling variation in the Within-County Periodicals costs would be offset, to some extent, by the certainty of higher measurement costs.

3. NNA's pooling proposal is not a "free lunch."

NNA's proposal to pool Within-County Periodicals costs purports to improve the accuracy of the cost data without the expenses of increasing IOCS sampling rates or engaging in special cost studies. NNA calls it a "practical and reasonable" "solution to the small sample problem."³¹ However, as Dr. Bozzo notes, the "problem" of the Within-County Periodicals cost increase is not a matter of sampling variability of the data.³² Nor does witness Siwek's pooling proposal constitute an application of "sequential sampling" methods, as advertised by witness Siwek. The appearance established by witness Siwek's proposal is that reducing Within-County Periodicals costs from the BY 2005 levels is more important than the stated goal of reducing sampling variability of the costs.³³

The main problem with the NNA's proposal – and why it is "practical" but unreasonable – is that pooling costs from statistically distinct populations is inappropriate.³⁴ Witness Siwek agrees.³⁵ The upshot is that any benefit from reduced

³⁰ Tr. 36/12347.

³¹ NNA Initial Brief at 12.

³² USPS-RT-5 at 20.

³³ *Id.* at 22.

³⁴ USPS-RT-1 at 21.

³⁵ Tr. 29/9685.

sampling CVs is offset by the introduction of a downward bias to the cost, since the pooled cost estimate includes the understated BY 2004 figure.³⁶

4. NNA's claim that Within-County Periodicals mailers bear a one-sided risk from variation in cost estimates is incorrect.

NNA argues that Within-County Periodicals mailers face a risk from sampling variation in cost estimates that the Postal Service does not share. NNA contends that overestimates of costs will be borne by mailers in the form of higher rates, while the contingency provision in the Postal Service revenue requirement protects the Postal Service from underestimates of cost.³⁷ NNA's argument misapprehends the main purpose of subclass-level cost estimation.

Subclass-level costs have the functions of determining the efficiency of the rate structure (the function of unit volume-variable, or marginal, costs) and, especially, ensuring that mailers using one subclass do not cross-subsidize mailers who use other subclasses (the function of incremental costs).³⁸ The latter is required by the statutory criteria for postal ratemaking.³⁹ NNA's contention that its "risk" from errors in cost measurement is one-sided is incorrect in that the "counterparty" is not the Postal Service, but rather other mailers who may be required to pay differences between Within-County rates and the associated costs. The statutory ratemaking scheme deprecates class- and subclass-level cross-subsidies, however small and diffuse the potential burden of small subclasses such as Within-County Periodicals on others might be.

³⁶ USPS-RT-1 at 21-22.

³⁷ NNA Initial Brief at 12-13.

³⁸ See, e.g., Tr. 36/12517-12518.

³⁹ 39 USC 3622(b)(3).

Of course, the introduction of more accurate causal costing methods may, in principle, raise or lower the incremental (or "attributable") cost floor on rates, as substantial evidence may dictate. In the case of Within-County Periodicals, the evidence shows that the BY 2005 cost estimates are the most accurate estimates available to the Commission, so the NNA proposal for cost relief through pooling should be rejected.

B. RPW Data: NNA Again Sings Its Usual Refrain Claiming That The Postal Service Estimate of Within-County Periodicals Volume Is Inaccurate.

NNA commences its refrain with "BRPW fails to accurately measure much of the Within-County's volume."⁴⁰ NNA then moves on to describe (accurately) how the BRPW (Bulk Revenue, Pieces and Weight) Within-County volume estimate draws from a census group of automated facilities plus a random sample of non-automated offices. NNA observes that BRPW reports a continuing volume decrease,⁴¹ and attempts to rebut that trend line using the qualitative opinion of an NNA expert who asserts that the trend is not decreasing.

NNA's argument contains two flaws, neither of which provides a dispositive basis for concluding whether there is a downward trend in Within-County volumes. First, NNA's expert witness Heath is familiar only with NNA members, who consist of successful weekly and daily community newspapers. NNA-T-1 at 3. Within-County mailers also include less commercially focused interests, such as the newsletters of small religious groups or other nonprofit organizations. So even while witness Heath

⁴⁰ NNA Initial Brief at 15.

⁴¹ Technically speaking, the BRPW volume estimates for 2004 and 2005 do not show a downward trend, since the estimates for each year are within the confidence intervals for both years.

claims not to have seen a long term decline in NNA membership, nor the types of mailers typical of NNA, he cannot speak for the entirety of the subclass. The second flaw in NNA's argument is more general: since the advent of the internet, Periodicals publications in general have been recognized as decreasing in number; this is consistent with the observations of Postal Service witness Thress.⁴²

NNA also documented one other weakness in its claim denying the existence of a downward trend in Within-County Periodicals volumes. NNA asked Postal Service witness Pafford (the RPW witness) whether the proportion of Within-County volume reported by the census of offices had changed from the last previous omnibus rate case. Witness Pafford informed NNA that the percentage of Within-County volume reported from *PostalOne!* (census of mailing statements) had increased from 49 percent in 1999 to 60.6 percent in 2005.⁴³ So sampling variation can contribute considerable less error than once it could.

NNA's initial brief contains one gross inaccuracy that should not be left unchallenged. NNA claims the Commission "recognized that NNA continued to refute the reliability in the data systems," citing to the Commission's use of a four-year average of volumes in its Opinion in Docket No. R2000-1 at 451.⁴⁴ However, the Commission in fact gave no credit for refutation to NNA. What the Commission Opinion actually says is that, notwithstanding Postal Service attempts to improve data quality, "[t]o allow for the possibility that there is still some failure to capture Within County volume in its entirety" the Commission returned to the approach it employed in Docket No. R97-1.

⁴² Tr. 6/1361; USPS-T-7 at 204.

⁴³ Tr. 9/2256, 2306.

⁴⁴ NNA at 17.

The Postal Service believes that the RPW volume numbers are now sufficiently consistent from year to year that the base year 2005 estimates can be used without any modification.

C. MMA's Claim That the Postal Service Is Not Responsive Regarding First-Class Presort Cost Increases Is Incorrect.

Major Mailers Association (MMA) expresses displeasure at the increase in costs for First-Class Presort and claims that the Postal Service failed to clarify the cause.⁴⁵ In fact, the explanation was provided in the response to one of their interrogatories, referenced in MMA's own brief.⁴⁶ In their direct testimonies, both Dr. Czigler and Dr. Bozzo explain that some shifts in costs are due to the more accurate identification of markings in the redesigned IOCS survey instrument.^{47,48} Dr. Bozzo further indicates that the IOCS redesign is the likely source for the small increase in costs of First-Class Presort as well as for Standard ECR.

Consequently, increasing the accuracy with which rate markings are identified "shifts" costs to categories requiring additional rate markings for subclass identification. For Standard Mail, the effect is to reduce measured costs for Standard Regular and to increase measured costs for Standard ECR. In First-Class Mail, the same phenomenon would tend to increase costs for presorted First-class Mail relative to Single Piece First-class Mail.⁴⁹

The shift from Standard Regular to Standard ECR is large and statistically significant since markings are critical for correct subclass identification. For First-Class

⁴⁵ MMA Initial Brief at 55-57.

⁴⁶ MMA Initial Brief at 56, footnote 42 (citing to the responses to MMA/USPS-T22-53 (Tr. 4/603-04 (Abdirahman) and Tr. 9/2365-66 (Bozzo)).

⁴⁷ USPS-T-1, p. 12.

⁴⁸ USPS-T-46, Section II.D at 13-15, and Table 6

⁴⁹ Tr. 9/2365-2366.

Mail, most pieces also have postage indicated as well as a marking, as MMA points out. The shift from First-Class Single-Piece to First-Class Presort is correspondingly much smaller, and is not statistically significant, as shown in Table 6 of USPS-T-46. In addition, a new feature of the redesigned IOCS survey instrument is that it warns data collectors of apparent inconsistencies between postage and lack of markings.

While MMA may not like the answer, the Postal Service has provided ample explanation for the increase in First-Class Presort costs. The Commission can accordingly rely the Postal Service's reports of costs, including those for First-Class Mail.

III. NO SERIOUS CHALLENGES TO THE POSTAL SERVICE'S FORECASTING PROCEDURES ARE PRESENTED IN THE BRIEFS OF OTHER PARTIES

The Postal Service's initial brief at pages 33-62 explained why the Commission should once again rely on the established volume forecasting methodology once again sponsored by the Postal Service. No brief submitted by any other party seems to advocate different volume forecast based on any alternative methodology. This fact is not surprising, as no witness sponsored any such alternatives specifically for the purposes of volume forecasting. The dispute instead focuses on elasticity estimates primarily as used in pricing policy.

Besides the brief of the Postal Service, discrete discussion of forecasting-related issues have been identified in four briefs. Three of these contain relatively short discussions. The DMA/ANM Brief Concerning Allocation of Institutional Costs at pages 2-5 expresses general support for the elasticities relied upon by the Postal Service, and identifies the work of Dr. Clifton as wholly inadequate. In criticizing Dr. Clifton's proposed elasticities for both First-Class single piece and for Standard Mail, that brief relies on the rebuttal testimonies of Postal Service witness Thress, and witness Buc (DMA-RT-1). *Id.* at 5. MOAA likewise reviews the record and supports the conclusion that the GCA witnesses have provided no credible basis to challenge the elasticities of witness Thress. MOAA Brief at 37-41. On the other hand, NAA cites to Dr. Clifton's testimony as indicative of potential problems with the Postal Service's elasticities. NAA Brief at 37-38. NAA, however, fails even to acknowledge, much less address, the rebuttal testimony of witness Thress. Moreover, to the extent that the NAA brief cites to its own witness Sidak, NAA glosses over the fact that, despite superficial similarity between the policy arguments raised by Prof. Sidak and the general goal of Dr. Clifton's

testimony, Prof. Sidak's more basic perception of the relative costs and benefits of new technology that are driving diversion out of the mail puts him at fundamental odds with Dr. Clifton's mistaken notion that Internet diffusion must necessarily be increasing the price sensitivity of First-Class mailers. See Postal Service Brief at 41, 58.

The third fourth brief, of course, is that of GCA. As discussed next, the GCA Brief does not provide any basis to depart from the elasticities provided by the Postal Service in this case and supported by the testimonies of witnesses Thress and Bernstein.

A. GCA Misinterprets the Only Possible Conclusion That Can Properly Be Drawn From the Research of Prof. Martin: Stated Simply, Price Matters Least

In its discussions on Prof. Martin's research, GCA attempts to draw the following conclusion:

State simply: price matters.

GCA Brief at 24, 35. GCA claims that the testimony of Dr. Martin is un rebutted. *Id.* at 36. In fact, however, for the reasons discussed at some length in the Postal Services initial brief at pages 38-55, Prof. Martin's testimony actually rebuts itself. His research does not support his conclusions. There is no clearer example demonstrating the ineluctability of this judgment than the portion of his survey results which shows that, for every category of respondents, postal rate changes were rated the least important factor in selecting payment method. See Postal Service Brief at 47-48. Moreover, they were not rated last among just three or four other factors, but were rated as the *tenth of ten*. GCA would prefer to ignore this fact, merely observing in a footnote that

respondents rated other factors “as also being important.” GCA Brief at 36, n. 25.¹ The facts, however, cannot be ignored. Prof. Martin’s rhetoric offers no explanation for why electronic diversion has been greater in certain periods without nominal postal rate changes than in others periods with nominal rate changes. See Postal Service Brief at 48.

GCA (Brief at 35-36) tries to draw attention to the results of Prof. Martin’s “trigger questions,” but those questions were both inartfully drafted, and artificially confined to one possible type of trigger event (postal rate changes), such that no reliable conclusions can be drawn from the responses. See Postal Service Brief at 48-55. Moreover, for one important category of respondents, those who have actually shifted all of their bill payments out of the mail, Prof. Martin never even posed the “trigger questions.” For respondents in this group, all we know about postal rate changes and their decision to actually leave the mail (as opposed to an intent to “seriously consider”

¹ GCA footnote 25 tries to minimize the significance of the ranking of postal rate changes at the very bottom of Prof. Martin’s list by suggesting that brain function, cardiac function, and liver function are all important. GCA’s example, however, stacks the deck by confining its consideration to body parts that are all, *by definition*, vital organs. If GCA wishes to discuss body parts, however, other body parts can be used to illustrate the weakness of the survey research approach for the purpose GCA seeks to apply it. Consider the tip of the pinkie finger. If asked to identify the body parts that they would be *least* willing to part with, survey respondents would undoubtedly (and correctly) rank the tip of the pinkie finger well behind the brain, the heart, and the liver. But if asked, in isolation, whether they would be seriously upset if they were to lose the tip of their pinkie finger, respondents would quite likely indicate they would. Such a survey question would be akin to Prof. Martin’s “trigger” questions on postal rates. Yet medical research, in contrast, would show that tips of pinkie fingers are lost fairly commonly without any discernible medical consequences. Econometric research, such as that relied upon by the Postal Service, is much more comparable to objective medical research, and is much better suited to reveal the true empirical relationship between actual volume diversion, and actual postal rate changes.

leaving the mail) is that postal rate changes were once again the least important factor, ranking tenth out of ten. GCA-T-2 at 30; Tr. 21/7618-21, 7625-27.

Finally, even putting aside all of its critical deficiencies, GCA misstates the implications of the Martin survey, broadly claiming that it shows that the greater the price increase, the greater the number of consumers likely to consider switching. GCA Brief at 37. Because of the way in which Prof. Martin structured his market survey approach, however, he could not and did not offer any evidence whatsoever on whether there would have been any difference at all in mailers' reported propensity to consider switching as between a 41-cent rate and a 42-cent rate. His research is silent on that issue. Instead, what his research stands for is the unremarkable proposition that when it comes to electronic diversion, postal rates matter the least among possible factors driving that development. In other words, his research merely confirms the thrust of the conclusions offered 12 years ago by Prof. Spulber.

B. The Elasticity Estimates of Witness Thress Are the Best Available Estimates, and the GCA Brief Fails to Provide Any Valid Basis For the Commission Not to Rely on Those Estimates

To review GCA's case regarding econometric demand analysis through the lens offered by the GCA initial brief (pgs. 40-62), one's natural reaction can only be described as a sense of schizophrenia ("the presence of mutually contradictory or antagonistic parts or qualities" Webster's Ninth New Collegiate Dictionary). Reading the GCA brief, on the one hand, we have Dr. Jekyll, echoing to some extent the testimony of Prof. Kelejian, that every step in the estimation process of witness Thress must be subjected to every test ever conceived in an econometrics textbook. On the other hand, we have Mr. Hyde, advocating adoption of witness Clifton's elasticity

estimates, despite the fact that his econometric practices bear absolutely no resemblance to the standards articulated in the same brief as mandatory with respect to witness Thress. The surreal split personality exhibited by the GCA brief is manifest. Coming back to reality, however, and contrary to GCA's contentions, the elasticity estimates presented by witness Thress are highly credible, and those of witness Clifton are not.

1. The thrust of GCA's econometric argument focuses on an issue with no practical relevance.

It is disappointing that GCA has chosen to elevate inflated rhetoric over substance, devoting nearly one-half (pgs. 40-48) of the section of its initial brief on elasticity estimates to what is, in reality, a non-issue: the reliance by witness Thress on the minimization of Mean Square Error as his primary goodness-of-fit criterion for model selection.² GCA injects an irrelevant legal standard (*Daubert*) into the discussion, the application of which it later affirmatively abandons, with the only apparent purpose being to extract one catchy little phrase ("junk science"), which GCA then converts into

² In fact, the description on page 43 of GCA's brief of witness Thress's approach to model selection, indicating it is based entirely on Mean Square Error, is somewhat truncated. Witness Thress indicated, both in his choice trial library reference (USPS-LR-L-65 at 128) and later in response to specific questions from GCA (Tr. 6/1239), that having reasonable estimates for all of the coefficients would take precedence even over goodness-of-fit. Thus, as he explained in detail, of the 23 models for single-piece that he examined, the one he selected did not have the overall lowest Mean Square Error, but did have the lowest after two equations were removed from consideration because of unreasonable coefficients. Tr. 6/1239-40. Nevertheless, with the understanding that it is something of an oversimplification, GCA is correct that witness Thress used Mean Square Error as his primary regression diagnostic, at least in terms of goodness-of-fit. To simplify the discussion, therefore, this brief will likewise generally focus on minimization of Mean Square Error as the primary selection criterion.

another catchy little phrase (“junk econometrics”). The culmination of this exercise in hollow bluster is as follows:

But as the product of junk econometrics [witness Thress’s elasticity estimates] cannot be considered competent evidence. Judged against the applicable literature, Mr. Thress’ technique of model selection was no better than throwing darts. This fundamental error renders all of his First-Class elasticity estimates beyond the bounds of consideration – they are entitled to no weight.

GCA Initial Brief at 47-48.³

As explained in the rebuttal testimony of witness Thress (USPS-RT-2 at 60-61), and reiterated in the Postal Service’s Initial Brief at page 61, model selection criteria (among the models estimated by witness Thress) is essentially a non-issue in this case because no other witness advocated in favor of any model other than the one selected by witness Thress. Neither Dr. Clifton nor Dr. Kelejian actually employs any alternate model selection criterion. Both were asked which of the models presented in LR-L-65

³ There is some irony in GCA fascination with the notion of “junk econometrics,” which it repeats on pages 40, 46, and 47. The term “junk” is, in itself, highly provocative, but it also carries particular connotations in the postal community and within the postal lexicon. When forced to comment on its usage in that context, some postal employees will often, for example, simply refer instead to the “j-word.” The irony in this instance thus comes in with the similarity between the “j-word” and another term that pops up frequently in GCA’s brief, the J-test. If one insists on using the term “junk econometrics” (a phrase which the Postal Service submits is generally more prudently avoided), the J-test would certainly seem to be one candidate for probing which work product most nearly fits that description. Yet as shown by the J-test results reported in USPS-RT-2, if that were so, the finger in this case would not be left pointing at witness Thress. Perhaps that explains why GCA has retreated to a “scorched earth” policy – attempting to concoct an abstract theoretical standard so high that if its own witness does not meet it, neither can anyone else, and then suggest that the Commission really does not need to concern itself over which elasticity estimate is better. See GCA Brief at 61-62. That suggestion is nonsensical, however, as the Commission must “resolve the battle of the elasticities” in order to construct the volume forecasts required for its recommended decision, and the record is clear that the models and elasticities sponsored by witness Thress are superior in all respects to those of Dr. Clifton.

they would have chosen using the model selection criterion of their choosing, and both declined to identify any of Mr. Thress's alternate models as being superior to his preferred model. Tr. 24/8761, 29/9845. Moreover, Dr. Clifton in fact used Mr. Thress's chosen model as the starting point for his analysis of First-Class single-piece letters. Tr. 29/9845. Therefore, the abstract question of whether witness Thress "might" have chosen the wrong model has no practical application unless and until some other witness is prepared to come forward to select some other model he or she believes to be better, and to explain why on the basis of some other selection criterion. Since that did not happen in this case, the entire issue is fundamentally a red herring.⁴

Nevertheless, despite the practical irrelevance of the matter, GCA uses it to launch a detailed discussion (GCA Brief at 41-48) of a type of analysis named after a prominent Supreme Court decision, the *Daubert* opinion. As the cases cited by GCA make clear, though, the sole function of the *Daubert* analysis is to determine whether expert testimony is *admissible* in court or not. Yet GCA not only acknowledges that the evidentiary rules underlying *Daubert* do not even apply in Commission proceedings (GCA Brief at 42), but also itself affirmatively disclaims any intent to challenge the admissibility of the testimony of witness Thress, or his elasticity estimates (*Id.* at 47).

⁴ Nowhere in the testimony of Dr. Clifton does he ever make reference to a model selection criterion which he used as the basis for choosing his model. Nor does he provide any interim results from which he chose his model. In reading Dr. Clifton's testimony, it appears to be the case that the First-Class single-piece letters equation he presented in Table A9 is the first and only First-Class single-piece letters equation (using current data) which he investigated. If so, that hardly reflects well on either the scope or the depth of Dr. Clifton's research, as GCA's other witness, Prof. Kelejian, emphasizes the need to test one's model against alternative hypotheses. Tr. 24/8780-81. If not, it is Dr. Clifton who would appear to be out of compliance with the choice trail requirements of Rule 31(k).

Since GCA thus discards admissibility as an issue, one is left to wonder why GCA even bothered to drag the *Daubert* line of cases into the discussion at all.⁵

The only plausible explanation is GCA's intent to latch on to the phrase "junk science," reproduced by GCA in a quote from the *Pasha* case. *Id.* at 42. Of course, GCA makes no attempt to provide the context in which the term was used in that case. The court in *Pasha* ruled to exclude the testimony of a witness who intended to testify that certain documents purported to be official forms of the Albanian government were instead fraudulent, when this so-called expert neither spoke nor read Albanian, nor had access to any actual genuine Albanian government forms of the type comparable to the allegedly fraudulent documents. *Pasha v Gonzales*, 433 F3d 530 532, 535 (7th Cir 2005). To note that this example of "junk science" under the standards of *Daubert* has nothing to do with the testimony of any witness in this case is to state the obvious.

In comparison with the type of extreme case presented by the inherently unreliable mode of analysis offered in *Pasha*, consider what the Commission has stated in past cases about the analysis done by Mr. Thress. In the last rate case, the Commission observed:

⁵ Moreover, even if the *Daubert* analysis had any relevance (which it does not), the very cases cited by GCA on page 47 show that the standard is nowhere near as rigid as GCA has tried to express it. In the *Paoli* case, the court cautioned that the "grounds for an expert's opinion merely have to be good, they do not have to be perfect," and that a "judge should only exclude evidence if the flaw [in the expert's investigative process] is large enough that the expert lacks 'good grounds' for his or her conclusions." *Paoli R.R. Yard PCB Litigation*, 35 F3d 717, 744, 746 (3d Cir 1994). In the *Amorgianos* case, the court likewise held that a "minor flaw in an expert's reasoning or a slight modification of an otherwise reliable method will not render an expert's opinion *per se* inadmissible." *Amorgianos v National RR Passenger Corp*, 303 F3d 256, 267 (2d Cir 2002). Moreover, the same court explicitly stated that the *Daubert* standard "did not suggest that an expert must back his or her opinion with published studies that unequivocally support his or her conclusion." *Id.* at 266.

Witness Thress models mail markets using a set of demand equations, identifies and quantifies the factors that affect mail volumes, and projects these factors through the test year for the purpose of developing a set of volume forecasts. Such a forecasting procedure has in the past generally proven accurate in providing mail volume forecasts over the typical rate case time horizon.

PRC Op&Rec Dec., R2005-1 at 39 (Nov. 1, 2005). Going back a few cases further, to Docket No. R2000-1, we find the Commission commenting more specifically about witness Thress's model selection:

On the other hand, witness Thress conducted a thorough and effective revision of witness Tolley's models and econometric practice prior to the R97-1 proceeding. ... [W]itness Thress' revisions appeared to be the result of a wide-ranging and open econometric reexploration of the underlying economic theory, the identification of suitable variables and the selection of appropriate estimation techniques for the Postal Service's volumes models. It was exactly the kind of econometric research that the Commission's Rules of Practice and Procedure for statistical evidence are intended to encourage.

PRC Op&RecDec, R2000-1, Vol. 1 at 27-28 (Nov. 13, 2000). Bearing in mind that witness Thress was using the Mean Square Error selection criterion as far back as Docket No. R2000-1 (see, e.g., USPS-T-7, Docket No. R2000-1 at 104), and thus over the period covered by both of these Commission's Opinions, the absurdity of GCA's claim's of "junk econometrics" is apparent. GCA summarizes the *Daubert* principles on page 41 of its brief to require a court to "make certain that an expert ... employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field." Suggesting that the procedures employed by witness Thress over the last three rate cases and in this case do not manifest such a level of intellectual rigor is tantamount to a claim that the Commission itself has consistently both endorsed and relied upon substandard and deficient econometric practice.

GCA's attempts to invoke the Commission's own rules in support of its frivolous argument are equally unavailing. On pages 42, 46, and 47 of its brief, GCA claims that evaluation of the Mean Square Error model selection criterion used by witness Thress is governed by Commission Rule 31(k)(iv)(e). (The correct cite for the subpart GCA intends to cite is actually Rule 31(k)(2)(iv)(e).) In fact, however, that provision is inapposite. The provision actually governing model selection is the immediately preceding subpart:

(d) For any alternative model whose computed econometric results influenced the choice of the preferred model, a statement of the reasons for rejecting that alternative, an identification of any differences between that alternative and the preferred model with respect to variable definitions, equation forms, data, or estimation methods, and, upon request, the computed econometric results for that alternative;

Rule 31(k)(2)(iv)(d). GCA has no basis whatsoever to argue that witness Thress did not comply with this provision, since his choice trail library reference clearly states the reasoning behind his rejection of certain alternatives in favor of others, including the prominent role of Mean Square Error comparisons. USPS-LR-L-65 at pages 128 – 129. With specific respect to single-piece First-Class Mail, his reasons for rejecting alternatives relative to his preferred model were restated in response to GCA interrogatories. Tr. 6/1229-33, 1238-40. Witness Thress complied with the applicable provision, Rule 31(k)(2)(iv)(d), and therefore all of GCA's discussion on Rule 31(k)(2)(iv)(e) is totally off the mark.

Even assuming *arguendo* that Rule 31(k)(2)(iv)(e) had some relevance, however, GCA's arguments do not hold water. Subpart (e) states:

(e) A reference to a detailed description in a text, manual, or technical journal for every econometric technique used in the estimation process and the reasons for selecting the technique, or, in the alternative, a description and analysis of the technique that is sufficient for a technical evaluation;

Rule 31(k)(2)(iv)(e). First of all, contrary to GCA's illogical claim at pages 47 and 52 of its brief, witness Thress provided a sufficient description and analysis of his model selection criteria to allow technical evaluation. In their direct testimonies, both Dr. Clifton (GCA-T-1 at 33-35) and Prof. Kelejjan (GCA-T-5 at 14-15) critically evaluate his procedure, and in neither testimony did either witness claim that their technical evaluation was hindered by an insufficient description of Mr. Thress's technique.⁶ Thus, even though subpart (e) is not applicable, Mr. Thress at the very least met the alternative means of complying with the requirements of that subpart. In accordance with GCA's own brief (at page 46), that "should be the end of the inquiry."

Nevertheless, given the amount of space in GCA's brief devoted to the state of the literature on the role of Mean Square Error in model selection, and certain misstatements therein, some further discussion on why Mean Square Error comparisons are a formal procedure as witness Thress indicated (Tr. 38/13107-08, 13112-13) may be helpful. As GCA explains, "the standard [witness Thress] employed for choosing between ... models was to select the model that exhibited the least mean squared error." GCA Brief at 43. The thrust of GCA's erroneous criticism is that

⁶ In an interrogatory response, Prof. Kelejjan did suggest that he was unsure how Mean Square Error had been calculated, but that was through no shortcoming of witness Thress. Prof. Kelejjan acknowledged during oral cross-examination (Tr. 24/8787-89) that he did not read any of witness Thress's library references or interrogatory responses in this case, which may explain why he was unfamiliar with the four places on the record in this case where witness Thress defined how he calculates mean-squared error. See USPS-RT-2 at 60.

witness Thress's "test for model selection has no basis in the literature or the econometric community." *Id.* In fact, such a selection criterion lies at the heart of Least Squares regression analysis, which provides the foundation and the framework for all of the econometric work in this case, not just that of witness Thress, and not just that relating to demand analysis.

The underlying premise of Least Squares Regression Analysis is the minimization of the sum of squared residuals. Obviously, a minimum mean-squared error model selection criterion flows directly from this. While certainly not endorsing it, even Prof. Kelejian states that "model selection via a minimization of a mean squared error is an intuitive thing to do." GCA-T-5 at 14. In the fifth edition of Econometric Analysis by Dr. William Greene, which Mr. Thress cited (Tr. 38/13112) as a source for a mean-squared error selection criterion, chapter 8.4 starts on page 159 and is entitled "Model Selection Criteria".⁷ This section begins as follows (emphasis added):

"The preceding discussion suggested some approaches to model selection based on nonnested hypothesis tests. Fit measures and testing procedures based on the sum of squared residuals, such as R^2 and the Cox test, are useful when interest centers on the within-sample fit or within-sample prediction of the dependent variable. When the model building is directed toward forecasting, within-sample measures are not necessarily optimal. As we have seen, R^2 cannot fall when variables are added to a model, so there is a built-in tendency to overfit the model. This criterion may point us away from the best forecasting model, because adding variables to a model may increase the variance of the forecast error (see Section 6.6) despite the improved fit to the data. With this thought in mind, the adjusted R^2 ,

$$\hat{R}^2 = 1 - [(n-1)/(n-K)] \cdot (1 - R^2) = 1 - [(n-1)/(n-K)] \cdot [(e'e) / \sum_{i=1}^n (y_i - \hat{y}_i)^2]$$

⁷ In fact, the GCA, in their brief quotes their own econometric expert, Dr. Harry Kelejian, making specific reference to this very passage of Greene: "There are, of course, many formal procedures which relate to model selection. Some of these are nicely described in the econometric text by Greene on pages 152-160." GCA Brief at 44.

has been suggested as a fit measure that appropriately penalizes the loss of degrees of freedom that result from adding variables to the model. Note that \hat{R}^2 may fall when a variable is added to a model if the sum of squares does not fall fast enough. (The applicable result appears in Theorem 3.7; \hat{R}^2 does not rise when a variable is added to a model unless the t ratio associated with that variable exceeds one in absolute value.) The adjusted R^2 has been found to be a preferable fit measure for assessing the fit of forecasting models.

Perhaps GCA was confused by the fact that Dr. Greene did not explicitly mention the term “mean-squared error”. In fact, however, adjusted- R^2 and mean-squared error, as defined by witness Thress, are identical selection criteria.⁸ Witness Thress explained his preference for looking at mean-squared error as opposed to adjusted- R^2 in his response to GCA/USPS-T7-10:

“[T]he goal of econometric estimation is not to maximize the explained variation but to minimize the unexplained variation within a model. While these two goals are, in some sense, literally identical there is an important distinction. Improving the adjusted- R^2 value in an equation from 0.986 (Model Number 7) to 0.990 (Model Number 23, which is used by me to make volume forecasts in this case) increases the explained variation in the model by 0.4 percent. Yet, reducing the percentage of variance which is unexplained from 0.014 (1 – 0.986) to 0.010 (1 – 0.990) reduces the unexplained variation in the model by nearly 30 percent.

Because of these limitations of R^2 and adjusted- R^2 measures, my preferred diagnostic measure for evaluating demand equations is mean-squared error.

⁸ Using Dr. Greene’s nomenclature, mean-squared error (MSE), as defined by witness Thress, is equal to $(e'e)/(n-K)$, so that, $\hat{R}^2 = 1 - \text{MSE} \cdot [(n-1)/\sum_{i=1}^n (y_i - \hat{y}_i)^2]$. For a comparison across equations for which the sample period and dependent variable are the same (as is the case in Mr. Thress’s USPS-LR-L-65), the term $[(n-1)/\sum_{i=1}^n (y_i - \hat{y}_i)^2]$ will be constant across all equations and maximizing \hat{R}^2 will be equivalent to minimizing MSE. The same point is made in another prominent econometrics text, Elements of Econometrics, Jan Kmenta, Second Edition, in which Prof. Kmenta’s section 11-10 on “Model Choice” first explicitly lays out the Mean Square Error Norm as an “alternative criterion [for model choice that] involves the comparison of mean square errors of the two models.” *Id.* at 594. Prof. Kmenta next lays out, as yet another alternative, the “ \hat{R}^2 criterion,” and then demonstrates that “the \hat{R}^2 criterion is *exactly equivalent* to the operational mean square error criterion. *Id.* at 595 (emphasis in original). Thus, both Prof. Kmenta (directly) and Prof. Green (less directly) confirm that Mean Square Error comparisons may properly play a role in model selection.

Mean-squared error is equal to the sum of the squared residuals divided by the number of degrees of freedom. This is equivalent to the square of the standard error of the model and can therefore be thought of as measuring the variance of a model.”

Tr. 6/1232. If GCA’s argument is that adjusted- R^2 is a valid model selection criterion while mean-squared error is not, then the obvious answer to such a critique is simply to point out that a maximum adjusted- R^2 criterion is mathematically equivalent to a minimum mean-squared error criterion, so that witness Thress’s choice from among the candidate equations shown in his Library Reference USPS-LR-L-65 would have been the same using either criterion.

One of the more disturbing aspects of the inflammatory arguments that GCA presents on its interpretation of the Commission’s rules on econometric evidence is the apparent claim that any testimony which purports to select and defend a particular econometric model over alternative models on any basis other than a J-test, a Bayesian posterior odds approach, or a Cox test, can necessarily be dismissed as “junk econometrics.” GCA Brief at 47. This claim does not square with experience observed across the spectrum of econometric issues litigated in postal rate proceedings. The issue of model selection is a thorny one, and the notion that full consensus always exists on how to proceed seems unduly optimistic. For decades, expert econometricians in rate cases have been hotly debating competing models of, among other things, carrier costs, transportation costs, mail processing costs, window service costs, as well as price elasticities. Although the Postal Service does not claim to have made a comprehensive review of all of those decades of research in the short time available to prepare this reply brief, it does seem fair to say that most (if not all) of those debates have been conducted to date without the experts involved claiming that

opposing analyses were fatally flawed "but for" application of one of the three specific testing procedures sanctioned by GCA.⁹ GCA certainly points to no other prior instances in which witnesses in Commission proceedings have applied those particular procedures to establish them as the *sine qua non* of model selection.

This is not to suggest, of course, that a wide variety of statistical tests have not been conducted and reported and used to guide the flow of research. And certainly dueling experts have employed numerous types of tests to support their models and challenge those of their opponents. Through this process, the parties and the Commission on a routine basis have been able to work through such disputes and presumably select the best model on the basis of appropriate criteria under the applicable circumstances. In many cases, more basic goodness-of-fit measures such as t-values and adjusted R-square statistics have been sufficient to select the superior model. For GCA to advocate absolutely rigid requirements regarding an extremely narrow set of highly formal procedures, at a level of complexity far above what might be necessary, does not do justice to prior econometric practice before the Commission. While more advanced testing may be warranted in certain instances, such tests should not be elevated to the level of baseline requirements.¹⁰

⁹ On the other hand, just in this case, Prof. Bradley identified circumstances under which Mean Square Error may be used as a metric for selecting between models, although the context of his discussion was choice of functional form. Tr. 13/3793. At the very least, however, this underscores the absurdity of GCA's attempts to imply that examination of Mean Square Errors is totally foreign to standard model selection procedures.

¹⁰ For example, consider that Mr. Thress presented 23 different First-Class single-piece letters demand equations in his choice trail library reference, USPS-LR-L-65. A J-test can be used to compare two equations to each other and, ideally, should be run twice, once with each of the two equations as the null hypothesis. Hence, to fully test which of 23 possible models is best using J-tests would have involved performing, and

What GCA seems particularly unable to appreciate is that while postal ratemaking proceedings may occasionally involve choosing from among competing models, such proceedings are not conducted for the purpose of establishing abstract standards for model selection criteria. Debates on model selection criteria are only relevant in rate proceedings in the context of selection from among real competing models, proposed by competing witnesses. For example, the GCA Brief at 46 mentions an alternative model (#6) estimated by witness Thress that generated a higher estimate of own price elasticity. Since GCA has made no secret of its objective in this case to propose a higher elasticity, GCA certainly could have had a witness testify that the alternative model (#6) was superior to that selected by witness Thress, perhaps on the basis of a J-test, or one of the other methods GCA has postulated. Having chosen not to present any such testimony, however, it is a waste of every one's time for GCA to complain on brief that the statistical criterion by which witness Thress selected his preferred model is not appropriate.

And, as noted earlier, the irrationality of the GCA argument only becomes more apparent when one considers that the GCA witness who presents his own models did none of the testing so vehemently identified as mandatory in the GCA brief. For example, Dr. Clifton claims that a linear model is better than a log-log model (GCA-T-1 at 48), yet he provides no statistical test to support that claim. Dr. Clifton also claims

presenting the results of, 506 J-Tests. The inclusion of 506 additional tests would have unnecessarily complicated and lengthened the already quite lengthy choice trail process, and that would only cover the single-piece First-Class portion of the testimony. The reflexive imposition of such an undue burden would be unwarranted, particularly when GCA has not even attempted to present any testimony that it would have made any difference.

that he does not need to apply any transformation to the internet variable in his model (*Id.* at 51), but, once again, he provides no statistical test to support that claim either. As witness Thress demonstrates in his rebuttal testimony, both of those claims can be tested, and both are incorrect. USPS-RT-2 at 47-50. GCA is advocating a standard which is so far removed from the practice exhibited by its own witness as to defy comprehension.

2. GCA's other arguments on econometric issues misconstrue the record.

GCA presents several other arguments which do manage to present more relevant, albeit equally unfounded, challenges to the substance of the econometric procedures used by witness Thress.

- a. Witness Clifton's failure to employ the use of broadband to measure Internet diversion is far more "inexplicable" than any action or omission by witness Thress.

On page 48, GCA argues that "witness Thress's failure to use a broadband variable to model and estimate the diversion of First Class single piece mail is inexplicable." The brief even goes so far as to quote Dr. Clifton, "It would have made sense ... for witness Thress to include a broadband variable in his single piece demand equation as part of his never-ending experimentation to model the impact of Internet diversion correctly." In fact, however, as even acknowledged in the portion of Dr. Clifton's testimony quoted in the GCA brief, Mr. Thress did include a broadband variable in his single piece demand equation as part of his experimentation to model the impact of Internet diversion correctly, and he thus presented the results of several experiments which included the number of Broadband subscribers in the First-Class single-piece

letters demand equation in his Library Reference USPS-LR-L-65 at pages 210 – 227. Mr. Thress explained his reasons for rejecting each of these results in his response to GCA/USPS-T7-14.

What in fact is truly “inexplicable” is Dr. Clifton’s failure, despite his rhetoric as quoted in the GCA Brief, to “use a broadband variable to model and estimate the diversion of First-Class single piece mail.” Dr. Clifton presented no results which showed any attempt to model the demand for First-Class single-piece letters as a function of the number of Broadband subscribers or any other measure of Broadband usage. When questioned about this, in USPS/GCA-T1-9(b), his explanation for this failure was the following:

In this model I was merely trying to investigate whether Mr. Thress’ estimated price elasticity is dampened due to: (1) the use of a mislabeled Box-Cox transformation; and (2) the stochastically imposed workshared discount coefficient.

Tr. 29/9818. Yet the “model” to which Dr. Clifton refers in this response is the model on which he bases the elasticity he is proposing that the Commission adopt. Thus, Dr. Clifton appears to be claiming here that his goal was not, in fact, to provide the best possible model for use by the Commission (as implied by his statement of purpose in GCA-T-1 at 2). Rather, his goal was merely to identify the factors within Mr. Thress’s model which led to the own-price elasticity identified by Mr. Thress. This admission by Dr. Clifton undermines the credibility of his entire testimony as a serious effort to generate a model reflecting his beliefs as to the true determinants of single-piece volumes. Contrary to the erroneous claims in the GCA brief, witness Thress’s consideration and rejection of the use of broadband to measure internet diversion shines in comparison.

- b. GCA offers no valid criticism of witness Thress's specification of the Internet variable in his First-Class Single-Piece letters equation.

GCA criticizes Mr. Thress because "he incorrectly described his one of a kind data manipulation as a Box-Cox transformation." GCA Brief at 50-51. As witness Thress acknowledged in his rebuttal testimony, it is correct that the "data manipulation" by which Mr. Thress introduces his Internet variable, consumption expenditures on Internet Service Providers, is not a conventional Box-Cox transformation. USPS-RT-2 at 53.¹¹

With respect to his own transformation procedures, however, GCA is simply wrong when it claims that Mr. Thress has failed to provide "a description and analysis of the technique that is sufficient for a technical evaluation." GCA Brief at 52. Mr. Thress showed the precise specification which he employed in equation (3) on page 37 of his direct testimony (USPS-T-7) in this case. He even went so far as to provide a detailed example of this specification – using First-Class single-piece letters for his example – at page 37 of his testimony starting at line 23. Once again, one can reasonably conclude that the GCA's econometric expert witness in this case, Dr. Harry Kelejian, considered

¹¹ On the other hand, as Prof. Kelejian admitted in response to USPS/GCA-2, Mr. Thress's "data manipulation" here is mathematically identical to a traditional Box-Cox transformation in those cases where the coefficient on the transformed variable is constant over time. Tr. 24/8748-49. In previous rate cases where Mr. Thress performed these "Box-Cox transformations" – R2001-1 and R2005-1 – the coefficients on variables transformed in this way were all, in fact, constant over time. Hence, Mr. Thress's identification of these transformations as "Box-Cox transformations" was correct in all past rate cases.

Mr. Thress's description "sufficient for a technical evaluation", given that Dr. Kelejian provided a technical evaluation of Mr. Thress's specification.

In his rebuttal testimony, witness Thress explains in detail the grounds on which his specification could be preferable to a conventional Box-Cox transformation (USPS-RT-2 at 53-55), but also shows (*id.* at 62-63) that shifting between the specifications does not cause a material difference in the estimated own price elasticity. GCA observes that Mr. Thress agrees that he could have conducted a different test to show that his specification constituted an improvement over the conventional Box-Cox, but GCA does not (and, empirically, cannot) argue that using this different test would have led to any different conclusion. GCA Brief at 50-51. Nothing in the GCA Brief offers any basis to question the clarification and resolution of the Box-Cox issue presented by witness Thress in his rebuttal testimony.¹²

¹² A long footnote on page 51 of the GCA's brief (footnote 30) seriously misinterprets the model shown on pages 78-79 of witness Thress's USPS-LR-L-191, and confuses it with a model discussed on pages 54-55 of the rebuttal testimony. During his oral cross-examination (Tr. 38/13135), witness Thress identifies the equation on page 78 of his Library Reference as "my equation if you used a correct Box-Cox." The equation discussed at pages 54- 55 of USPS-RT-2, which "shows that his selected model did not need to include the variables TREND and T02Q4, despite the fact that a mathematically correct Box-Cox transformation would have required the inclusion of these variables" is a different equation. It is found on page 62 of Library Reference LR-L-191.

The constraints applied to the model on pages 78-79 of LR-L-191, which GCA identifies as errors in footnote 30 ("Mr. Thress has in essence estimated the same coefficient, b_1 , for two different variables"), in fact represent the "correct Box-Cox transformation" as explained by Mr. Thress in his rebuttal testimony at page 54 on lines 5 – 7. GCA is simply wrong to state that, "His equation is not correctly estimated as a result of these errors." These are not errors; they are necessary to implement a "correct Box-Cox transformation", ironically, the very transformation which the GCA criticizes Mr. Thress for failing to implement.

Further, the rhetorical question which follows this alleged "error" ("What is happening when his computer software runs such a mis-specified equation as that shown on pages 78-79 of LR-L-191?") simply makes no sense. There is no problem with EViews (or any other respectable statistical software package) estimating an

- c. GCA's discussion of the J-tests in witness Thress's rebuttal testimony does not advance its cause.

On pages 57 and 58 of its Brief, GCA focuses on a J-test performed by Mr. Thress to test whether Dr. Clifton's linear specification for the demand for First-Class single-piece letters was appropriate (USPS-RT-2, page 48). GCA makes several statements in their Brief which indicate a lack of understanding of this test and the appropriate conclusions which one can draw from it. GCA's lack of understanding begins with the sentence underlined on page 57 of the brief, "It is important to note that witness Thress did not run a J-Test to compare his model against Dr. Clifton's." The latter half of this statement is true; Mr. Thress did not run a J-Test to compare his model against Dr. Clifton's. There is no important need for GCA to note this, however, as Mr. Thress was clear about this very fact in his testimony, "For this initial test, a pure log-log specification is considered as the alternate hypothesis." (USPS-RT-2, page 48, footnote 10). The stated purpose of this test was not to compare Dr. Clifton's model to Mr. Thress's final model. The stated purpose of this test was to test whether the linear specification used by Dr. Clifton was appropriate, or, in other words, to conduct the test that Dr. Clifton should have conducted if he wished to propose that the established log-log model accepted by the Commission over numerous cases might no longer be

equation which includes the same parameter twice within a single equation. This is no different, mathematically, from a constraint that two coefficients are equal (in fact, in this case, as explained in witness Thress's testimony, this is literally a constraint that two coefficients are equal). Such constraints are commonly imposed in empirical econometric work. In summary, footnote 30 on page 51 of the GCA Brief provides no valid criticism of the analysis or the conclusions of the rebuttal testimony of witness Thress regarding issue presented by the transformation of the Internet variable.

applicable. To do the test that Dr. Clifton should have done, it was necessary to base the test on two versions of his model, not his models versus witness Thress's model. The test clearly showed that Dr Clifton was using the wrong functional form for his equation. USPS-RT-2 at 47-48.

GCA exhibits still more confusion when claiming that "if the Commission were to credit witness Thress's J-test of linear versus a log-log version of Dr. Clifton's model, it would need to accept the own-price elasticity of demand associated with the log-log version." GCA Brief, page 58. GCA, however, cites no authority to support this totally illogical claim. As noted throughout Mr. Thress's rebuttal testimony (USPS-RT-2), Dr. Clifton's First-Class single-piece letters equation is beset with a host of serious problems. These include an inappropriate coefficient on the average First-Class worksharing discount (*id.* at 42-43), an autocorrelation correction technique that Dr. Kelejian described as "a specification problem" (*id.* at 43-44), and an inappropriate specification of consumption expenditures on Internet Service Providers (*id.* at 48-50). Obviously, one would need to correct all of these problems if one were to seriously consider relying upon Dr. Clifton's First-Class single-piece letters demand equation, and merely changing the functional form from linear to log-log does nothing to address these other critical deficiencies.. As a practical matter, the estimated elasticity cited by GCA on page 58 of its brief is as invalid as that presented in Dr. Clifton's testimony.¹³

¹³ Fundamentally, the same reasoning undermines GCA's implicit suggestion (pg. 57) that Mr. Thress should have conducted a J-test to compare his final model to Dr. Clifton's final model. As witness Thress explained both in his choice trail library reference (USPS-LR-L-65 at 128) and in response to discovery (Tr. 6/1239), the paramount criterion for model selection (preceding even econometric fit) was that all of the variables must have reasonable coefficient estimates (e.g., the correct sign). Since Dr. Clifton's model has the wrong sign on the workshare discount variable (as will be

GCA also questions the statistical tests witness Thress conducted which demonstrate (USPS-RT-2 at 48-50) that Dr. Clifton errs by failing to adjust his internet variable via a Box-Cox or some other non-linear transformation. GCA Brief at 58. GCA misunderstands why one might investigate a non-linear relationship between volume and an explanatory variable, arguing that “[t]he very reason for employing a Box-Cox transformation is to address problems that do not exist in a linear model such as Dr. Clifton’s.” *Id.* There is, however, simply no basis for such an assertion. As Dr. William Greene explains in Econometric Analysis, fifth edition (page 173), “[t]he Box-Cox transformation is a device for generalizing the linear model.” Contrary to the GCA’s assertions to the contrary, such a generalization is neither “methodologically pointless” nor “unsound.” As Mr. Thress showed in his rebuttal testimony at pages 49 and 50, there is overwhelming statistical evidence that the relationship between First-Class single-piece letters volume and consumption expenditures on Internet Service Providers is not linear. By failing to recognize and account for this in his model, Dr. Clifton has not “explain[ed] much with little,” but rather has badly misspecified his model.

In the midst of discussing the J-tests that witness Thress conducted for his rebuttal testimony, GCA once again returns to the issue of the model selection criteria:

The most important observation that can [sic] made with respect to witness Thress’ rebuttal testimony is what he failed to do. Witness Thress failed to run any formally recognized model selection tests on his own 20 odd experimental models. (Tr. 38/13109).

discussed in more detail below), no J-test could possibly have provided an adequate basis to conclude that his model could be considered an adequate alternative to that of witness Thress. On that basis alone, conducting such a J-test would have been pointless. If GCA is attempting to suggest the possibility, however, that the results of such a J-test possibly might have favored Dr. Clifton, those hopes are groundless.

GCA Brief at 59. This statement is strictly false, as Mr. Thress evaluated each of these models using a formal mean-squared error selection criterion. What GCA means to criticize here is the fact that Mr. Thress “did not go back and run a J test of [his] 20 experimental models” (Tr. 38/13109). If GCA is of the view that more J-tests would have led to the defensible selection of an alternate model, GCA had every opportunity to present such an approach in its direct case.¹⁴

d. Witness Thress did not employ an inappropriate data set.

GCA also criticizes Mr. Thress for “his reliance upon an inappropriate data set.” GCA Brief at 52. Elaborating on what is viewed as “inappropriate,” GCA claims that “witness Thress’s model drowns out the important near term data with data going back

¹⁴ The argument on page 59 of the GCA brief regarding the use of J-tests to revisit the initial selection by witness Thress of his preferred model is a repetition of the exact same argument on page 47. GCA’s obsession with whether the approach followed by witness Thress allows him to select the best possible model from among those he investigated brings to mind an anecdote from the heyday of the great Tiger slugger, Ty Cobb. According to baseball lore, a young unknown pitcher approached the Tiger manager and assured him that, given the chance, he could strike out Ty Cobb in three pitches. The manager obliged the young man’s request during batting practice the next day, and the result of the three pitches was a line drive up the middle that nearly took the pitcher’s head off, a second shot that bounced off the wall in right, and a third blast that disappeared over the fence in left, never to be seen again. The manager sauntered out to the mound to inquire what the youngster had to say for himself. The wannabe pitcher glared at the manager, squinted back at the plate, wheeled around again to the manager, and disparagingly snorted “Well, I ain’t so sure that’s Ty Cobb you got up there.” Like the hapless pitcher, GCA apparently has no clue that it matters not whether the model proffered by witness Thress is truly the Ty Cobb of his lineup, when it so thoroughly demolishes the only alternative advanced by Dr. Clifton on any rational basis for comparison. Dr. Clifton assured us (GCA-T-1 at 2) of his intent to introduce an estimate of the own price elasticity of single piece First-Class Mail better and more accurate than that relied upon by Mr. Thress. Having tried and utterly failed to do so, questioning the method by which witness Thress selected his demonstrably superior model can do nothing to excuse Dr. Clifton’s shortcomings, or rehabilitate his own flawed model.

over 20 years,” and quotes Dr. Clifton’s criticism (GCA-T-1 at 36) that “recent data is simply homogenized by being added to all prior time series data in Mr. Thress’ model, which includes prolonged periods in the 1970s and 1980s where there were few if any competing substitutes for FCLM.” GCA Brief at 52-53.

First, it is rather astonishing that GCA would quote that erroneous portion of Dr. Clifton’s testimony in its brief, when the sample period used by witness Thress began in 1983 (USPS-T-7 at 63), and, after two tries, Dr. Clifton begrudgingly had to admit that his testimony was wrong and that witness Thress did not use data from “prolonged periods in the 1970s.” Tr. 29/9846, 9906. Putting that aside, this is yet another criticism by GCA that is blatantly hypocritical. All of the First-Class single-piece letters demand equations presented and discussed by Dr. Clifton in his testimony use sample periods which begin in 1983Q1, the same starting period as that used by Mr. Thress. If the inclusion of data from the 1980s is sufficient grounds to reject a model of the demand for First-Class single-piece letters – and the Postal Service in no way believes that it is – then Dr. Clifton’s model must be rejected as surely as Mr. Thress’s would be.

- e. There can be no legitimate question regarding the appropriate sign of the workshare discount elasticity.

In its brief, GCA tries once again to explain the inexplicable: Dr. Clifton’s presentation of a single-piece model with a positive workshare discount elasticity. GCA Brief at 59-61. There is, in fact, only one possible explanation: abject confusion on the part of GCA and its witness regarding the nature and purpose of the workshare discount variable. To try once again to sort this out, it is necessary to quote the portion of the direct testimony of witness Thress in which he explains why the variable is introduced

into the model, which he also reproduced in the rebuttal testimony in an apparently vain attempt to clarify the situation:

“Shifts between First-Class single-piece and workshared letters due to changes in price are modeled through the inclusion of the average First-Class worksharing letters discount in the demand equations for both single-piece and workshared letters. The same is true of single-piece and workshared cards as well. **The discount is used in these cases, rather than the price, to reflect the nature of the decision being made by mailers, which is whether to workshare or not, as opposed to a decision of whether to send the mail or not.**

Holding all other factors constant, the total volume leaving First-Class single-piece mail due solely to changes in worksharing discounts should be exactly equal to the volume entering First-Class workshared mail.”

USPS-T-7 at 53, USPS-RT-2 at 38 (emphasis added). By construction, the sign of the workshare discount in the single-piece equation must be negative, because when the only decision we are examining is whether a piece that is going to be mailed will be sent single piece or workshare, there is absolutely no plausible reason why an increase in the discount would cause fewer single piece mailers to opt for workshare, or why a decrease in the discount would cause more single piece mailers to shift to workshare. USPS-RT-2 at 38.

GCA attempts to make two points to argue the contrary. First, GCA postulates that “current market realities” suggest that, compared with earlier periods, there is very little mail left to convert from single piece to worksharing, or vice versa. GCA Brief at 60-61. Even assuming that were true, however, such circumstances might bear on the *magnitude* of the coefficient on the variable, but not the *direction*. The scenario hypothesized is that very few mailers will shift based on the discount, and consistent with that would be the expectation of a reduction in the strength of the observed response to changes in the discount level. Whatever the amount of candidate mail that

still exists, however, a higher discount means more of that mail is likely to leave single piece, and a lower discount means less of that mail is likely to leave single piece. The “outdated ‘conversion/reversion’ assumption” argument provides no support for GCA’s misguided attempt to justify a positive coefficient.¹⁵

GCA’s second attempt to elude the logical requirement of a negative coefficient involves a slightly different scenario. In this instance, GCA claims that because of the Internet, a reduction in the worksharing discount could cause mailers “to opt out of the mail altogether in favor of electronic substitutes.” GCA Brief at 60. Here again, this argument manifests a fundamental misunderstanding of the workshare discount variable. If workshare mailers are responding to a price change by leaving the mail altogether, they are responding to the absolute price (the response to which is measured by the own price elasticity), and not the change in the discount level (the response to which is measured by the discount elasticity). USPS-RT-2 at 42. This must be the case because, by construction, the discount elasticity only addresses the decision regarding how the piece is mailed, not whether the piece is mailed. Once GCA postulates mail volume leaving the system, it is no longer attempting to measure what the discount variable is intended to measure. Simply stated, GCA is hopelessly confounding the own price effects and the workshare discount effects.

¹⁵ GCA’s brief at page 60 relies heavily on statements by MMA in an NOI response (rather than in testimony), but even those statements, as witness Thress points out, contradict the notion that workshare mailers are indifferent to the level of the workshare discounts in choosing how to enter their mail. Tr. 38/13091-92. Moreover, as witness Thress also indicated, the fact that economic incentives are already in place for workshare mailers to seek to move to less expensive electronic transactions is not a function of whether workshare discounts are reduced, or remain constant. Tr. 38/13144-47. The incentives are there, and diversion will continue regardless. *Id.*

The type of problems this creates is perfectly illustrated by the fact that Dr. Clifton's model would forecast a *reduction* in single piece volume (relative to volume at the Postal Service's proposed rates) if the Commission were to adopt his suggestion to lower the proposed single-piece rate by one cent and leave the workshare rates as proposed by the Postal Service (effectively reducing the proposed workshare discount by one cent). USPS-RT-2 at 42-43. Amazingly, GCA argues that this result is "perfect consistent with economic theory once it is recognized that worksharing mailers can forgo using the mail by using electronic substitutes." GCA Brief at 61. But the rate reduction under consideration is confined to single piece mailers. Workshare rates stay exactly where they are. The change in single-piece rates under this scenario would not cause workshare mailers (whose rates have not changed) to forgo using the mail. While this is true under any circumstances, it would be even more true under GCA's (erroneous) contention that the link between discount levels and discount volumes has been broken because the "conversion/reversion" assumption is now outdated, in which case workshare mailers would be utterly indifferent to single-piece rates. But even if workshare mailers for some unexplained reason were to respond to the reduction in the single piece rate by moving to electronic substitutes, that would still do nothing to explain Dr. Clifton's prediction of a direct reduction in single-piece volume. Dr. Clifton's model stands economic reasoning on its head, and GCA's brief does nothing (and can do nothing) to put it right again. A positive discount elasticity estimate in the single piece model is as unacceptable on theoretical grounds as a positive own price elasticity estimate.

3. GCA's arguments on broader economic issues are equally unavailing.

In addition to issues focusing more on the econometric structure of the research, GCA also raises some matters relating more to broader economic theory and practice.

- a. The branded drug example provides a plausible hypothesis regarding why the absence of any material increase in the estimate of the own-price elasticity is consistent with rational economic theory.

GCA misconstrues both the purpose of and the record relating to the portion of the rebuttal testimony of witness Thress (USPS-RT-2 at 12-15) regarding the pharmaceutical industry. GCA argues:

A marked feature of the Thress rebuttal testimony are arguments that Thress himself does not credit. For example, Thress suggested that it is plausible for First Class single piece mail to increase in elasticity in the face of broadband competition because in other industries price sensitive customers had departed for new competitive substitutes. (USPS-RT-2 at 13, Tr. 38/13022). But on cross-examination, Mr. Thress refused to say that the First Class customers shifting to electronic substitutes were price sensitive. (Tr. 38/13098-99; 13102). In other words, in order for Mr. Thress' comparison to have any purpose, he has to admit the very thing he adamantly refuses to acknowledge: that postal prices are material to the scope of electronic diversion.

GCA Brief at 55 (emphasis in original).¹⁶ The purpose of the branded drug example in Mr. Thress's rebuttal was specifically to rebut the testimony of Dr. Clifton that the empirical result of no material increase in the single-piece elasticity over the years was inconsistent with basic economic theory. Dr. Clifton asserted that "[t]o imply that major structural changes in market conditions faced by single piece mail have not changed the

¹⁶ Although not significant in the greater scheme of things, GCA's paraphrase of Mr. Thress's rebuttal testimony in the second sentence of the above quote seems incorrect; the word "increase" probably should be "decrease."

elasticity of single piece mail at all is as incredible as claiming that such innovations have reduced postal own price elasticities for single piece mail.” GCA-T-1 at 39. The example of the effect of generic-drug competition on the demand for branded drugs was intended as an example of another market in which the introduction of new competitive substitutes did not lead to an observed increase in the own-price elasticity of demand, proving that Dr. Clifton’s understanding of economic theory is not sufficiently comprehensive to support his opinions.

In his rebuttal testimony, Mr. Thress explicitly stated that he was not necessarily claiming that the circumstances present in his branded drug example were directly applicable to the postal situation in all respects. USPS-RT-2 at 15. Therefore, it was not surprising that he repeated those views during hearings, stating that he had made no definitive statement regarding why the postal price elasticity was relatively constant, but that the branded drug example offered one possible hypothesis, and there might be others. Tr. 38/13099-100. As Mr. Thress said, “the entire basis of my testimony is that elasticities are an empirical matter, and I really think that it’s dangerous to speculate about potential differences in elasticity based on one characteristic which implicitly holds all else constant without thinking through the implications of the assumption.” Tr. 38/13102-03.¹⁷

¹⁷ Witness Thress also clearly stated as his conclusion (page 67) of USPS-RT-2:

To the extent that Dr. Clifton is suggesting that there is price competition within the markets served by First-Class single-piece letters, the models presented by myself and others on behalf of the Postal Service have never suggested the contrary. Clearly, the Postal Service competes on price. I believe that the extent of this price competition is best reflected by my own-price elasticity estimate for First-Class single-piece letters of -0.184 .

GCA, however, is simply wrong to claim that “in order for Mr. Thress’ comparison to have any purpose, he has to admit the very thing he adamantly refuses to acknowledge: that postal prices are material to the scope of electronic diversion.” As witness Thress testified, the change in the relative price between mail and electronic substitutes that is driving diversion is the dramatic decline in the real price of such electronic substitutes, not any increase in the real price of mail, which has been essentially flat over time. Tr. 6/1320. Therefore, shifting customers might be price sensitive to large declines in the price of electronic substitutes (or might switch on non-price grounds such as convenience), but not materially price sensitive to small changes in postal rates, even if they are relatively more price sensitive than mailers who do not switch. As witness Thress correctly notes, however, once they have shifted and are no longer mailers, their price sensitivity to postal rates is not meaningfully defined. Tr. 38/13100. The only relevant postal price elasticity is the relatively lower price elasticity of the remaining non-shifting mailers. That is the moral of the branded drug example, and it does not require the hypothesized bifurcation of the market to be driven to any material extent by changes in postal prices.

- b. GCA misconstrues the nature of witness Thress’s estimates of electronic diversion.

On pages 36-37 of its brief, GCA observes that the structure of witness Thress’s models for First-Class Mail is such that his *explicit* estimate of volume lost to electronic diversion and the internet in the test year is the same regardless of the level of the proposed postal rates. In fact, although GCA fails to acknowledge it, the explicit impact is likewise the same on a before-rates basis, assuming that there is altogether no

change in postal rates. See, e.g., USPS-T-7 at 59, 67. This situation is hardly surprising, given the Commission's Rule 54 requirements to forecast volumes on both a before-rates and after-rates basis. But GCA misconstrues the significance (or more accurately, the insignificance) of this phenomena, which witness Thress readily explained during oral cross-examination.

Although his model does not explicitly identify how many pieces of the after-rates mail volume loss he estimates due to the proposed rate increase are lost to electronic diversion, those diverted volumes are included in the overall volume reduction. Tr. 38/13094-96. His model forecasts larger volume losses with larger rate increases, and implicitly, therefore, he is forecasting more diversion with higher rate increases. *Id.* This situation is no different than, for example, the situation with respect to the UPS cross price in Retail Parcel Post. See USPS-T-7 at 174. The before-rates forecast and the after-rates forecast of volumes lost to UPS are same, which could likewise be misinterpreted to suggest that the volumes lost to UPS following a rate increase are not a function of the size of the increase. In reality, though, the larger the rate increase, the larger the own-price effect, and UPS would obviously be expected to pick up more volume as rates are increased more.

Therefore, what GCA observes on pages 36-37 of its brief with respect to electronic diversion is not a weakness in witness Thress's analysis, but a strength. The goal is to achieve the best possible before-rates and after-rates postal volume forecasts. To do so requires two things: an estimate of electronic diversion that is independent of postal rate changes, and an estimate of the overall response of mailers to postal rate changes. Because witness Thress has reliable empirical estimates of

both of these elements, he can achieve his forecasting objective. Based on his empirical research, moreover, he can also compare the historical and forecasted volume impacts of internet diversion with those of postal rate changes, and in light of the fact that future volume lost to the Internet on account of postal rate changes will only be a subset of total estimated volume lost, he can quite reasonably conclude that the proposed postal rate changes cannot be the source of a material portion of the total volumes expected to be lost over the forecast horizon to electronic diversion. That conclusion, for example, follows directly from the impact tables shown on pages 59 and 67 of USPS-T-7. For GCA to call witness Thress's articulation of that conclusion "rank speculation based on nothing" (GCA Brief at 36) is simply wishful thinking on the part of GCA. It is a sound conclusion, based on years of careful empirical econometric research.

- c. GCA's criticisms of witness Thress's use of a lagged measure of the number of broadband subscribers in the First-Class workshared letters equation is not valid.

The Postal Service is willing to concede one misstatement in its initial brief. In commenting on the very last three sentences in Prof. Martin's testimony (GCA-T-2 at 56), the Postal Service expressed the following view with regard to the first of the three:

Certainly there is no disagreement about the first of those sentences. ("In other words, the diversions of either consumers or businesses are interactive with and upon one another.")

Postal Service Initial Brief at 43. Lo and behold, however, GCA seems quite prepared to disagree with its own expert on this point. Specifically, in arguing that there is no "theoretical or real world" basis for witness Thress's choice of variables for purposes of

modeling the impact of electronic diversion on single piece or workshare mail (GCA Brief at 48-50), GCA repeats witness Clifton's gaffe that a broadband variable is unsuitable for estimating diversion in the worksharing equation "because businesses turned to broadband some years ago." *Id.* at 49. No matter when businesses turned to broadband, however, until their household customers likewise had broadband to receive the communication, the pace of the diversion of workshare mail was largely unaffected by the computer sophistication of the business mailers. In other words, it takes two to tango. Prof. Martin gets it; GCA apparently does not. Once Dr. Clifton's blunder was pointed out in discovery (Tr. 29/9814), one would have thought the matter would have gone away, but the GCA brief proves otherwise.

On the same topic, GCA points approvingly to a comment by NAA witness J. Gregory Sidak regarding witness Thress's one-year lag of the number of broadband subscribers as the explanatory variable in his First-Class workshared letters equation. GCA Brief at 49. GCA quotes witness Sidak's criticism that "the lagged variable trails reality by a year," and that "as a telecommunications expert," it is unlikely that the lagged variable is achieving its intended purpose. *Id.* at 49-50. In fact, however, Prof. Sidak's criticism here is without merit. Prof. Sidak may be an expert on telecommunications and the diffusion of internet technology, but that expertise gives him no particular insight into how quickly or slowly that internet penetration translates into diversion of mail, which is entirely an empirical matter. As witness Thress stated in his direct testimony:

While, to a certain extent, the question is, "How many households do we expect to have broadband Internet access in 2008?" the more relevant question to us is,

“How much mail is expected to be diverted due to electronic substitution by 2008?” ”

USPS-T-7 at 27-28. The “real world” that Mr. Thress is attempting to model here is the reality of the process by which broadband penetration actually affects First-Class workshared mail volume through electronic diversion.¹⁸ According to the Household Diary Study Recruitment Interview, 29.7 percent of Households had Broadband access in 2005, up from 23.7 percent of Households in 2004. Yet, of these households with Broadband access, only 48.0 percent of them paid at least one bill via the Internet in 2005, up from 45.6 percent in 2004. Clearly, not even a majority of households with Broadband Internet access immediately begin to use their Broadband connection to divert mail.

In the real world, there is a lag between broadband access and mail diversion. By challenging this reality, it is the testimony of Dr. Clifton which GCA is now ignoring. Dr. Clifton agreed that the conversion from mail is not immediate following access to broadband. Tr. 29/9817. This is, of course, consistent with Mr. Thress’s use of the lagged Broadband variable in his First-Class workshared letters equation, a decision which was made by Mr. Thress based on firm empirical research and which is well supported by the reality of households’ use of Broadband Internet access to divert mail.

¹⁸ Alternatively, one might say that Mr. Thress has focused his research to attempt to develop an analysis of the demand for mail volume that best takes into account the extensive and pervasive technological developments being adopted by businesses and consumers, which have a very complex relationship with communications and transactions that previously would have been conducted entirely or primarily by mail. Mr. Thress carefully explained his approach to this very difficult task, which necessarily involves a delicate blend of theory and empirical exploration, in his direct testimony. USPS-T-7 at 25-29. For GCA flippantly to suggest that this approach lacks a “theoretical or real world basis” is both inaccurate and misleading.

- d. Other miscellaneous arguments offered by GCA do nothing to support its erroneous proposals.

The testimony of Dr. Clifton contained a Table 3, from which he purported to draw a number of conclusions. GCA-T-1 at 17-23. In his rebuttal testimony, witness Thress identified a large number of theoretical and empirical errors in Table 3 and the accompanying analysis, and did his best to sort out the mishmash presented by Dr. Clifton. USPS-RT-2 at 16-31. At page 56 of its brief, GCA mistakenly suggests that “witness Thress could not meaningfully explain why he had included in his rebuttal testimony (his singularly mischaracterized) ‘more correct analytical approach.’” In fact, however, on the very transcript pages cited by GCA, Mr. Thress explained that his rebuttal included further analysis of Table 3 “to provide a proper context for Dr. Clifton’s analyses in this case.” Tr. 38/13139-40. Witness Thress very explicitly used his analysis to demonstrate that the conclusions which Dr. Clifton purported to draw from his Table 3 data were, in fact, entirely unsupported by that data. USPS-RT-2 at 29-31. Why GCA perceives the need any further explanation of the rationale behind witness Thress’s rebuttal presentation is a mystery.

In its brief GCA states:

Indeed, Postal Service witness Thress could not even say whether the Postal Service was competitive in the payments delivery market. (Tr. 38/13103-05).

GCA Brief at 28 (emphasis in original). Citing the same portion of the transcript, GCA repeats the exact same claim on page 56. What is distinctly unclear is why GCA believes this to be of any importance. What the transcript pages show is that, when asked his opinion on the above proposition, Mr. Thress indicated that the answer

depends on what is meant by the term “competitive,” that the Postal Service has a majority of the bill payment market as he defines it, but that its market share is clearly declining. Tr. 38/13104-05. Mr. Thress clearly has a firm grasp of the salient facts. The purpose of this proceeding is to set postal rates, not conduct a market analysis of the type one perhaps might do in an antitrust case. GCA wishes to focus on tangential issues that have no ultimate relevance to either the goals of witness Thress’s demand research, or the tasks before the Commission.

Finally, in perhaps the most schizophrenic portion of its brief, GCA affirmatively embraces the view of NAA witness Sidak that the ultimate upshot of electronic diversion may be a residue of remaining mailers who, as a practical matter, have not been benefited from the availability of increasing substitutes via the internet. GCA Brief at 38-40. GCA advocates this perspective with no apparent recognition that it fatally undermines the entire thrust of GCA’s elasticity argument. If the remaining mailers truly had no chance of benefiting from new Internet-based options, then witness Thress’s finding of no material upsurge in the price elasticity is easily reconciled with the emergence of Internet competition, contrary to the pronouncements of Dr. Clifton. Prof. Sidak, however, essentially does recognize that conclusion. Tr. 32/10879-80. In terms of the forecasting issues, therefore, the views of Prof. Sidak now adopted by GCA confirm that proposition that postal rate changes on the margin (which are certainly unrelated to which consumers do or do not have practical access to the Internet) are not among the primary factors driving the loss of postal volumes to electronic diversion.

In terms of pricing policy (although that is not the general topic of this portion of the reply brief), GCA distorts the limited significance of this issue. The Postal Service

and the Commission have always been conscious of the need to diligently protect the interests of Aunt Minnie, the prototypical First-Class mailer. As Prof. Sidak acknowledged, the resulting single-piece rates have been constant in real terms over several decades. Tr. 32/10886-87.¹⁹ Moreover, in assessing his proposed First-Class Mail rates against criterion 5 (availability of alternatives), Dr. O'Hara already explicitly balanced his recognition of the opportunities provided by the Internet against considerations of "cost and accessibility" that limit practical alternatives for many mailers. USPS-T-31 at 18-19. In any event, Dr. O'Hara's proposal of rate increases for First-Class Mail below the systemwide average (*id.* at 17) raises no valid concerns of unfairness or inequity on the basis of the factors GCA has suggested.

4. Conclusion: the Commission should rely on the elasticity estimates of witness Thress.

As in previous cases, witness Thress applied methodologies developed over decades of careful research devoted specifically to postal forecasting, combining truly massive amounts of empirical analysis with careful analysis of recent market trends, to prepare and present before-rates and after-rates volume forecast across virtually the entire array of postal services. GCA presented the testimony of two witnesses challenging his econometric models for two categories of mail (although the unmistakable focus of their concern was on only one). Dr. Clifton presented both theoretical and empirical work, but flaws in both resulted in his proposal of an alternative

¹⁹ Additionally, as Prof. Sidak also acknowledges, some consumers have the option to bill pay electronically but continue to use the mail because they value some of the features it offers. Tr. 32/10881-82, 10884. Since higher value of service under the Act is a criterion associated with relatively higher rates, charging higher rates to those mailers who choose on value may be appropriate, a factor which GCA ignores in its discussion.

model that simply is not useable. Prof. Kelejian, on the other hand, offered a wholly theoretical critique of econometric issues that “might” cause problems with Mr. Thress’s estimates. Witness Thress attempted to respond to the theoretical concerns raised by Prof. Kelejian as constructively as possible. The approach taken for his rebuttal testimony was to address those concerns head-on, and investigate, to the extent possible, whether they had any practical significance or not. The results, presented in his rebuttal testimony, clearly show that the matters raised by Prof. Kelejian were not material factors driving the single piece elasticity estimated by Mr. Thress. GCA’s unseemly attempts in its initial brief to make rash accusations regarding the overall quality of the research conducted by witness Thress merely demonstrate the lack of substance in the arguments that GCA has to offer.

IV. THE POSTAL SERVICE'S SUBCLASS COSTING METHODOLOGIES AND RESULTS SHOULD BE ADOPTED BY THE COMMISSION

In this section of the reply brief, the Postal Service addresses the arguments made on brief by other parties in favor of and in opposition to the Postal Service's subclass costing presentations. As in the initial brief, included are discussions on mail processing costs, window service costs, carrier costs, and transportation costs. Additionally, a final section addresses a new matter raised on brief by MPA-ANM regarding the potential consequences of new postal reform legislation on cost attribution matters. As indicated in that section of this brief, the Postal Service's view is that the new legislation should have no effect on the treatment of costs in this case.

- A. The Record in this Case Demonstrates by Overwhelming Evidence that Mail Processing Costs are Less than 100 Percent Volume-Variable, and that the Postal Service Methodology Provides the Most Accurate Treatment of Mail Processing Costs.

The OCA, UPS, and Valpak oppose the Postal Service variability analysis for mail processing. UPS and Valpak recommend that the Commission continue with its existing "100 percent volume-variability" assumption. UPS Initial Brief at 13, Valpak Initial Brief at II-2. The OCA recommends the use of a subset of Prof. Roberts's results for letter sorting, cancellation, and Priority mail sorting, which would involve greater than 100 percent variabilities, overall, for those operations. OCA Initial Brief at 40-41. MPA and ANM recommend the Postal Service econometric models, and also note that the IOCS-based Commission method may be modified to reflect the evidence on setup and take-down costs developed in the case. MPA and ANM Brief on Periodical Rates at 2.

A common thread in the opposing presentations are claims that restrictions in the Postal Service models prevent them from reflecting the true response of operations to volume changes. Postal Service witness McCrery and rebuttal witness Oronzio indicate that the intervenors' stories are inconsistent with the reality of current operations. The intervenors also raise complex technical issues with Dr. Bozzo's econometric analysis and, in some cases, the related cost distribution and mailflow models, arguing that various assumptions – some real, some merely claimed – embodied in the Postal Service models are not empirically supported. However, as described below, the intervenor arguments inappropriately neglect substantial testing of the Postal Service models that directly address the issues they raise. Those results validate the Postal Service approach in light of concerns raised with the modeling effort by the Commission in Docket No. R2000-1.

As the Postal Service noted in its Initial Brief, the Postal Service and Intervenor methods – when the latter are correctly implemented – show a remarkable conjunction of results, all supporting the general finding that mail processing costs are less than 100 percent volume-variable. Postal Service Initial Brief at 68-69. Given these results, and the extensively documented flaws with the econometric analysis presented in the intervenor testimony, the record strongly supports the Commission adopting the Postal Service method.¹

¹ In the alternative, Dr. Bozzo recommends adoption of the Roberts model as updated in USPS-T-12 or the modification of the Commission's IOCS-based method presented by MPA *et al.* witness Elliott. USPS-RT-5 a 75-76.

1. By heightening differences with the Postal Service models, the OCA spotlights serious shortcomings of Prof. Roberts's latest analysis.
 - a. The Postal Service's operations testimony negates the OCA's contentions that its results are consistent with the exercise of "discretion" of the Postal Service's field management.

Central to the OCA's defense of Prof. Roberts's results is the claim that the Postal Service models fail to reflect the exercise of "discretion" by field managers, or the possibility of binding automation capacity constraints, that would lead the Postal Service to more intensively employ high-cost operations for marginal mail volumes. See, e.g., OCA Initial Brief at 12-13. UPS and Valpak make similar claims. UPS Initial Brief at 15-16; Valpak Initial Brief at II-3 to II-4. Postal Service witness Oronzio explains why Prof. Roberts's account is "not operationally plausible." USPS-RT-15 at 10-11.

First, witness Oronzio notes that managers' budget pressures provide a strong incentive not to shift processing from automated to manual operations, given that costs per sort are much lower in automated operations. USPS-RT-15 at 10. Witness Oronzio confirms Dr. Bozzo's observation that discretionary substitution of manual sorting for automation is not economically desirable. USPS-T-12 at 14. Second, the technical substitutability of manual sorting in the present work environment is limited in precisely those operations where automation capacity constraints might be expected to occur. Manual secondary sorting requires scheme knowledge, and typically such scheme-trained clerks are now only located in delivery units. The actual substitution is to employ idle OCR capacity at low cost. *Id.* at 11. In outgoing operations, and incoming primary operations, machine utilization rates are such that automation capacity

constraints are not reached in practice. *Id.* at 10-11; Tr. 36/12293-12294. Third, the intervenors neglect managers' actual discretion to adjust operations to avoid the use of high-cost manual sorting. They may defer their deferrable mail and/or begin processing mail earlier to maximize the automated processing windows for non-deferrable mail. Tr. 11/3294; Tr. 36/12297.

Outside of OCA-T-1, none of the models – including Prof. Roberts's 2002 model (Roberts 2002 at 102), the March 2006 update using data through 2004 (Roberts 2006 at 70), Dr. Bozzo's update of Prof. Roberts's model with 2005 data (USPS-T-12 at 130), Dr. Neels's model estimated for letter-shape operations (USPS-RT-5 at 40), and the Postal Service models – show any sign of the disproportionate increase in manual letter sorting costs with letter FHP. Nor is there any sign of a corresponding phenomenon for manual flats, even in Prof. Roberts's OCA-T-1 models. The basic fact of manual letter sorting is that its use has been declining rapidly, both in absolute terms and as a fraction of letter sorting costs, over the time period covered by the Postal Service's analysis. This reflects managers' ability to process compatible mail in automation, rather than with manual processing. The absence of an appropriate operational foundation reinforces the view that Prof. Roberts's manual letters elasticity is an outlying result driven by Prof. Roberts's inappropriate modeling choices in OCA-T-1. Postal Service Initial Brief at 91.

- b. The OCA fails to acknowledge the extent to which "restrictions" incorporated in the Postal Service models are true.

The OCA characterizes a number of differences between the Postal Service and OCA models as having been "examined empirically" and claims that the "evidence does

not support the USPS framework." These include the "separability assumption... proportionality assumption... and the assumption that TPF is an exogenous regressor." OCA Initial Brief at 13-14. The OCA also contends that there is no role for the plant-level volume of mail, either in total or disaggregated by processing category. OCA Initial Brief at 26. The record shows otherwise. Each of the OCA's claims is addressed in the following sections.

- i. The "exogeneity" of automated operations' TPF was tested, and shown to have no material effect on variability levels for those operations.

In claiming that the "exogeneity" of TPF has been tested and rejected, the OCA references Prof. Roberts's responses to Postal Service interrogatories investigating TPF-based models in Table 1 of OCA-T-1 and seeking the specific basis for the claim that TPF are endogenous. Prof. Roberts's responses make it clear that he conducted no new analysis to test the exogeneity of TPF using contemporary data, but rather relied solely upon the results of the testing he had conducted for his 2002 paper. Tr. 23/8377-8378. Prof. Roberts's "vintage" analysis, now four years old, assesses defunct operations such as LSM and FSM 881 and does not cover recently implemented but important operations such as the AFSM 100. Having failed to update his analysis, Prof. Roberts also cannot show whether his results are sustained given contemporary operating practices and the associated data. Nor were Prof. Roberts's 2002 results unequivocal. Prof. Roberts could not reject exogeneity, using the fixed-effects/instrumental variable estimator he currently employs, for several cost pools, including LSM, FSM 1000, BCS (i.e., non-DBCS), and even manual parcels. Tr, 23/8378.

The OCA also errs in stating that only Prof. Roberts had conducted analysis reflecting the possible effects of TPF endogeneity. OCA Initial Brief at 32. In fact, Dr. Bozzo directly addresses the issue of possible endogeneity of automated operations' TPF by implementing instrumental variables models derived from Prof. Roberts's methods. USPS-T-12 at 87-89. While these are not identical to the methods employed in Prof. Roberts's Table 1, the differences are in the details; the corresponding results are broadly consonant.

Dr. Bozzo shows that treating automated TPF as endogenous has little effect on the variability level compared to the translog/GLS results used in the Postal Service CRA – 89 percent versus 88 percent – but the cost pool-level elasticities have considerably more statistical variation. *Id.*; see also Postal Service Initial Brief at 93-94. Thus, to whatever extent the exogeneity hypothesis might or might not pass an update of Prof. Roberts's tests, the practical consequences for the level of variability are negligible. In any event, if the Commission were to conclude that TPF is endogenous, the Commission could adopt the full set of instrumental variable models estimated by Dr. Bozzo.

- ii. Manual operations' TPH is not assumed to be exogenous at all.

In the case of manual sorting operations and cancellation, Dr. Bozzo recommends instrumental variable models, which treat the TPH² as "endogenous," for use in the Base Year 2005 CRA. For those five operations, the Postal Service models

² For these operations, the MODS TPH variable is used in the Postal Service models. Manual TPH and automated TPF are conceptually similar, and for the purposes of this discussion may be used interchangeably.

expressly do not assume that TPH are exogenous, and Dr. Bozzo testifies that the instrumental variable estimates are appropriate and behave as expected given the known presence of measurement error in the TPH. USPS-T-12 at 51, 54, 86-87. The OCA is mistaken to suggest otherwise.

- iii. The Postal Service models do not assume "separability" in the sense addressed by Prof. Roberts's tests.

The "separability assumption" tested by Prof. Roberts is the assumption that labor demand in a particular sorting operation depends only on the capital in the same operation. Tr. 23/8290. This relatively limited sense of "separability" is important to note, because the OCA also makes grander claims for its effects, contending that the "separability assumption... requires the whole [volume-workhours] relationship to operate through the intermediate step of a cost driver [TPF or TPH]." OCA Initial Brief at 26. The OCA's claim is unfounded as its own witness, Prof. Roberts, expressly denies that the separability tests lead him to "draw any conclusions... regarding the aggregation or use of FHP as a measure of output." Tr. 23/8367.

In fact, Dr. Bozzo's models do not assume "separability" in the more limited sense tested by Prof. Roberts, because the capital measure employed in the models is not a measure of capital used only in the operation, but rather is an index of capital for the various types of equipment used for processing in the mailstream. USPS-T-12 at 52. Indeed, Dr. Bozzo notes Prof. Roberts's claim in his March 2006 paper that using the indexes combining capital input for several equipment types was a "misspecification." USPS-T-12 at 91. It is impossible for the Postal Service models to

simultaneously exhibit the misspecification claimed in Prof. Roberts's 2006 paper and the "separability assumption" claimed by the OCA on brief.

Regarding the potential effects of the different capital specification approaches, Dr. Bozzo noted that Prof. Roberts had not, in criticizing the Postal Service's formulation, actually showed that the misspecification materially affected the relevant results, the labor demand elasticities. *Id.* In order to investigate whether there was practical significance to Prof. Roberts's misspecification critique, Dr. Bozzo compared his capital treatment to Prof. Roberts's treatment using log-linear models. As is the case with the "exogeneity" of TPF, the "misspecification" identified by Prof. Roberts has little practical significance, since the labor demand elasticities are not sensitive to the capital specification. USPS-T-12 at 92-93. In this case, the OCA mischaracterizes the assumption embodied in the Postal Service models and fails to note that the difference between Dr. Bozzo's and Prof. Roberts's methods is inconsequential for the estimates of interest.

- iv. The OCA's analysis of the "proportionality assumption" is rendered invalid by serious conceptual and econometric failures.

As evidence of failure of the "proportionality assumption," the OCA cites to portions of OCA-T-1 in which Prof. Roberts presents results of regressions of TPF on FHP. OCA-T-1 at 12-16, esp. Table 1. However, Prof. Roberts's analysis addresses the wrong quantities – "plant volume" as opposed to "delivered (RPW) volume" – and contains major errors in his specification of the econometric models. These issues are described in greater detail in the Postal Service's Initial Brief (at 79-82 and 104-106), so the following focuses on points emphasized in the OCA Initial Brief.

While Dr. Bozzo is clear on the actual relationship between TPH/TPF and RPW volume embodied in the Postal Service models, and its implementation in the CRA (USPS-T-12 at 45-56), the OCA nevertheless insists that there is an (implicit) "proportionality" assumption regarding the relationship of TPF/TPH and "plant volume" (literally, FHP). OCA Initial Brief at 32. However, the relationship between FHP and RPW volume is unmeasured by Prof. Roberts (Tr. 23/8368-8369), and Dr. Bozzo shows that the approximation feature of the distribution key method renders the FHP "correction" unnecessary. USPS-T-12 at 107-108. This also implies that the "proportionality assumption" incorporated in Prof. Roberts's proposed method is not empirically validated.

Indeed, the OCA discusses the "proportionality assumption" in terms that suggest, incorrectly, that the relationship is between a single plant or system volume and operation-level piece handlings. For example, the OCA asserts that the Postal Service method "does not recognize any mechanism through which an increase in plant volume results in a change in the mix of sorting operations." OCA Initial Brief at 29; see also pp. 12-13. On another tack, Prof. Roberts claims that it is unnecessary to reflect mailflows from various components of FHP to TPF in his TPF-FHP model. Tr. 23/8326/8327; see also USPS-RT-5 at 65-67. Prof. Roberts's approach makes little sense as a literal characterization of mailflows, but may at least be understood as assuming a scalar relationship between volumes and sorting workloads, contrary to the actual assumption embodied in the distribution key method.

However, the relationship under consideration clearly is not a scalar one. The handlings (or "cost driver") is taken to be a linear combination of the appropriate

volumes, where the coefficients of the combination reflect how each volume contributes to handlings. This is readily apparent from the matrix equations that summarize Dr. Bozzo's discussion of the relationships between RPW volumes, FHP, and TPF (USPS-T-12 at 35-45, esp. equation 5), as well as the linear combination that describes the correct relationship between TPF and FHP (USPS-RT-5 at 66, esp. equation 2a).³ Accordingly, the estimating equations with which Prof. Roberts purports to test the assumption are misspecified.

In the Postal Service framework, different categories of volumes are expressly allowed to use operations in different combinations – i.e., because machinable pieces will receive the bulk of their handlings in automated operations, whereas non-machinable pieces must be sorted manually. Through this mechanism, an increase in volume that shifts the mix of mail characteristics, for instance to increase the proportion of machinable mail, will affect the operation mix as the marginal handlings would be more likely to be carried out on automation. Were volume in non-machinable mail categories to increase, more manual handlings would be required and accordingly the use of manual operations would increase. The OCA's claim that the Postal Service methods provide no mechanism for changes in operation mix is, therefore, false.

Even if Prof. Roberts's approach to testing the "proportionality assumption" were otherwise appropriate, his results would still be rendered unusable due to the

³ The equations relating MODS workloads and volumes also make clear that UPS's statement that TPF is a "proxy" for volume is incorrect. UPS Initial Brief at 17. TPF and volume are conceptually distinct in the analysis. Moreover, FHP and volume are related in the same general way as TPF and volume. In particular, both depend on details of the path in which pieces are handled, with TPF depending on the number of sorts and FHP depending on the number of unique facilities that sort the pieces. See also USPS-T-12 at 23-25.

inappropriate specification of instrumental variables for the models, paralleling a similar error Prof. Roberts discovered in his labor demand models. See Postal Service Initial Brief at 104-106 for additional details. While the OCA is technically correct that Dr. Bozzo's shape-level models do not directly address potential variations in the TPF-FHP elasticities by cost pool (OCA Initial Brief at 32), Prof. Roberts's econometric errors leave him without appropriate operation-level results.

Additionally, the OCA is incorrect in suggesting that Dr. Bozzo's results have no bearing on the "proportionality" question. Given Dr. Bozzo's showing in USPS-RT-5, Table 10 that TPF do not increase disproportionately with FHP at the shape level, the behavior of handlings at the cost pool level are constrained – the component elasticities cannot all be above average. In particular, given that the vast majority of letter and flat handlings are in automated operations (see Postal Service Initial Brief at 74-75), which also constitute the preponderance of the costs, the automated operations would not show a material departure from "proportionality" even if Prof. Roberts's result for manual letters withstood the application of proper econometric techniques.

- v. The absence of material cross-operation TPF effects for automated operations was empirically validated, not merely assumed.

The OCA claims that "there is no role for the plant-level volume of mail, either in total or disaggregated by processing category" in the Postal Service models. OCA Initial Brief at 26. The OCA's characterization of Dr. Bozzo's efforts is incomplete. While Dr. Bozzo's recommended models employ only the same-operation TPF, he empirically validated his approach by estimating labor demand models permitting

flexible cross-operation effects for the automated letter and flat sorting operations.⁴ Dr. Bozzo shows that the cross-operation elasticities are negligible, which confirms the operational account suggesting little role for the plant-level (beyond operation-level) volumes for some \$2.44 billion in labor costs. Thus, for the automated sorting operations studied by Dr. Bozzo, the "restriction" on the sorting outputs is true. USPS-T-12 at 93-95; see also Postal Service Initial Brief at 92-93.

Dr. Bozzo also shows that other cross-operation volume effects on sorting workhours are nonexistent. Applying Dr. Neels's model specification to letter-shape operations, Dr. Bozzo shows that there are no effects of non-letter volumes on letter-sorting workhours. This empirically confirms, in part, the shape-level analysis used in both the Postal Service and OCA models against Dr. Neels's empty contention that even cross-shape effects must be considered in a valid model. USPS-RT-5 at 40; see also Postal Service Initial Brief at 93. In general, intervenor criticisms of Dr. Bozzo's models for incorporating "restrictions" are inappropriate, in that such restrictions are shown either to be true or to be immaterial to the elasticity estimates.

- c. The OCA's general theoretical framework is implemented by a set of empirical models that are unduly restrictive.
 - i. The OCA's model description highlights the oversimplification between Prof. Roberts's theoretical framework and his empirical models.

While much of the OCA's criticism of the Postal Service mail processing framework is based on erroneous claims that the Postal Service approach is

⁴ In the OCA's terminology, Dr. Bozzo's approach is the "disaggregated by processing category" method. It is appropriate because it would not be expected that sorting volumes in other operations would have the same effects as the mail actually sorted within the operation.

excessively restrictive, Prof. Roberts's models are highly restrictive as implemented – and, in contrast to the Postal Service models, often in ways that even Prof. Roberts does not assert to be true a priori.

Prof. Roberts's conceptual framework, as described by the OCA, is very general:

[M]ail that will receive piece sorting in the facility is recombined into distinct processing categories based on its **shape, machinability, level of mailer processing, and level of final dispatch** (p.15) ... The mail in each [letter-shape] processing category moves through the separate sorting operations, represented as OCR, BCS, and manual, generating both labor hours and piece feedings/handlings in each operation. **Sorting the mail in each processing category will generally require a different mix of sorting operations and thus have a different quantity of labor hours and cost.**

OCA Initial Brief at 15-17, emphasis added.

The OCA's description makes its repeated assertions that there is no particular role for TPF in its framework particularly puzzling. (UPS, piggybacking on Prof. Roberts's analysis, makes similar claims regarding the sufficiency of FHP. UPS Initial Brief at 17-18.) The OCA's own description of its model makes it clear that not only the number of pieces, but also the amount of sorting required (*i.e.*, the differences between the "level of mailer processing" and "level of final dispatch), are relevant to understanding costs. Indeed, the operational accounts make clear that the amount of sorting is more important for understanding the sorting operations' costs than the unique number of pieces. See, *e.g.*, USPS-T-12 at 26-32; USPS-RT-5 at 46-47; USPS-RT-15 at 12. In the Platonic ideal of Prof. Roberts's analysis, hypothetically it may be possible to obtain sorting volumes that perfectly identify all relevant processing-categories and to precisely estimate labor demand elasticities for each. But the reality of Prof. Roberts's empirical implementation is much different.

Shifting to Prof. Roberts's empirical model, the array of "distinct processing categories" with distinct cost characteristics is reduced to "the total volume [MODS FHP] of mail in each processing category [*i.e.*, shape] incoming or outgoing." *Id.* at 17. The machinability of the mail is not represented at all, and the "level of mailer processing" and "level of final dispatch" are not distinguished within the incoming and outgoing FHP categories, including between presorted and non-presorted mail. Prof. Roberts's two-output (incoming and outgoing) models are actually significant improvements over his original 2002 model, which distinguished no processing categories within shape. USPS-T-12 at 7.

The OCA goes so far as to claim:

It is not necessary to distinguish the exact pathways that letters follow as they pass through the sorting operations. All that is necessary is to estimate the relationship between the volume in each processing category and total hours in each operation.

OCA Initial Brief at 17-18. The OCA's statement would be unobjectionable if it could identify the volume in each processing category and accurately measure the associated costs. In practice, Prof. Roberts implements a specification that recognizes few of the cost differences among processing categories, since the relationships between volumes and hours will depend on, among other things, the amount of sorting pieces require in each operation – which the OCA framework theoretically recognizes, but which the sole dependence on FHP in the empirical models ignores. USPS-T-12 at 25. Thus, Prof. Roberts's empirical models eliminate details that the OCA theoretical framework suggests are relevant, directly out of the starting gate.

With the only differences in the "quantity of labor hours and cost" being those reflected in the incoming and outgoing FHP, Prof. Roberts's models yield costs that

appear equally inapplicable to machinable and non-machinable mail alike. For instance, Prof. Roberts's models imply that a generic outgoing letter FHP gets 57 percent of its marginal labor cost from manual operations (0.267/0.465). Tr. 23/8348. For a non-machinable piece, which cannot be sorted on automation, the manual labor fraction is 43 percent too low. For an automation-compatible piece, the manual fraction is implausibly high, especially in the face of data provided in Prof. Roberts's 2006 paper showing that manual handlings per FHP have declined rather markedly, from 0.15 per FHP in FY 1999 (PQ 1) to 0.08 per FHP in FY 2004. Roberts 2006 at 68.

- ii. Prof. Roberts acknowledges that certain restrictions on the models may be warranted.

The OCA's unwarranted fixation on "restrictions" on the structure of output in the Postal Service models (OCA Initial Brief at 26), particularly to the exclusion of those in its own, is out of line with the possibility – if not probability – that some restrictions on the structure of output are warranted. Prof. Roberts states, reasonably, that mail bypassing particular operations should generate no cost in those operations. Tr. 23/8340. Prof. Roberts further agrees that this may give rise to zero restrictions on certain volumes:

Q. Okay. Let me focus for a second here on the word "volume". Is it possible at least in principle that the labor demand model for a particular operation, that some of those volumes may prove to be irrelevant in the sense that they have no significant effect on work hours?

A. [Prof. Roberts] That's certainly possible, and that's allowed for in the empirical model.

Tr. 23/8397. Given the level of aggregation of volumes in Prof. Roberts's models, the possibility would not seem very likely, since all of the labor groups he models would

process some amounts of both outgoing and incoming mail. The possibility becomes more likely, however, as outputs are disaggregated further.

One way that mailflows can matter for costs, even in Prof. Roberts's view, is in cases where particular types of mail are known to bypass other operations entirely. An example is pieces inducted into the manual mailstream:

Q So nonmachineable pieces or other pieces that are first processed in manual operations will not flow to the automated mail stream?

A Yes.

Q And therefore they will cost either little or nothing in the automation operations?

A Correct.

Tr. 23/8406-8407. Thus, when the OCA characterizes the restriction that manual volumes do not affect automation workhours as "a relationship that is basically imposed in the USPS model" (OCA Initial Brief at 35-36), they are describing a relationship that Prof. Roberts himself believes to be true, but is not represented in any of his models.

While the different cost-causation patterns for non-machinable vs. machinable pieces in automated operations is clear-cut, it is not the only relevant distinction that might be made. That bulk-entered pieces bypass cancellation also is relatively obvious, and indeed is shown in the mailflow representations Prof. Roberts agrees to be substantially correct. USPS-T-12 at 17 (Fig. 1); Tr. 23/8393-8395. Yet Prof. Roberts specifies the entirety of outgoing FHP⁵ as the cancellation "output," instead of the actual volumes of canceled pieces (available in the cancellation operations' TPH), indicating only that he cannot "see any way" to do otherwise. Tr. 23/8359-8360.

⁵ This would include mixed AADC presort mail, according to witness Abirahman's letter mailflow model. See USPS-LR-L-48, file FCM.xls, sheet 'AUTO MAADC MODEL.'

It would also stand to reason that pieces inducted directly into manual operations may have different effects on manual sorting labor, which also is not reflected in Prof. Roberts's recommended models. Prof. Roberts's general approach, rightly, has been to pursue further disaggregations of output. Prof. Roberts states:

[T]he path I've attempted to follow throughout my analysis is to disaggregate first handling pieces into finer categories to allow for the fact that different categories of mail volume will have different cost implications. That's what the disaggregation is designed to do.

Tr. 23/8409. Whether finer disaggregations of outputs are practical within Prof. Roberts's empirical modeling approach remains to be seen. However, the cost distinctions captured in the OCA models clearly are insufficient to support the cost distribution approach Prof. Roberts advocates.

- d. The OCA advocates an approach to distributing costs to subclasses that would reflect a clear step backwards from current methods.

The OCA suggests a volume-based cost distribution system as an alternative to the current methodology were Prof. Roberts's variability models to be implemented in the CRA. OCA Initial Brief at 21-23. This method would involve calculating pools of volume-variable costs associated with Prof. Roberts's output measures (e.g., incoming letter FHP) and distributing the cost to subclasses using subclass volume shares. *Id.* at 22. Significantly, this approach assigns the same unit cost to every piece associated with one of Prof. Roberts's FHP output measures, regardless of presort characteristics, machinability, or degree of finalization – the characteristics not measured by Prof. Roberts's output measures. USPS-RT-5 at 71. Regardless of whether Prof. Roberts's models reliably measure the degree of volume-variability in mail processing, they clearly

do not measure costs for a sufficient variety of mail types with distinct cost-causing characteristics to support the OCA's suggested distribution method.

The result of the OCA's proposed method would overstate volume-variable costs for low-cost mail (e.g., automation-compatible and/or more highly presorted processing categories) and understate costs of higher cost mail (e.g., nonmachinable and/or less presorted mail). Introducing such errors into the mail processing costing system is unnecessary, since the current IOCS-based method presently accounts for workload differences between subclasses and other rate categories. *Id.*

Recognizing that the subclass volumes required by its proposed method do not exist, the OCA proposes an even less appropriate alternative method of distributing a single volume-variable cost pool for all letters in proportion to letter processing volume shares. OCA Initial Brief at 22-23. This would assign the same unit cost to **every** letter, a gross error in representing actual marginal costs for each processing category. It is also completely at odds with the OCA's statement of Prof. Roberts's conceptual model, which indicates that the true processing categories exhibit cost differences. OCA's criticisms regarding "restrictions" in the Postal Service model – restrictions that are true, that have no material effect on results, or that are not incorporated in the models at all – appear especially disingenuous when the OCA itself advocates restrictive methods that would lead to patently false results.

- e. At best, Prof. Roberts's models are minimally useful for developing worksharing cost avoidances; additionally, the OCA mischaracterizes the applicability of the Postal Service models.

The OCA mistakenly claims that the Postal Service framework "never estimates marginal costs for processing categories." OCA Initial Brief at 21; also at 26-27, 35. Dr. Bozzo's testimony shows that his models do not do so on their own, but rather provide inputs to the subclass volume-variable cost calculations and mailflow models. Dr. Bozzo clearly explains how marginal costs by processing category may be calculated by combining his models of sorting costs with mailflow models identifying the sorts required for pieces of various processing categories:

By estimating the marginal costs of sorts by cost pool (i.e., processing mode), the Postal Service econometric models may be **combined with mailflow models such as those presented by witnesses Miller (USPS-T-20) and Abdirahman (USPS-T-22) to estimate cost savings from substituting processing modes and/or avoiding sorting stages...** For instance, substituting automated for manual processing of a piece involves a decrement of sorting output from manual operations and an increment of sorting output in automated operations. The cost savings may then be calculated from the marginal sorting costs by mode. Of course, similar methods also allow calculation of cost avoidances for bypassing sort stages in the various processing streams.

USPS-T-12 at 22-23, emphasis added. Using this method, the Postal Service calculates cost avoidances for a far greater variety of processing categories, representing various presort levels and machinability characteristics, than Prof. Roberts's models have even aspired to show.

The OCA's claim that Prof. Roberts's models can be used directly in pricing is overstated at best. The most Prof. Roberts's recommended models can show is the effect of avoiding outgoing FHP. Dr. Bozzo notes that Prof. Roberts's models would need to be augmented with an unspecified mailflow model to provide any

comprehensive set of cost avoidances. *Id.* at 23. Prof. Roberts himself does not support the OCA's claims for his models. He agrees that his models have limited utility for measuring costs for processing categories that are not distinguished within his FHP aggregates. For instance:

Q Could you use your recommended letter-shaped models to measure a marginal cost difference between pieces in the manual and pieces in the automation mail streams?

A [Prof. Roberts] No, you cannot.

Tr. 23/8402. It follows that Prof. Roberts's models also cannot estimate the effects of the near-entirety of presort cost differences that are not represented in his models. The OCA erroneously claims that Prof. Roberts's models can do things beyond what is claimed by their author, and ignores clear testimony describing the system by which the Postal Service estimates costs by processing category.

- f. The OCA's effort to explain Prof. Roberts's interpretation of TPF and TPH only underscores the fundamental inconsistency of Prof. Roberts's views.

The OCA brief revives an argument from Prof. Roberts's March 2006 paper that TPF is a measure of "the flow of capital services or capital input." OCA Initial Brief at 18-19. Dr. Bozzo explains that Prof. Roberts's interpretation is faulty in that it confuses inputs (capital and labor) with outputs (sortation of pieces). USPS-T-12 at 28-29. That is, the Postal Service's operating plan specifies the sorting paths for pieces in the various distinct processing categories, thereby indicating the sorts in various operations required to advance the mail to its destinations. Both labor and capital inputs are used to produce plants' sorting outputs.

Prof. Roberts had indicated, during his March 2006 seminar, that he based his characterization of TPF on an equation in Dr. Bozzo's R2005-1 testimony linking TPF with the machine runtime requirement.⁶ A comparable equation is presented in USPS-T-12 at 28 (equation 1C). However, a companion equation relates TPF to the corresponding runtime **labor** requirement for sorting the mail. USPS-T-12 at 28, equation 1A. Thus, Prof. Roberts's stated basis for equating TPF with capital input could just as easily have equated TPF with labor input. Or, as Dr. Bozzo suggests, consistency would require that he characterize TPF as measuring both labor and capital input at the same time, an obvious contradiction. USPS-T-12 at 29. While the OCA is correct in saying this "makes no sense," the basis for it making no sense is Prof. Roberts's confusion of the sorting operations' outputs (the sorts) with the inputs (labor and capital) that produce the sorts. *Id.*

In suggesting that manual TPH is "of course" "not a measure of capital input" in manual sorting operations, but rather a count of the number of pieces handled (which is correct), the OCA only underscores the problem with Prof. Roberts's original account. The problem is that manual TPH and automated TPF are conceptually equivalent piece count measures⁷ (USPS-T-12 at 24), yet in the OCA's telling, they have totally different interpretations. Only Dr. Bozzo's interpretation of TPF (and TPH) as measures of sorting outputs is consistent with the definition of the MODS workloads and the relationship of the piece handlings to both labor and capital inputs. USPS-T-12 at 29.

⁶ Transcript of Prof. Roberts's March 14, 2006 workshop at 12, *et seq.*, accessed at <http://www.prc.gov/OCA/papers/framework/workshop.doc>.

⁷ Since manual operations do not generate rejects, manual TPH would also measure "TPF" (the number of attempted manual sorts).

- g. The OCA does not seriously challenge Dr. Bozzo's conclusion that an update of Prof. Roberts's March 2006 models provides the most reliable variability estimates within the Roberts framework.

The OCA brief includes an extended response to Dr. Bozzo's rebuttal testimony, USPS-RT-5, portions of which appear to provide surrebuttal testimony not in the record. See OCA Initial Brief at 34-39. The Postal Service anticipates that the Commission will weigh the OCA's arguments only to the extent they are supported by the record. The following sections briefly reply to the issues raised by the OCA.

- i. The OCA's arguments regarding Prof. Roberts's "additional outputs" models for letter operations neglect the basic fact that those models simply do not function as advertised.

The OCA considers it "puzzling" that the Postal Service would express concern about distinguishing automation from non-automation mail, suggesting that the Postal Service models themselves cannot do so. OCA Initial Brief at 35. As discussed in section 1(e) above, the Postal Service modeling effort, properly viewed in its entirety, in fact can do so, so that portion of the OCA's reply is unfounded. Moreover, the OCA's reply seems to underscore its apparent indifference to appropriately reflecting cost differences that are generally understood to exist (see, e.g., Tr. 23/8400) within the volume categories employed in Prof. Roberts's models. The issue is a significant one as long as the OCA advocates subclass volume-variable cost methods that would fail to reflect major cost differences by subclasses and other mail categories. See section 1(d), above.

The OCA admits that Prof. Roberts's models so far have shown a limited ability to precisely estimate elasticities using more finely disaggregated FHP variables than

Prof. Roberts employs in his recommended models. OCA Initial Brief at 34-35. By having inappropriately combined automation and non-automation mail in his "nonautomation" category, Prof. Roberts made it difficult for his models to distinguish the cost differences, since the bulk of the pieces in the "nonautomation" category are actually automation-compatible pieces. USPS-RT-5 at 60. Those, Prof. Roberts agrees, would have similar cost characteristics to prebarcoded mail once the barcode is applied. Tr. 23/8404. In effect, Prof. Roberts wasted the resolving capacity of his model.

- ii. The OCA's reply with respect to Prof. Roberts's inconsistency in using of seasonal variation mischaracterizes witness Moden's testimony and the plain language of Prof. Roberts's 2002 report.

The OCA admits that Prof. Roberts's approach to seasonal controls has been inconsistent, but attempts to paint the situation as a positive evolution of Prof. Roberts's views. OCA Initial Brief at 36-39. The record suggests otherwise. Prof. Roberts had justified the absence of seasonal controls in part on the claimed lack of operational testimony indicating their need. As Dr. Bozzo showed, Prof. Roberts's research had not extended to witness Moden's testimony from Docket No. R97-1, which directly addressed the matter. USPS-RT-5 at 51-52. Accordingly, there was a prior reason to include seasonal controls. Moreover, the controls, when included, are statistically significant. Dr. Bozzo concludes that, "Excluding variables that are both significant and which are expected theoretically to play a role is highly unusual." USPS-RT-5 at 53-54.

In its attempt to explain why witness Moden's testimony is not relevant, the OCA mischaracterizes it as only describing changes in mail volumes and characteristics.

OCA Initial Brief at 36. This is incorrect; witness Moden also noted, if briefly, the change in the "mix of more- and less-skilled workers" due to seasonal hiring. USPS-RT-5 at 52. The OCA also suggests that in 2002, Prof. Roberts simply accepted the Postal Service's treatment without question. Dr. Bozzo's direct quote of Prof. Roberts's 2002 paper indicates otherwise:

The cyclical fluctuations in hours can, however, reflect more than variation in output. Differences in work effort or changes in the mix of more- and less-skilled workers may also occur from quarter-to-quarter. In order to control for these other potential sources of variation in hours we will include a set of three quarterly dummy variables (DQ2, DQ3, and DQ4) to identify observations in the second, third, and fourth postal quarters, respectively.

Roberts 2002 at 24, quoted at USPS-RT-5, p. 52. Prof. Roberts, evidently, had recognized witness Moden's point on labor quality variations (and other possible exogenous seasonal factors) on his own, and Prof. Roberts indicated no deference to Postal Service methods in reaching the conclusion in his 2002 report that he should control for exogenous seasonal variations in workhours.

Finally, the OCA's characterization of the quarterly dummy variables as "useful and appropriate in six out of 10 sorting operations" (OCA Initial Brief at 38), when used as instrumental variables, is misleading. It neglects to mention the identities of the four operations for which the variables are inappropriate. Those are BCS, Manual Letters, FSM 1000, and AFSM 100. Tr. 23/8311. Those operations constitute 88 percent of the BY 2005 costs for letter and flat sorting operations. Prof. Roberts's treatment is, in fact, broadly inappropriate for the bulk of the sorting operation costs under study.

- iii. The OCA fails to address Dr. Bozzo's main critiques of Prof. Roberts's update: that Prof. Roberts inappropriately rejected changes constituting improvements within his own framework, while accepting changes that were inappropriate.

Notably absent from the OCA's reply to Dr. Bozzo's rebuttal is a substantive defense with respect to Dr. Bozzo's central critique that Prof. Roberts rejected appropriate, evolutionary changes to the March 2006 model in favor of the more radical modifications in OCA-T-1, some of which were proven to be inappropriate (see the preceding section). The main issues are reviewed in the Postal Service's Initial Brief at 99-103.

2. Contrary to UPS's claims, the weight of the evidence supports less than 100 percent variability for mail processing labor.
 - a. UPS neglects the substantial development of econometric models of mail processing since Docket No. R2000-1.

In characterizing the Postal Service model as "twice rejected" and an "unreliable basis for abandoning" the 100 percent volume-variability assumption (UPS Initial Brief at 13), UPS misrepresents the record of substantial development of mail processing modeling methods since its participation in Docket No. R2000-1, as well as extensive analysis that directly validates the Postal Service methodology. These include the adjustments in the Postal Service and intervenor models to deal with the "endogeneity" of TPH and other MODS variables that measure sorting output (see section 1(b)(i)-(ii), above), which should resolve longstanding issues over MODS data issues, and the convergence of all of the mail processing econometric analyses on panel data econometric methods, as recommended by Prof. Greene six years ago (Postal Service

Initial Brief at 89-90). Moreover, while Prof. Roberts's models differ from Dr. Bozzo's in a number of important respects, both agree that it is possible to estimate well-founded econometric models of sorting labor demand using Postal Service data, contrary to UPS's assertion that the data are "ill-suited" to the task. See Postal Service Initial Brief at 83.

- b. UPS overstates MODS data quality issues and inaccurately characterizes the effect of screening procedures on variabilities.
 - i. Dr. Neels's excessive screens for MODS data anomalies are out of step with the Postal Service and OCA treatments of the data, and misrepresent MODS data quality.

Few, if any, data sets are perfect. The central issue, as stated by Prof. Greene in Docket No. R2000-1, is to extract the useful information from the data. The application of reasonable data screening and the use of econometric techniques make the use of MODS data uncontroversial in the Postal Service and OCA methods.⁸ However, given UPS's sidelong reference to Dr. Neels's identification of "data quality problems" in MODS (UPS Initial Brief at 14), it is important to note that, in his zeal to identify MODS data anomalies, Dr. Neels committed numerous errors in handling data from both IOCS and MODS, and broadly neglected to consider whether the "suspicious" data he identified were materially erroneous. In effect, Dr. Neels is subject to his own critique of Prof. Bradley from Docket No. R97-1 by conducting screens that are more restrictive in the face of relatively minor anomalies and by defeating data handling procedures designed to minimize errors in the variables used in estimation. USPS-RT-5 at 12-27.

⁸ Of course, the methods use different MODS variables in to represent sorting "output."

Dr. Neels's untoward focus on minor data anomalies is especially inappropriate given the use of econometric estimation procedures that are robust to measurement error in the MODS data. USPS-RT-5 at 27-28.

UPS's references to Prof. Roberts's screens (UPS Initial Brief at 14-15) do not support the claim that the MODS data are "ill-suited" for mail processing variability analysis. First, the count of sites that do not "report FHP or capital stocks consistently over time" is not, in itself, an indicator of MODS data quality. Some facilities actually do not report MODS data over the entire sample period. As Dr. Bozzo noted in response to UPS interrogatories, a number of post offices and other processing facilities ceased reporting data to MODS during the sample period, and a variety of new facilities joined the MODS panel or began reporting MODS data. Tr. 10/2644-2646. Dr. Bozzo also observes that "certain operations, particularly Priority Mail and [manual] parcel sorting, may only be present in some facilities at periods such as seasonal peaks." Tr. 10/2643. Screening data from a relative handful of other facilities leaves Prof. Roberts with estimation data sets covering nearly 300 facilities, which is roughly comparable to the cross-section breadth of the Postal Service samples. Dr. Neels's more restrictive sample only covers 139 facilities, and provides an average of only 6.6 quarterly observations per site. USPS-LR-L-192, file USPSmod_output_LDC.log. Dr. Neels's smaller sample does not cover a "reasonably broad collection of the underlying costs." Tr. 36/12497.

Dr. Neels attempts to show, using application of data screens to weekly data, that much of the MODS data has hidden errors. UPS-T-1 at 18-20. Dr. Bozzo notes that since the weekly data provide dramatically more observations than the quarterly

data (12 or 16 weeks per old-calendar postal quarter), even relatively low error rates in the weekly data would eliminate much of the quarterly data. Since even the most stringent weekly screens still leave substantial numbers of good quarterly observations, the underlying error rates must be relatively low. USPS-RT-5 at 26-27. In fact, the fraction of good weekly observations underlying the samples in the Postal Service models is very high, as shown in the table below. Dr. Neels's screens eliminate very large quantities of data to remove small fractions of the underlying weekly data from the analyses. He makes no serious case that such additional screening is necessary.

Fraction of "Good" Weekly Observations in Postal Service Regression Samples

	(a)	(b)	
Cost Pool	Potential Weeks in Sample /1	Good Weeks in Sample /2	% Good (b)/(a)
Incoming BCS	89,508	89,116	99.6%
Outgoing BCS	86,060	85,121	98.9%
OCR	78,164	76,942	98.4%
AFSM 100			
incoming	26,360	26,293	99.7%
outgoing	26,360	26,051	98.8%
FSM 1000	54,292	53,933	99.3%
SPBS	58,440	58,163	99.5%
Manual Flats	93,424	90,824	97.2%
Manual Letters	109,860	108,647	98.9%
Manual Parcels	63,064	59,115	93.7%
Manual Priority	71,720	67,486	94.1%
Cancellation	106,196	104,907	98.8%

1/ 12 weeks for postal quarters 1-3, 16 weeks for postal quarter 4, for regression sample observations as described at Tr. 10/2647.

2/ USPS-LR-L-56, file vvscreens.xls. Sum of weekly 'good' observation counts over regression sample observations.

- ii. UPS incorrectly characterizes the roles of sample screening procedures in the variability results.

UPS is incorrect in implicating Prof. Roberts's data screens as a specific cause of the high measured variabilities reported in OCA-T-1. UPS Initial Brief at 15.

Substantially similar screens are associated with variabilities of less than 100 percent in Prof. Roberts's March 2006 results, and the associated update with FY 2005 data presented in USPS-T-12. Roberts 2006 at 73; USPS-T-12 at 104.

UPS also improperly claims that Dr. Bozzo's "plant-level" analyses, with "tight data quality standards," support variabilities of 100 percent. UPS Initial Brief at 15.

However, in the LDC 17 analysis cited by UPS, the increased sampling imprecision

from the smaller sample means that the "results [cited by UPS] are not actually significantly different from the results that are reported in Table 7 [of USPS-RT-5] for LDC 17." Tr. 36/12498. Moreover, the broadest plant-level model estimated by Dr. Bozzo, covering the entirety of mail processing workhours including allied labor, support labor, and supervision, yields essentially identical results from both samples – 0.908 from the small sample, 0.902 from the larger sample. USPS-RT-5 at 44 (Table 8); USPS-LR-L-192, file USPSmod_output_FCTMODS.log.

Likewise, the Postal Service analysis of the weekly screening criteria shows that the weekly screens have little effect on letter and flat-shape variabilities. Effects on the elasticities for manual Priority, and to a much lesser extent manual Parcels, are accompanied with large increases in the standard errors as the sample size decreases. USPS-T-12 at 97, 99. Even including the imprecisely estimated manual Priority variability, the weekly screens yield variabilities below 100 percent, and not materially different from the Postal Service BY 2005 variabilities otherwise. *Id.* Again, the analysis provides no indication that eliminating minor errors systematically increases variabilities.

- c. Short-run marginal costs are appropriate for the Base Year CRA, and UPS fails to account for the function of the rollforward model in the costing process; the "full cost consequences" of reconfiguring operations over the rate cycle are reflected in the Test Year costs.

UPS reiterates the shopworn claim that the Postal Service models are inappropriate because they are intended to measure "short run" costs. UPS claims that Dr. Bozzo's models fail to reflect the "full cost consequences" of changes to the

configuration of the Postal Service's operations over the rate cycle. UPS Initial Brief at 14.

The short run cost critique is not applicable here because "short run" costs are conceptually appropriate. The actual costs applicable to a finite time period such as that during which a set of postal rates will be in place formally will be short run costs. See, e.g., Docket No. R87-1, USPS-T-3 (Baumol) at 12. Prof. Roberts's models for the OCA, for that matter, also are explicitly short run labor demand models. Roberts 2002 at 4.

In claiming that Dr. Bozzo's models fail to reflect potential reconfigurations of operations over the rate cycle, UPS fails to recognize the proper role of the Base Year variability models and the rollforward model used to estimate costs in the Test Year. The rollforward model takes costs reflecting Base Year operating conditions and explicitly accounts for effects of forecasted volume growth, cost level changes, other workload changes, and "special programs." The special programs, in particular, reflect the effects of deploying new equipment and other operational initiatives. Postal Service Initial Brief at 66; see also, e.g., Docket No. R2000-1, USPS-T-22 at 38-40. If Dr. Bozzo's models functioned as UPS recommends, those effects would be double-counted in the computation of test year costs.

3. Valpak's arguments in favor of full attribution of mail processing costs are contradicted by the correct application of economic cost concepts.
 - a. Valpak's claims regarding the attribution of setup and take-down activities do not withstand a full reading of the record.
 - i. Valpak's selective reading of the testimony regarding setup costs is contrary to the main thrust of witness McCrery's responses.

Valpak cites interrogatory responses by witness McCrery to illustrate a case showing some relationship between volume and setup and take-down costs. Valpak Initial Brief at II-6. The example described by Valpak – the initiation of a separate sort scheme for Standard Mail when sufficient volume is available –does not depict setup costs varying with mail volumes on the margin. Therefore, it does not contradict the analysis suggesting that the degree of volume-variability for setup and takedown costs should be very low, and it is not even a proper reading of witness McCrery's responses. MPA *et al.* witness Elliott describes in detail a series of responses by witness McCrery that highlight the routine processing of multiple classes of mail, particularly in the incoming operations that give rise to the bulk of the econometrically-estimated non-volume-variable costs. MPA *et al.*-RT-2 at 9-12. Dr. Elliott observes that the entirety of witness McCrery's account shows that "single-class sortation runs occur only for a minority of sort schemes." MPA *et al.*-RT-2 at 12.

Witness McCrery's testimony also provides no support for Valpak's characterizations of the fixity of setup and take-down costs as representing "slight" discontinuities in the cost relationships. He notes that the "vast majority of schemes" are run on single machines, and subsequently supported the claim with data showing

that a substantial number of single-machine schemes are present even for primary sorting stages. USPS-T-42 at 36; Tr. 11/2896; MPA *et al.*-RT-2 at 3. To whatever extent the cost relationship is, as Valpak describes it, a "discontinuous step function" (Valpak Initial Brief at II-6), the fact of the matter is that most schemes never venture beyond the first step, and thus are mostly invariant with respect to volume changes.

- ii. Witness McCrery addresses the Commission's concerns related to setup costs from Docket No. R2005-1.

Valpak criticizes Dr. Bozzo for "fail[ing] to address explicitly an important concern raised by the Commission" regarding the structure of setup costs. The Commission had identified two scenarios regarding setup costs and suggested that the setup costs would have unit variability in one case, and may have low variability but be "very small" as a proportion of costs in the other. Valpak Initial Brief at II-15, referencing PRC Op., Docket No. R2005-1, App. I at 52. While Dr. Bozzo did not directly address the Commission's concerns, witness McCrery did so in USPS-T-42.

Witness McCrery strongly disagrees with the Commission's reasoning. The Commission's scenarios inaccurately depict the actual features of sort runs. In the first scenario, the situations in which schemes may, as a practical matter, be run on multiple machines are quite limited, and so the circumstances in which setup time variability may be relatively high are not prevalent. In the second, it is not possible to run single-machine schemes indefinitely since each such scheme must be set up and taken down to accommodate the day's mail. As a result, in a correct version of the Commission's second scenario, the variability of the setup costs would be low but the setup costs are not as small as the Commission suggests as a proportion of overall costs. Witness

McCrery concludes that "Absent other factors, volume-variability in an automated distribution operation that involves significant set-up incident to scheme changes must be less than 100 percent." USPS-T-42 at 36.

- iii. Valpak, ignoring its own witness's advice, mistakenly suggests that any setup costs that have some connection to volumes should be treated as "volume-variable" costs.

Valpak admits that the effects of volume on setup and take-down costs involve what it terms "slight discontinuity" with the costs, but nevertheless suggests that the costs "should be considered volume variable." Valpak Initial Brief at II-10 to II-11. Valpak's characterization of the relevant "discontinuity" as "slight" is inconsistent with witness McCrery's account of the costs, described above. Valpak's inconsistency is underscored by the fact that its own witness, Dr. Haldi, in the course of a single interrogatory response, manages to both support and oppose it.

Asked about his understanding of the treatment of inframarginal costs in the Postal Service incremental cost model, Dr. Haldi first suggested that the non-volume-variability of some costs may be ignored under some circumstances. Tr. 23/8612. However, Dr. Haldi then embarked on a lengthy discourse on the need to be clear regarding cost concepts and terminology, in which he negates his own previous suggestion:

It is neither reasonable nor a good precedent to treat a discontinuous, fixed incremental cost as though it were volume variable.

Tr. 23/8614. This is not simply a throwaway line in favor of proper costing methods. Dr. Haldi explains further:

In other words, **when the Postal Service has costs which are fixed at**

the margin of a single piece of mail, but some of which vary with infra marginal changes in volume - i.e., they are "semi-fixed" or "semi-variable" costs... - references to "marginal costs" need to be unambiguous. Attempting to have it both ways, where "marginal cost" refers to (i) the change in cost that occurs when the volume of mail changes by a single piece, AND (ii) average incremental cost over some larger but finite change in volume, is likely to create unnecessary confusion.

Tr. 23/8615, emphasis added.

Valpak, in fact, sows the unnecessary confusion. Dr. Bozzo clearly and correctly indicates that variation with volume on the margin is, definitionally, the basis for "attribution" specifically as volume-variable costs (or, equivalently, under the concept of economic marginal costs). When Valpak criticizes Dr. Bozzo for maintaining what it calls an "absolutist position" on the criteria for "attribution" of costs as volume-variable, without specifying that the criteria in fact apply to volume-variable costs (Valpak Initial Brief at II-13 to II-14), Valpak is trying to "have it both ways" by blurring the distinction between volume-variable and incremental costs. Dr. Bozzo, over the course of lengthy exchanges with Valpak counsel, clearly described the distinct criteria for "attribution" as incremental costs. Tr. 10/2692-2696; Tr. 36/12510-12520. Dr. Bozzo's disambiguation of the proper treatment of marginal costs, which are "attributable" as volume-variable costs, and infra-marginal costs, which may be "attributable" as incremental costs, is conceptually correct by Dr. Haldi's own account.

- iv. There is no question regarding the conditions under which non-volume-variable setup and take-down costs may be "attributed" to classes and subclasses as incremental cost.

Responding to Dr. Bozzo's observation that class-specific setup costs are not incremental costs of the component subclasses, Valpak states that Dr. Bozzo "rejects

any attribution of those costs on grounds that they are **invariant with respect to the volume of mail in each subclass** being processed simultaneously on the sort scheme." Valpak Initial Brief at II-11 to II-12, emphasis in original. In incremental costing, the "grounds" that the costs are invariant with respect to the provision of the "volume of mail in each subclass" is precisely what establishes that the costs are not "attributable" as incremental costs. Dr. Haldi agrees that non-volume-variable costs are not incremental to mail categories to which they are invariant:

[USPS/VP-T2-22] Consider a mail processing operation where the schemes are not normally specific to a single class or subclass of mail, e.g., letter DPS operations. Assume the operation has some non-variable cost. Please confirm that:

a. There is no individual mail class or subclass whose elimination will lead to the elimination of such an operation.

b. The **non-variable cost of the operation is not causally "attributable" to any individual class or subclass of mail as either volume-variable or incremental cost.**

If you do not confirm either statement, please explain fully.

Response:

a.-b. Confirmed: see my testimony starting at page 53, line 16 to page 54, line 4.

Tr. 23/8620, emphasis added.

When the scheme is specific to a particular class, the setup and take-down costs may be attributable to the class as incremental costs, but not to the constituent subclasses. Tr. 10/2677-2678. Dr. Haldi, again, agrees that class-specific schemes would not be eliminated by removal of an individual subclass or rate category within the class:

Where class-specific processing exists (e.g., for letters, in sort schemes prior to DPSing), it is my understanding that separate processing is a result of the different service standards applicable to First-Class and Standard mail. It also is my understanding that those service standards

apply uniformly to all rate categories within each class of mail. **In general, therefore, eliminating a single rate category from a class of mail would not be expected to eliminate class-specific processing for the remaining rate categories.**

Tr. 23/8622, emphasis added. It follows immediately that if the class-specific processing is not avoided, its costs are invariant with respect to the subclass or rate category volumes. In the absence of schemes specific to subclasses and other rate categories within classes – which Dr. Haldi does not posit to exist – there is no basis for "attribution" of the non-volume-variable setup costs to subclasses and other rate categories by any account.

- b. Valpak's "economies of scale" argument shifts dramatically from Dr. Haldi's testimony, but gains no traction.
 - i. Valpak largely ignores Dr. Bozzo's demonstration of serious conceptual errors in Dr. Haldi's presentation on the "economies of scale" subject.

Valpak contends that Dr. Bozzo's testimony is "deficient... in that it fails to address economies of scale." Valpak Initial Brief at II-2. Dr. Bozzo shows, with reference to the economic production literature, that Dr. Haldi misstates the connections between the labor demand elasticities and economies of "scale" and "size," such that Dr. Haldi fundamentally misstates the connections between the measures. Technical conditions that Dr. Haldi cites as supporting his contention that the labor demand elasticities tell little about "scale" economies are conditions in which the measures correspond *exactly*. Moreover, the conditions are commonly employed in applied production analysis. USPS-RT-5 at 2-3.

The other leg of Dr. Haldi's "economies of scale" critique is the contention that the Dr. Bozzo's models failed to include variables for plant size. See, e.g., Tr. 23/8604.

Dr. Haldi's claim simply underscores his basic lack of familiarity with the Postal Service models. In fact, Valpak directly asked Dr. Bozzo whether his models included facility size variables, and Dr. Bozzo responded affirmatively, mentioning capital and delivery points variables as specific examples. Tr. 10/2658. Under questioning regarding his assertion, Dr. Haldi agreed that the variables cited by Dr. Bozzo were facility size measures. Tr. 23/8629-8630. As Dr. Bozzo notes, the intervenor models also include facility size variables, so the absence of facility size measures is not a valid basis for criticism of any of the competing econometric models. USPS-RT-5 at 5.

- ii. Valpak's arguments regarding the interconnection of operations fail, and Dr. Haldi accepts the standard economics result that efficient reconfiguration of Postal Service operations should result in *lower* mail processing costs in the "longer run."

Given the failure of Dr. Haldi's technical critiques of Dr. Bozzo's models, Valpak emphasizes the purported failure of the Postal Service models to properly represent the interconnection of operations. As detailed in section 1(a), above, the critique is operationally empty. Moreover, as described in section 1(b)(v), above, Dr. Bozzo conducted analysis that demonstrates that the interconnections actually are sufficiently weak as to be negligible. See also Postal Service Initial Brief at 92-93.

Valpak's discussion begs the question of why the Postal Service's full response to a volume change should lead to **higher** measured costs. The fundamental economic result relating long-run and short-run costs is that when the firm is free to adjust all of its productive inputs (*i.e.*, in the long run), its costs will go down: what it is capable of doing given its short-run constraints can be no better than what it can do free of such

constraints. And Dr. Haldi confirms the implication that the long-run average cost therefore does not exceed the short-run cost. Tr. 23/8590, 8607.

- iii. Valpak continues to misapprehend the relevance of "economies of density."

Valpak erroneously suggests that Dr. Bozzo "fails to explain how an economic concept developed to reflect the economics of an airline system applies to the volume variability of mail processing costs." Valpak Initial Brief at II-5. Valpak inappropriately focuses on the specific application of the concept to a transportation industry while ignoring its general applicability for characterizing the costs of network industries by and large. Dr. Bozzo clearly explains the relevance of economies of density to postal cost measurement:

In analysis of network industries, economies of "density" distinguish the cost effects of increasing outputs from those of increasing both outputs and the network served by the firm. The concept is germane to analysis of Postal Service costs because it must serve delivery points that are growing steadily with population, while mail volumes have been relatively flat.

USPS-RT-5 at 4, lines 2-7. There is no question, from witness McCrery's operational testimony, that there are network-related costs in mail processing. Avoiding confounding effects from the network-related costs on the measurement of costs for the volumes processed in the Postal Service network is important for accurate measurement of the marginal and incremental costs of mail classes and subclasses. Valpak's critique on this front accordingly has no merit.

- c. Valpak's discussion of Cost Segment 8 is irrelevant to the substantive issues regarding mail processing cost methodology.

Valpak seeks to draw a distinction between what it terms an "absolutist" approach to cost attribution expressed by Dr. Bozzo in relation to mail processing in Cost Segment 3 and what it alleges to be "arbitrary" methods applied in Cost Segment 8 (vehicle service drivers). After describing purported shortcomings in the Cost Segment 8 distribution key, Valpak states that the Postal Service "should not be allowed to have it both ways" by maintaining supposedly different costing standards for the two cost components. Valpak Initial Brief at II-12 to II-14. As discussed above, what Valpak considers Dr. Bozzo's "absolutism" simply reflects correct application of the economic concepts of marginal and incremental cost. Additionally, Valpak's arguments with respect to Cost Segment 8 fail because they inappropriately analytically separate steps of the costing process, and further because they are based on significant mischaracterizations of the basis for Cost Segment 8 volume-variable costs.

- i. Valpak's argument confuses the analytically separate "attribution" and "distribution" steps of the costing process.

The development of volume-variable costs normally involves two steps, what is sometimes called an "attribution" step (or, more precisely, a "volume-variability" step) in which pools of volume-variable costs are determined, and a "distribution" step in which the volume-variable costs are assigned to subclasses. See, e.g., USPS-LR-L-1, App. H at H-4.

It is important to specify the cost concept being employed in the "attribution." For example, Valpak references "Dr. Bozzo's stated criteria that, in order for costs to be attributed, they must change continuously with and reflect each marginal change in the volume of mail in each subclass." Valpak Initial Brief at II-13 to II-14

Valpak's criticisms of the adequacy of the Cost Segment 8 volume-variable cost distribution key methodology are with respect to the "distribution" step, while questions of the "attributability" of setup and take-down costs are properly with respect to the first step – i.e., whether the costs are volume-variable in the first place. The additional matter of whether non-volume-variable costs may be "attributable" to products as incremental costs likewise is conceptually distinct from the distribution of volume-variable costs.

- ii. Valpak fails to properly recognize the basis for cost attribution in Cost Segment 8.

In characterizing Cost Segment 8 costing methods as "arbitrary," despite recommending a variability level for Cost Segment 3 that is assumed rather than measured – Valpak neglects to mention that Cost Segment 8 volume-variable costs are based on a causal model empirically assessed through an econometric special study. The basis for Cost Segment 8 volume-variable costs clearly distinguishes the roles of network- and volume-related factors for vehicle service driver costs:

The requirements for VSD labor will primarily be driven by two factors: 1) the network of postal facilities, collection points, and delivery points; and 2) the cubic volume of mail distributed [sic] over the network. The volume variability for Cost Segment 8 is based on the methodology developed in R97-1 and is 60.44% (USPS-T-20, Exhibit 2 Revised, page 22).

USPS-LR-L-1 at 8-2. The Cost Segment 8 description subsequently describes the special study from Docket No. R97-1 at some length.

The Cost Segment 8 analysis shows that vehicle service driver costs change on the margin with the cubic volume of mail (with a non-unit elasticity), establishing the costs being distributed as volume-variable costs. Clearly, changes in the cubic volume of mail for a subclass will, other things equal, affect the vehicle service driver labor requirement on the margin as well, so the Cost Segment 8 variability and distribution key are not disconnected to the extent indicated by Valpak.

To whatever extent Valpak may have identified room for improvement in the Cost Segment 8 distribution key, the basic issue is not that the Postal Service is inconsistently applying causal methods across cost segments. The volume-variable portion of Cost Segment 8 is specifically that portion which has been shown empirically to vary on the margin with volumes via the cubic feet of mail transported by vehicle service drivers. The setup and takedown costs, in contrast, do not vary with volumes on the margin and thus are not "attributable" as volume-variable costs. Thus, there is no inconsistency in the Postal Service methods.

- d. Concerns related to worksharing pricing policy are beyond the scope of the testimonies of cost witnesses such as Dr. Bozzo.

Finally, Valpak notes that Dr. Bozzo had not addressed Commission concerns regarding the impact his methodology might have on worksharing discounts. Valpak Initial Brief at II-16. To the extent such concerns may exist, they would be addressed by an appropriate pricing witness, not by a costing witness such as Dr. Bozzo. Pricing issues clearly are beyond the stated scopes of Dr. Bozzo's testimonies.

B. The Postal Service's Updated Study for Window Service Costs Should Be Adopted

The only party addressing on brief the Postal Service's updated Window Service cost study was the OCA. OCA Brief at 66-91. The OCA, however, presents no valid basis to criticize the Postal Service study, much less to prefer Dr. Smith's (relatively similar) variability estimates to those of Prof. Bradley.

1. The OCA's criticisms of the 2005 transaction study have no merit.

The majority of the OCA's criticisms of the 2005 transaction have already been rebutted in the rebuttal testimonies of Kelley (USPS-RT-6) and Bradley (USPS-RT-4), as summarized in Postal Service's initial brief. However, the OCA's claim that Postal Service witness Bradley stated that the 1997 transaction time study was based on flawed methodology is both new and interesting. OCA Initial Brief at 71. It is interesting because Dr. Bradley never made such a claim. Dr. Bradley stated that "a review of the established methodology for calculating variabilities revealed that the *computational formula* used was not correct." USPS-T-17 at 1 (emphasis added). Dr. Bradley never stated that the 1997 transaction study was based on flawed methodology.

As for the OCA's criticisms of the number of "dropped" observations (*id.* at 75), the reality is that none of the observations were "dropped." There were simply some instances where it was not possible to get a match between POS volumes and the recorded times. However, the probability of this occurring was accounted for, and the sizes of the samples were adjusted accordingly. The OCA asserts that witness Nieto

“did not refer to the statistical literature to determine whether a significant amount of data had been dropped.” *Id.* at 76. However, the OCA itself does not cite to any statistical literature which would support the claim that too much data was “dropped.”

2. The OCA’s criticisms of the window service econometric model are weak and/or were already thoroughly rebutted.

The OCA’s brief makes four comments regarding Dr. Bradley’s window service econometric model. OCA Brief at 84-89. The first (*id.* at 84), “Witness Bradley’s model in the current estimation procedure is linear, but he has used a quadratic approach in other testimony,” is essentially saying that the fact that witness Bradley has used other functional forms in other analyses invalidates the use of a linear functional form for window service transactions. This is patently ridiculous. The fact that other functional forms have been used in other analyses does not invalidate the use of a linear functional form in *this* analysis. A functional form should be chosen on an analysis-by-analysis basis, and there have been a variety of reasons presented by Dr. Bradley for why a linear functional form is appropriate here. Furthermore, the OCA cites no evidence that another functional form is appropriate here (and OCA witness Smith did not present any); the OCA just speculates (as it admits at page 90) that a different functional form could be used.

The second, third, and fourth assertion, that the Postal Service’s model is sensitive to changes in the data and not robust, that walk time should be included in the model, and that the Commission should adopt witness Smith’s variabilities, as discussed on pages 86-89 of the OCA Brief, have already been thoroughly rebutted in witness Bradley’s rebuttal testimony. The new Window Service study represents a significant update of the previous study, and the Commission should accept both the

study; and the resulting variabilities estimated by Prof. Bradley. There is no theoretical or empirical basis to adopt the alternative variabilities presented by Dr. Smith, even though they are not materially different from those of the Postal Service. The repetition of these arguments by the OCA in their brief provides them with no additional force and they are without merit.

C. The Commission Should Rely on the Postal Service's Carrier Cost Estimates

Two parties presented testimony during hearings questioning the city carrier cost methodologies relied upon by the Postal Service. Those parties are the OCA and Valpak. Arguments raised in their briefs by those two parties are addressed next. Their arguments by no means support deviation in this case from the Postal Service's carrier cost methodologies and results.

1. The OCA presents no cogent reasons to depart in this case from the city carrier variabilities employed in the last case.

The Postal Service initial brief (at 119-124), explains why there are no acceptable alternatives on the record in this case to the city carrier variabilities proposed in the last case by Prof. Bradley, and relied upon by the Commission in that case. The Brief of MPA/ANM on Periodicals Rates advocates the same conclusion (at pages 13-31). Both briefs present compelling arguments, and the Commission should rely on the same variabilities it did in Docket No. R2005-1. The only party who appears to express an opposing viewpoint on brief is the OCA.

In its brief at pages 42-65, the OCA presents lengthy discussion of city carrier costing issues. The ultimate conclusion reached by the OCA (Brief at 64) appears to be

primarily that more work is needed, but in the interim, the Commission is urged to rely on a model first presented by OCA witness Smith in response to POIR No. 25 on November 27, 2006. That date occurred nearly three months after submission of Dr. Smith's direct testimony on September 6, and likewise after the submission of rebuttal testimonies responding to his direct testimony on November 20. On December 22, however, the day after the OCA filed its initial brief, the Commission issued Order No. 1 (of the newly re-constituted Postal Regulatory Commission). In that Order, in view of the late timing of the first appearance of the responses, the Commission essentially upheld the objection of a coalition of parties that had challenged the Presiding Officer's intent to include Dr. Smith's POIR No. 25 responses in the evidentiary record. Instead, the Commission ruled that the POIR No. 25 responses would be included in the record only for illustrative purposes, and "shall not serve as substantial evidence supporting any specific estimate of attributable carrier costs in this docket." Order No. 1 at 3-4 (Dec. 22, 2006).

In one sense, therefore, any compelling need to reply to the OCA's advocacy of the model (revised CC3) from POIR No. 25 is eliminated.⁹ The Commission Order precludes reliance on that model regardless of what is said by any party on brief. On the other hand, it may be useful to discuss briefly why the value of that model is negligible, even for illustrative purposes, as well as to highlight the other flaws in the OCA's brief on carrier costing issues.

⁹ This leaves the OCA with no useful variabilities to recommend to the Commission. In his rebuttal testimony, Prof. Bradley convincingly demonstrated that Dr. Smith's proposed variabilities contained fatal flaws and, as a result, could not be relied upon by the Commission. Nothing in the OCA brief rehabilitates these variabilities, as it instead relies upon the POIR No. 25 results. It is thus too late for the OCA to "take it back" and attempt to rely upon Dr. Smith's earlier flawed work.

Dr. Smith's new version of "CC3," like the earlier versions, completely omits any measure of density, and therefore suffers from a potentially serious defect. As pointed out in Prof. Bradley's rebuttal testimony, inclusion of this variable is not only theoretically correct, but also widely done by previous researchers in this area. USPS-RT-4 at 1-9. Omission of the density variable is a potentially serious mis-specification of the equation. *Id.* at 17-18. Because it is likely to be correlated with volume, omitting density is likely to bias the volume coefficients downward, as manifested in Dr. Smith's results when density is omitted. *Id.* Prof. Bradley's conclusions regarding density are shared by witness Crowder in her MPA et al.-RT-1 testimony at pages 8-10.¹⁰

The OCA Brief attempts to resurrect Dr. Smith's arguments about the lack of a conceptual economic structure to the models estimated by Prof. Bradley. OCA Brief at 44-49. Prof. Bradley already explained why the alleged deficiencies are not manifestations of shortcomings in his approach, but of shortcomings in either Dr. Smith's understanding of Prof. Bradley's models, or of the current state of micro-economic theory. USPS-RT-4 at 10-13. The OCA apparently wants to revisit these matters to bolster its argument that the density variable does not belong in the equation. But the linchpin of all of its new arguments seem to be the assertion that density has already been "subsumed" in something else, either "subsumed in the production process" (OCA Brief at 46), or "subsumed in reaching a solution" (*id.* at 48), or "subsumed in some type of maximization or adjustment process for efficient City Carrier

¹⁰ At page 51, the OCA repeats Dr. Smith's erroneous claim that Dr. Bradley did not compute the density variable correctly. That claim was addressed and dismissed in Prof. Bradley's rebuttal testimony, which also shows that it was Dr. Smith who defined the density variable incorrectly (in those models, which Dr. Smith now repudiates, in which he included a density measure). USPS-RT-4 at 15-17.

delivery” (*id.*). In none of these instances, however, is any authority or record evidence cited to support the “subsumed” allegation.¹¹ Prof. Bradley has already shown the fallacy of this line of attack in his rebuttal testimony. USPS-RT-4 at 5-13. Previous researchers (including Prof. Bradley) have properly included the density variable for valid theoretical and operational reasons, and Dr. Smith’s models which omit density are unusable. *Id.* at 17. See, also, MPA et al-RT-1 at 8-10 (Crowder). Since the revised CC3 in the POIR No. 25 response does not contain a density variable (OCA Brief at 64), it likewise is unusable.

In his POIR No. 25 responses, Dr. Smith makes two theoretical points that are in error and must be clarified. First he attempts to establish that a version of a quadratic model that omits some of the cross product terms can still be a full quadratic model:

Accordingly, CC3A with “spr” cross products removed is a (limited) full quadratic with marginal costs that appear to comport with what one would expect.

Response of OCA Witness J. Edward Smith to POIR No. 25 at 12 (Nov. 27, 2005).

(The OCA essentially repeats this claim on page 56 of its Brief.) Despite Dr. Smith’s attempt to create a new type of full quadratic, the “limited” full quadratic, the model with the “spr” cross products dropped is indeed a restricted quadratic. Specifying the model in this way is a different restriction from, and eliminates fewer cross products than, the restriction proposed by Prof. Bradley in Docket No. R2005-1. But it is a restriction

¹¹ The muddled nature of the OCA’s thinking on this issue is demonstrated by the fact that it asserts that it is theoretically correct to include delivery points (OCA Brief at 44). The OCA simply misunderstands the optimization process. The theoretical basis for including density is just the same as the theoretical basis for including delivery points. Both are constraints on the Postal Service’s cost minimization.

nonetheless and the revised CC3 model submitted in his POIR response is not a full quadratic.¹²

Second, Dr. Smith's POIR response attempts to cover his omission of analysis of large parcels and accountables by arguing that estimation of their variabilities is "irrelevant." (His arguments on this point, including his erroneous conclusion that the cost parcels and accountables are 100 percent attributable, are summarized in the OCA Brief at 56-57.) Dr. Smith makes this sweeping statement based upon his assertion that:

Clearly, all the time for delivery of large parcels and accountables should be attributable; this has been demonstrated by the Postal Service's ability to specifically and separately time and measure the activity. If accountables and large parcels were not delivered, then there would be not time measured; the Postal Service knows from the database exactly how much time is spent in delivering large parcels and accountables.

¹² The OCA Brief at 42-43, 52-54, appears to argue that a full quadratic model is most appropriate, but that multicollinearity renders results from a full quadratic unreliable, and therefore the OCA jumps to the conclusion that the CCSTS database cannot be used to produce reliable results. Prof. Bradley addressed this type of issue in his rebuttal testimony in this case. USPS-RT-4 at 13-14. The OCA Brief (on page 53) cites these pages of Prof. Bradley's rebuttal testimony (using transcript cites in the footnotes) to suggest that the problem of multicollinearity is insurmountable in the CCSTS database. But Prof. Bradley does not say that in his rebuttal testimony, and, in fact, in his original testimony in the last case, Prof. Bradley explained that multicollinearity can be addressed by using a restricted quadratic, which in this instance produced sufficiently reliable variabilities for Prof. Bradley to recommend them. Docket No. R2005-1, USPS-T-14 at 34-40. The OCA Brief is grossly distorting the record if it is attempting to suggest that Prof. Bradley's rebuttal testimony in this case can be construed to suggest that the CCSTS variabilities are necessarily critically "flawed" due to multicollinearity. Instead, his rebuttal testimony is that simply picking and choosing among full quadratic models on the basis of which ones produce negative variabilities is not an appropriate way to identify whether multicollinearity has been sufficiently ameliorated. In other words, multicollinearity is still a problem in a full quadratic model even if no negative variabilities are produced. That testimony is in no way inconsistent with his R2005-1 testimony recommending use of the restricted quadratic model, in which a review of the VIFs and tolerances was used to show that the degree of multicollinearity had been greatly reduced. Docket No. R2005-1, USPS-T-14 at 39.

Accordingly, the estimation procedures for Parcels (sic) and Accountables (sic) are irrelevant.

Response of OCA Witness J. Edward Smith to POIR No. 25 at 13.

But this assertion is wrong in both theory and in fact. First, despite Dr. Smith's implicit endorsement of the accuracy of the CCSTS database, the Postal Service does not know exactly how much time is spent delivering large parcels and accountables. Dr. Smith is apparently unaware that sometimes large parcels and accountables are delivered together, and in those instances, all that the Postal Service knows (or could know) is the time associated with delivering the combination of large parcels and accountables. The fact that the two shapes are delivered together means that individual variabilities must be estimated, just like separate variabilities are estimated for letters and flats.

Moreover, even if the Postal Service could separately identify the time associated with, say, accountables, a variability would still need to be estimated. First, the delivery of accountables could be (and is) characterized by economies of scale. Finding the volume variable cost for a product requires estimating how its cost varies with volume even in activities that handle only that product. Second, "accountables" is not a product. Rather is it a group of products, all of which require customer contact. Thus, to measure the volume variable cost of the products in the accountables group, an estimated variability and distribution key are both required. Just because the Postal Service could identify the block of time associated with this group of products does not obviate the need to measure the variability of that time. Suggestions to the contrary in the OCA Brief at 56-57 are totally unfounded, and contrary to decades of causality analysis in postal rate proceedings by all participants, including the Commission.

Therefore, even had the Commission's Order not precluded reliance on Dr. Smith's model from POIR No. 25, that model is far too flawed to be relied upon as a useable source of city carrier variabilities. Like all of the other models produced by Dr. Smith, it is demonstrably inferior to the model recommended by Prof. Bradley and relied upon by the Commission in Docket No. R2005-1.

Some comment is warranted on certain other arguments made in the OCA Brief. For example, the OCA claims that changes in technology have called the CCSTS variabilities into question (although the OCA sensibly recognizes that they still beat the variabilities from the previous methodology by several decades). OCA Brief at 61-62. As Prof. Bradley noted as early as his testimony in the last case, the DPS technology is now more universal.¹³ Yet it is not entirely clear that the "three bundle" approach is necessarily the way to go. As the OCA says, it will need to be seriously considered, but it would still be premature to state that the CCSTS approach is necessarily obsolete. Moreover, even if the three bundle approach were appropriate going forward, that still would not justify its application to a 2002 database collected under different circumstances. USPS-RT-4 at 18-19. Finally, as unequivocally demonstrated in Prof. Bradley's rebuttal testimony, the claims made by Dr. Smith regarding collection

¹³ The sequence of events claimed by the OCA on page 43 is somewhat confusing. The OCA claims that Dr. Smith demonstrated the feasibility of the "three bundle" approach, and that only "subsequently" did Prof. Bradley acknowledge the relevance of using DPS and cased mail in city carrier costs models. Yet the paper (of which Prof. Bradley is a co-author) cited by the OCA on page 43 in support of these claims was, in fact, presented months before Dr. Smith's testimony was submitted. Moreover, such a model was presented and discussed by Prof. Bradley in his testimony in Docket No. R2005-1 (USPS-T-14 at 47-48), and that discussion was actually cited by Dr. Smith in his testimony in this case (OCA-T-3 at 12). If Dr. Smith was able to cite to it in his testimony, that would seem to be a reliable indication that Prof. Bradley's work in this area came before Dr. Smith's work, not "subsequently."

practices (on delivery routes) are simply wrong. USPS-RT-4 at 26-27. The OCA's Brief at 62 does nothing to rehabilitate Dr. Smith's brazenly false statements that the collection variabilities from the CCSTS study are "now irrelevant."

With respect to Dr. Smith's analysis of DOIS data, the claim in the OCA Brief (at page 43) that preliminary results show "great promise" is unwarranted. The Postal Service's initial Brief at pages 122-123 amply summarizes the problems identified both by Prof. Bradley and witness Crowder with the DOIS research. The discussion in the OCA's Brief at pages 57-60 and 63-64 does not offer satisfactory response to the shortcomings those witnesses identified. Based on the concluding comments on pages 64-65, however, it does not appear that the OCA is any longer proposing reliance in this case on specific results of the preliminary work on DOIS by Dr. Smith.

In conclusion, the state of the record in this case points unambiguously towards continued reliance on the city carrier variabilities employed in the last case. The only party sponsoring a witness presenting alternative variabilities in this case is the OCA, and the results from that witness advocated by the OCA in its initial brief are, as a practical matter, no longer on the record. While it seems reasonable to expect under these circumstances that the OCA may propose to fall back to some of Dr. Smith's other results, in reality, none of his results are suitable candidates to replace the established variabilities.

2. Valpak's carrier cost arguments contain the same flaws as in the last case.

At pages III-3 – III-11 of its initial brief, Valpak raises the same types of concerns about capacity constraints and Saturation flats and letters carrier costs as it did in the

last case. As Valpak acknowledges (pg. III-5), the Commission rejected its proposal in the last case. The Commission should do the same in this case as well.

One immediate problem with the Valpak proposal is that it lacks any concrete substance. The bottom line proposal, to the extent that there even is any bottom line, consists of:

Accordingly, the Commission should take special note in this docket to guard against any undue elevation in the rates for saturation letters based on over-stated saturation letter costs and under-stated saturation flat costs.

Valpak Brief at III-10. That rhetoric is quite tame with some that appears earlier in the Valpak Brief:

If rates are predicated on flawed costs, mailers will be charged rates that are unfair, and be given wrong pricing signals. If pricing signals are sufficiently incorrect, and mailers respond rationally to those pricing signals, they could wind up converting letter mailings to flats in order to enjoy the lower in-office handling costs, while increasing total postal costs.

Id. at III-4. The inherent exaggeration in those statements may not be self-evident, but it is quickly revealed when one examines the actual ECR Saturation letter and flat unit delivery costs estimated by Postal Service witness Kelley. Mr. Kelley estimates unit delivery flat costs that are 63 percent higher than the corresponding costs for letters, amounting to an absolute difference of 2 cents. USPS-T-30 at 4 (Table 1). The notion that such relative unit costs would drive *letter* mailers to convert to *flats* is, to say the least, not credible.

Basically, the Postal Service's initial brief already explained why the testimony of Dr. Haldi on this topic is not meritorious. See Postal Service Initial Brief at 124-128. The same response applies to the Valpak Brief. In particular, Valpak's assertion that "**new and different record information**" (Brief at III-5, emphasis in original)

distinguishes this case from the last does not withstand scrutiny. For example, Valpak wishes to focus on alleged differences in the testimony of the Postal Service's operation witnesses in the two cases, identifying them as a "major change." Valpak Brief at III-6 – 7. But the reality is, in both cases, the delivery operations witness expressed the view that the capacity conflicts that Valpak is hypothesizing simply are not frequent enough to justify concern. In this case, witness Coombs described them as "highly unlikely," "not common," and "rare." Tr. 13/3710, 3717, 3718, 3721. In conjunction with the existence of the practice of running Saturation letters through DPS processing whenever possible, which SMC witness Crowder testifies (SMC-RT-1 at 38-39) is not caused by the presence or absence of saturation flats, these circumstances establish that Valpak is overstating the appropriate level of concern. The balance of her rebuttal testimony on the topic (*id.* at 33-40) amply buttresses this conclusion as do witness Kelley's estimates showing that in-office direct labor unit costs for Saturation flats are 41 percent higher than corresponding Saturation letters costs. USPS-LR-K-67, sheet 2.Summary TY.

One line of comment in the Valpak brief that does merit response relates to the variabilities from the CCSTS analysis. When comparing relative costs by category, Valpak continues to wish to look only at operational handlings of individual mail pieces of different types in isolation, in order to draw fanciful conclusions such as "[e]ven a rudimentary understanding of carrier operations would seem to suggest that something is seriously awry." Valpak Brief at III-9, n. 11. In fact, however, when Valpak actually asked Prof. Bradley a line of questions paralleling the rhetorical question posed in that footnote in its brief, he explained exactly why Valpak's "understanding" of the

appropriate range of factors affecting marginal costs estimates is deficient. Tr. 13/3850-52. As Prof. Bradley stated, mail delivery characteristics as well as operational characteristics come into play. *Id.* Similar statements were also made by witness Kelley. Tr. 12/3455-57, 3549-59. If Valpak continues to look in the wrong place, it should not be surprised that it continues not to find the right answers.

In general, therefore, Valpak's brief offers nothing to the discussion of city carrier costs. That conclusion applies equally to its discussion (at pages III-10 – 11) of the "fairness" testimony of witness Mitchell (VP-T-3) as it does to the discussion of the testimony of Dr. Haldi, since the concerns Mr. Mitchell raises are only as valid (or in this instance, invalid) as the analysis offered by Dr. Haldi. See Postal Service Initial Brief at 125-26.

D. With Respect to Purchased Transportation Air Cost, The Commission Should Adopt the Postal Service's Costing For The Fed-Ex Day-Turn

UPS argues, at pp. 10-12 of its brief, that the Commission should attribute all of the non-fuel transit charges of the FedEx Day-turn network, not just those which the Postal Service determines to be volume variable, citing Docket No. R2005-1, PRC Op. at ¶ 4094.

As the Postal Service explained in its Initial Brief at 128-133, Professor Bradley explained the proper cost attribution for the situation that arises on the day-turn, where the air transportation network was created essentially for the transportation of a group of products (First-Class Mail and Priority Mail) -- the volume variable costs for all products are computed in the traditional way, and the non-volume variable cost for that network are included in the incremental cost for that group of products. USPS-T-14 at 7.

Witness Kelley applied this policy so that the non-volume variable costs are included in the incremental costs of the group of products that caused the FedEx Day Turn network to arise -- First Class Mail and Priority Mail. USPS-T-15 at 4.

The costs which the Postal Service treats as non-volume variable are not marginal to either Priority Mail or First-Class Mail. Because they are not marginal in relation to any class of mail, the Postal Service respectfully submits that its treatment of them as incremental to the group of products comprised of First-Class Mail and Priority is appropriate and should be adopted by the Commission.

E. MPA-ANM's Arguments Regarding the Potential Effects of the New Legislation on the Attribution Treatment of Certain Costs Are Premature

The Brief of MPA-ANM on Periodical Rates, pages 31-33, appears to suggest that the level of attribution should decline because, at least in the view of MPA-ANM, some of the test year costs that the Postal Service would no longer have to pay under PAEA are currently treated as volume variable, while none of the new payments would be volume variable. In particular, MPA-ANM conclude, based on a three-paragraph analysis (pages 32-33), that the payment into the Postal Service Retiree Health Benefits Fund under PAEA "is as fixed and institutional as costs get."¹⁴

¹⁴ The brief of MPA-ANM, however, fails to correctly report the cost impacts of the legislation. It states at page 32, "The fixed payment is specified at \$5.4 billion in the Test Year of this rate case." Actually, the law says that the payment due on or before Sept. 30, 2008 is \$5.6 billion. (The \$5.4 billion is due in FY 2007.) Regarding the elimination of CSRS payments, the brief says: "the CSRS payments – roughly \$1.7 billion in the Test Year (USPS-T-6 at 21) – have been treated as attributable to the same extent that all labor costs are attributable." In fact, while under the new legislation the Postal Service is relieved of making both Continuing CSRS Contribution (\$1.36 billion in TY) and the Supplemental Liability Expense (\$290 million in TY) as shown in USPS-T-6 at page 21, the latter is treated as institutional and the former is attributable

The first point to be made in response is that, since the revenue requirement litigated in this case is based on the provisions of the previous law, it would not be appropriate to change the treatment of certain cost elements based on the new law unless the level of those costs elements were adjusted to conform to the new law as well. In some sense, MPA-ANM are arguing about the treatment of costs that currently are not even included in the revenue requirement. Moreover, and perhaps more importantly, the Postal Service's understanding of the new law is that it is not intended to interfere with the litigation of present or future proceedings being conducted under the provision and rules associated with the previous (i.e. pre-December 20, 2006) statutory regime. Therefore, it would be neither practical, nor consistent with the transition provisions of the new law, to attempt to revisit the type of issues that MPA-ANM seem to wish to contemplate reconsidering.

Second, even putting aside the lack of relevance of the provisions of the new law cited by MPA-ANM for this rate case, it is obvious that there is no record basis to consider these arguments. Such attribution issues are much more complex than MPA-ANM appear to suggest. MPA-ANM fail to consider the past practices of the Commission, or any expert analysis, in reaching their position. The Commission has a tradition of taking into account substantial complexities in the attribution of retirement related costs.

In Docket No. R76-1, Appendix J, pages 203-210, the Commission took up the question of the attribution of the amortization of the Civil Service Retirement System

to the same extent that all labor costs are attributable. So \$1.36 billion (rather than \$1.7 billion) of the costs the Postal Service will not owe in the test year is treated as attributable to the same extent that all labor costs are attributable.

(CSRS) deferred retirement costs associated with salary increases and annuitant COLAs. In Docket No. R76-1, the Postal Service argued that payments for prior years' deferred retirement costs should be considered institutional. This is the bulk of the deferred retirement payments in any given year. The Postal Service argued that liabilities incurred in prior years are not volume variable in the current year. The Commission disagreed, contrasting the difference in the way Workers' Compensation costs are accrued versus the retirement liabilities or deferred retirement costs. For Workers' Compensation the accrued costs include the full "present value of future payments." A similar treatment of retirement liabilities would require the accrual of the whole liability in the year it was incurred, rather than amortization. Thus, the Commission concluded that the Postal Service's proposed treatment would lead to an understatement of attributable costs.¹⁵ Therefore, the Commission treated CSRS payments of deferred retirement costs as volume variable as other labor costs.

In Docket No. R77-1, the issue was again debated and the Commission said:

The best available approximation of the costs that are causally related to the classes and services, therefore, must include a share of the prior year payment in order to reach the costs that have not yet been causally apportioned – but without giving undue weight to obligations that exceed the revenue requirement.¹⁶

The Postal Service has followed this approach since that Commission recommended decision. This approach would likely have implications for determining the impact of both the reduced payments for CSRS and the new payments for Retiree Health Benefits

¹⁵ PRC Opinion and Recommended Decision, Docket No. R76-1, Appendix J, pages 203-210.

¹⁶ PRC Opinion and Recommended Decision, Docket No. R77-1, Appendix J, page 219.

Fund on cost attribution. Similarly the Commission's treatment of imputed rents in the determination of the volume variable rents and depreciation is also relevant.¹⁷

The MPA-ANM Brief at 32 quotes a portion of the Commission's Opinion in the last case. In the paragraph immediately following the one quoted, the Commission stated:

The Commission agrees with the Postal Service that, in the instant proceeding, the escrow should be considered an institutional expense. However, in the event that Congress specifies a use for the funds, attribution of this expense will need to be reevaluated.

PRC Opinion and Recommended Decision, Docket No. R2005-1, page 53. The Postal Service agrees with the sentiment that the attribution will need to be revisited, but clearly the post-hearing and post-record portion of this docket is not the appropriate time to do so.

¹⁷ PRC Opinion and Recommended Decision, Docket No. R76-1, Appendix J, pages 177-187. In this case, witness Smith, USPS-T-13 at pages 18-19 discusses the use of imputed rents, rather than accrued costs, to determine the volume variable space provision costs.

V. THE PARTIES THAT CHALLENGE THE POSTAL SERVICE OFFER INSUFFICIENT GROUNDS FOR THE COMMISSION TO ADOPT RATE LEVELS OTHER THAN THOSE PROPOSED BY USPS WITNESS O'HARA

In section V of its Initial Brief, the Postal Service explained why the rate level proposals of witness O'Hara (USPS-T-31) should be recommended by the Commission to the Governors for approval and why various intervenor proposals should be rejected. The Initial Briefs filed by various parties take issue with the Postal Service's proposed rate levels and with the proposals of other intervenors. The soundness and validity of witness O'Hara's institutional cost allocations were amply addressed in the Postal Service's Initial Brief. Below, in this section of its Reply Brief, the Postal Service refutes some of arguments raised by parties who challenge witness O'Hara's application of the statutory pricing criteria in § 3622(b) to allocate institutional costs among the various subclasses. It is not the purpose of this Reply Brief to respond to each and every intervenor, as many of the arguments that the Postal Service could make have been ably presented by others for the Commission's consideration. Omission in this Reply Brief of discussion of any issues addressed in the Initial Briefs of other parties should not be construed as any indication that the Postal Service necessarily agrees with the views and positions expressed by those parties.

A. Full Consideration Is Provided Even When Full Litigation Is Not Pursued

In each omnibus rate docket, the opinion and recommended decision of the Postal Rate Commission reflects its considered judgment of how the relevant criteria of the Postal Reorganization Act should be applied in response to a Postal Service request, based on the evidence presented by the parties. The Commission's obligation to give full consideration to these statutory criteria does not intensify or diminish based

on the degree of “fullness” with which parties consider that they may have individually or collectively pursued the opportunity afforded by the Commission’s rules to litigate every aspect of the Postal Service’s request. In every case, the litigation is as “full” as the diverse parties, with their numerous competing objectives and agendas, choose to make it. However, all rates recommended by the Postal Rate Commission are required to meet the same statutory standards, irrespective of the number of documents filed by the parties during the opportunity for examination of the Postal Service’s request afforded under the Commission’s rules.

Accordingly, the Commission should bristle at the implicit suggestion in a number of parties initial briefs (for example, AAP Initial Brief at 1; Amazon.com Initial Brief at 6; GCA Initial Brief at 1; NAA Initial Brief at 1; PSA Initial Brief at 6; UPS Initial Brief at 9; Valpak Initial Brief at I-15) that its Docket No. R2001-1 and R2005-1 recommendations were not independent, or were somehow deficient or sub-standard, simply because large numbers of these same parties found themselves in sufficient agreement with the Postal Service’s requests so as to limit their opposition to those requests.

For example, at page 6 of its Initial Brief, Amazon.com observes that, in Docket No. R2000-1, the Commission recommended a Bound Printed Matter cost coverage between the cost coverages recommended for Media and Library Mail, on the one hand, and Parcel Post, on the other. Amazon.com’s assertion that this cost coverage ranking established a baseline for Docket No. R2006-1 is premised on the notion that there is a correlation between intervenor litigation activity and the validity of the recommendations of the Commission. The intensity of intervenor litigation activity has no bearing on the Commission’s responsibility to assure itself that there is an adequate

record basis to support the application of the statutory pricing criteria to recommend rates that, if approved, are consistent with the Act and can, therefore, withstand judicial scrutiny. Therefore, the rates and cost coverages recommended by the Commission in Docket Nos. R2001-1 and R2005-1 are no less valid than those recommended in Docket Nos. R97-1 and R2000-1. In any event, there is no indication in the Commission's Docket No. R2000-1 opinion that its policy from that point forward is to bias its application of the statutory pricing criteria to "nestle" the cost coverage for Bound Printed Matter between the coverages for Library/Media Mail and Parcel Post. See PRC Op. R2000-1 at 207, ¶¶4034-35.

B. The Current Docket Must Be Decided On Its Own Merits

The recent enactment of the Postal Accountability and Enhancement Act, Public Law 109-435, has sparked several parties to make alternative suggestions regarding the resolution of the cost coverage issues in the current docket, all of which should be rejected.

For instance, at page 19 of their Initial Brief, the Saturation Mailers Coalition and ADVO jointly suggest that the Commission use the *possibility* of the Postal Service filing one more *traditional* rate request during the current calendar year as the basis for mitigating the Standard Mail ECR cost coverage proposed in Docket No. R2006-1 before implementation of a new price cap regime. SMC/ADVO argue that "any downward adjustment in ECR cost coverage in this case should be moderate, with the understanding that the cost coverage issue will need to be fully and finally resolved in the next (and likely final) rate case under current law." SMC/ADVO Initial Brief at 19. The Postal Service submits that any debate about whether Docket No. R2006-1 is the

last *traditional* rate case is irrelevant conjecture. The Commission's responsibility in the current docket is to analyze the record evidence and apply the pricing criteria of the Postal Reorganization Act, unaffected by whether this is its final opportunity to do so.

C. A Private Express Primer Is In Order

At pages 105-106 of its Initial Brief, the OCA waxes eloquently, but inaccurately, about the relationship between the Private Express Statutes and the First-Class Mail stream.

The purpose of the Private Express Statutes is to restrict private competition in the carriage of hard copy "letters" (as defined by 39 C.F.R. § 310.1(a)) in such a way as to result in a high utilization of the mail stream. This infusion of letters into the mail stream generates revenues that are expected to help fund the Postal Service's operation of its universal service network, which no profit-driven enterprise would otherwise establish. These "letters" -- for which the Private Express Statutes impose restrictions on private carriage and, thus, drive into the mail stream consist largely of matter that, if mailed -- would generally qualify for either First-Class Mail or Standard Mail rates. Accordingly, contrary to the assertions of the OCA, to the extent that the pricing of mail classes in accordance with § 3622(b) is influenced by whether any mail class consists of hard copy "letters" that might otherwise be delivered by some private entity but for the Private Express Statutes, that influence is not limited to the pricing of First-Class Mail, or only to those First-Class Mail rate categories utilized by household mailers. Consideration of the impact of the Private Express Statutes applies to First-Class Mail workshare rate categories and Standard Mail as well. Thus, consideration of the impact of the Private Express Statutes to temper First-Class Mail single-piece rate

increases cannot be accomplished by merely indiscriminately and unfairly shifting institutional cost burden on other “monopoly-affected” workshare First-Class Mail rate categories or Standard Mail subclasses.

D. Accurate Attribution Is Not A Goal Reserved Only For Postal Costing

Not to be outdone in its advocacy for bigger First-Class Mail workshare discounts than those proposed by the Postal Service, Pitney Bowes tarnishes Section II.A of its Initial Brief with a mischaracterization of the testimony of Postal Service rebuttal witness Maura Robinson (USPS-RT-10; Tr. 32/10706). There, witness Robinson clearly testifies that:

In evaluating any postal rate proposal, the basic (single-piece, first-ounce) First-Class Mail rate (in this docket proposed to be 42 cents) is a keystone rate which is inextricably tied to the Postal Service’s revenue requirement and policy goals.

Curiously, in quoting this sentence at the beginning of page 3 of its Initial Brief, Pitney Bowes applies the editorial equivalent of a chainsaw and gouges out all three separate references to the very specific topic of this portion of witness Robinson’s testimony: the First-Class Mail rate category for which the Postal Service proposes a 42-cent rate.

Pitney Bowes is free to argue that the principles espoused by witness Robinson in reference to the basic First-Class Mail rate have some application to other rate categories within First-Class Mail. However, it is troubling that Pitney Bowes would obscure the subject of witness Robinson’s statement to create the impression that she was discussing First-Class Mail generally or workshare mail in particular. If Pitney Bowes wishes to argue at the beginning of page 3 of its Initial Brief that “[t]he Postal Service acknowledges” anything, greater care should be taken to ensure that the

argument accurately reflects what the Postal Service's witness actually acknowledged.

E. If At First You Don't Succeed, Re-write History

As part of its recurring drumbeat for a lower Standard Mail ECR cost coverage, Valpak asserts that:

In Docket No. MC95-1, the Commission established separate Standard Regular and ECR subclasses as a pricing improvement, to bring about increases in economic efficiency.

Its recollection refreshed by a review of the Commission's Docket No. MC95-1 opinion, the Postal Service remembers things differently:

The Commission adheres to the view that a convincing record of evidence of differences of demand, as well as cost, would normally be necessary to justify separate subclass treatment. Moreover, as the Commission found in Docket No. R87-1, it cannot and should not determine subclass status based on "economic efficiency concerns only" since doing so "would not square with the structure of § 3623(c), which sets forth a number of classification criteria."

PRC Op. MC95-1 at III-10, ¶3025 (citation omitted). Later the Commission reiterated:

The cost differences . . . combined with market and demand arguments and broad agreement among the users of Standard Mail, are sufficient to recommend an Enhanced Carrier Route subclass.

Id. at V-148, ¶5344. See also, *id.*, at V-160, ¶5344. It is one thing for Valpak to argue that the Commission should take the opportunity presented by Docket No. R2006-1 to reverse its Docket No. MC95-1 opinion and establish subclasses on the basis of considerations of economic efficiency. However, there is no basis for Valpak's revisionist argument that the Commission embraced that approach in Docket No. MC95-1. And there is no basis for doing so on the record in the instant docket.

F. The Moeller, The Whole Moeller, And Nothing But The Moeller

At page I-14 of its Initial Brief, in its quest to achieve a reduction in the Standard

Mail ECR cost coverage proposed by the Postal Service, Valpak references a snippet of the history of the development of the Standard Mail ECR subclass -- lines 4-7 of page 7 of the Docket No. MC95-1 testimony of Postal Service witness Joseph Moeller (USPS-T-18). There, witness Moeller testified that certain constraints in that docket prevented him from proposing a lower cost coverage for the Enhanced Carrier Route subclass than was reflected in his testimony. Valpak, however, fails to place the quoted statement in its proper context. Witness Moeller's Docket No. MC95-1 testimony assumed the creation of three Standard Mail subclasses (Regular, Automation and ECR), only two of which were ultimately established. And, as indicated by his Docket No. MC95-1 response to interrogatory OCA/USPS-T18-18, witness Moeller made clear that, while recognizing the importance of avoiding major rate relationship changes, based on information available to him at the time, he could not speculate how much lower the ECR cost coverage might otherwise be. See, Docket No. MC95-1, Tr. 11/4275-76. A review of the history of subsequent rate litigation referenced at pages 1-14-17 of Valpak's Docket No. R2006-1 Initial Brief demonstrates that the Postal Service's cost coverage witnesses have subsequently evaluated the Standard Mail ECR subclass cost coverage on the basis of the unique circumstances and relevant information available at the time of each request, irrespective of what may have seemed possible to Postal Service witness Moeller in 1995, when the circumstances relevant to Docket Nos. R97-1, R2000-1, R2001-1 and R2005-1 could not be known. In each case, the Postal Rate Commission considered the relevant evidentiary record and developed rate recommendations consistent with its view of the weight to which each of the statutory pricing criteria should be given. No more and no less should be expected of

the Commission in the instant docket. And no amount of pining about what may have been hoped for a dozen years should substitute for a reasoned analysis of the Docket No. R2006-1 evidentiary record, which supports the Standard Mail ECR cost coverage proposed by the Postal Service.

G. The UPS Demand For Even Higher Priority Mail Rate Increases is Without Merit

UPS advocates a price increase of more than 23 percent for Priority Mail, a product that competes with some of its products, urging the Commission to "reject the notion that competitive products should be priced low in order to protect the Postal Service's market share" UPS Brief at 3.

It is a stretch to claim that the Postal Service's proposed rates for Priority Mail in this docket amount to protecting market share. Indeed, TYAR Priority Mail volume is 121 million pieces less than in the TYBR. Compare USPS-T-33, Attachment B, Table 1 with USPS-T-33, Attachment C, Table 9. This volume decline of 12.8 percent, set against Priority Mail's current market share of 21.2 percent (USPS-T-33, p. 8, line 12), would translate to a market-share decline of two to three percentage points (everything else equal).

The Commission has consistently held that § 3622(b)(5) authorizes a reduction in rates to maintain the position of the Postal Service as a competitor in the mail delivery industry. See, PRC Op. R2000-1 at 313, ¶5317. And, the courts have found that moderating cost coverage to protect customers and to avoid harm to the Postal Service's market position is appropriate. *United Parcel Service v. United States Postal Service*, 184 F.3d 827,845 (D.C. Cir. 1999).

UPS writes that Priority Mail's "coverage plummeted as a result of the Docket No R2005-1 settlement." UPS Initial Brief at 4. UPS did not, however, object to the settlement in Docket No. R2005-1, and the result of that docket was to increase coverage over where it would have been if the case had not been filed.

UPS asserts, "Clearly, Priority Mail's high elasticity reflects the fact that users have competitive alternative to it, not that it is a low value service." UPS Initial Brief at 5-6. On the contrary, it reflects both factors -- there are alternatives, and those alternatives generally have more features than Priority Mail. For example, Priority Mail does not come with some of the product features typically offered by the competition, such as track-and-trace, day-definite (guaranteed) delivery, and the inclusion of minimum insurance in the base rate. USPS-T-33 at 7.

The economic value of-service for Priority Mail is much lower than that for First-Class Mail letters, as indicated by its much greater response to price changes. Priority Mail has a price elasticity of -1.02, much higher (in absolute value) than the First-Class Mail letters elasticities for single-piece (-0.18) and workshare (-0.13). See USPS-T-31 at 21-22.

At page 7, n. 1 of its Initial Brief, UPS implies that the decline in volume for Priority Mail is related to the implementation of the Commission's Docket No. R97-1 recommendation that the maximum weight for First-Class Mail increase from 11 to 13 ounces. There is, however, virtually no relationship between the two. The Docket No. R97-1 increase in the maximum weight of First-Class Mail was likely fully incorporated in the FY 2000 Priority Mail volume, which preceded the decline. Compare Docket No. R2000-1, USPS-LR-I-250 (Priority Mail volume by ounce increment for FY 1998 and FY

1999) to Docket No. R2001-1, USPS-LR-J-103 at worksheet “input data” cells A110::E145 (Priority Mail volume by ounce increment for FY 2000).

UPS characterizes the Postal Service as effectively arguing that the Commission should determine, in each competitive subclass, what market share is best for the Postal Service. UPS Initial Brief at 8. The Postal Service has never suggested such an approach. The Postal Service’s position, consistent with the pricing criteria requiring consideration of the effect of price changes on customers, is that there is a need, in pricing Priority Mail, to protect customers who may have limited alternatives. UPS is considering only the effect on competition, not any other criteria.

At page 9 of its Initial Brief, UPS points out that the Postal Service has proposed greater increases for other subclasses than UPS' proposed 23.6 percent increase in Priority Mail in this docket. Those higher increases are driven, however, by factors not present here. See, e.g., USPS-T-31 at 26 (proposing an average rate increase of 24.4 percent for Within County Periodicals based on the required mark-up formula).

In summary, UPS employs its hindsight to assert that historic Priority Mail rate increases were not sufficiently steep and its foresight to suggest that the current Postal Service request for a 13.6 percent rate increase is -- surprise! -- not sufficiently steep. Under the circumstances, the Commission should reject UPS' rote demand that Priority Mail rates increase by more than the level proposed by the Postal Service.

H. MOAA's Distortions And “Straw Man” Arguments Should Be Dismissed.

At pages 3-9 of its Initial Brief, the Mail Order Association of America argues that the Postal Service’s proposed cost coverages result in rates for Standard Mail ECR

that are too high and that this will severely hurt ECR volumes. The Postal Service's cost coverage is justified by Postal Service witness O'Hara (USPS-T-31). The relatively high degree of worksharing involved in the preparation of Standard Mail ECR accounts for its low rates and relatively high cost coverage, but its unit contribution is comparable to that proposed for Standard Regular Mail. MOAA's argument at page 5 of its Initial Brief that Standard Mail ECR has been harmed by recent rate increases distorts the record. There, MOAA cites a 14 percent Standard Mail ECR volume decline. However, the Commission will observe that this includes declines that have already occurred, owing to rates approved by the Commission as fair and equitable in previous dockets. The decline also reflects a migration of ECR mail to the Regular subclass that was assumed to take place because of the elimination of Automation Basic rates. This is not a loss of mail, so much as it is an inter-subclass migration as mailers pursue more economical automation rates.

At page 4 of its Initial Brief, MOAA argues that Standard Mail ECR cost coverages have turned out higher than previously predicted by the Postal Service. However, this argument has no merit. MOAA cites no evidence which identifies any systematic bias in estimating Standard Mail ECR revenues or costs. And, no participant challenged the Postal Service's Docket No. R2006-1 Test Year Standard Mail volume forecast. Without a clear identification of some problem, this string of higher coverages than estimated should have no more predictive value than, for example, three consecutive coin tosses coming up heads has with regard to a fourth coin toss. Moreover, MOAA's analysis is flawed by its "apples-to-oranges" nature. MOAA compares "inaccurate" Postal Service cost coverage proposals -- which are based on

volume-variable costs developed on the basis of the Postal Service's approach to volume variability to "actual" cost coverages based on the Commission's approach to measuring volume-variable costs.

At page 5 of its Initial Brief, MOAA asks the Commission to recommend rates now that address market trends as far back as 1998. This argument ignores the fact that the Commission has considered such factors in three intervening omnibus rate dockets. Also at page 5, MOAA argues that neither in this proceeding nor in prior proceedings has the Postal Service proposed ECR rates that accord with "market-based pricing." Although MOAA's Brief at page 5 describes market-based pricing as consistent with the criteria of the Postal Reorganization Act and favored by the Postmaster General, it does not identify the criteria of the Act to which it may be referring.¹ The Postal Service can find no provision in the Act that requires proposed rates to meet MOAA's vague market-based standard. The Postal Service does observe that, in all past omnibus rate dockets, the Commission has recommended rates that included what, in its judgment, was an adequate recognition of market factors, to the extent that such factors are implied by the pricing criteria of § 3622(b). Anything further is simply an item on MOAA's wish list, not a requirement of that section.

MOAA misconstrues witness O'Hara's testimony that the unit cost coverages of Standard Mail ECR and Standard Mail Regular are about the same. MOAA has turned this simple observation into a policy for pricing ECR. MOAA Brief at 6-7. MOAA provides no citation for its assertion that Postal Service witness O'Hara (USPS-T-31)

¹ Moreover, lest MOAA forget, the Board of Governors (of which the Postmaster General is a member) approved the request in this proceeding.

ever claims that this equality of unit contributions is the basis for his rate levels or that he relies on it. MOAA is invited to review Tr. 17/5271. Witness O'Hara's testimony clearly supports his proposed cost coverage for ECR and is reasonable and fair.

MOAA's "straw man" critique should be dismissed.

I. Valpak Mixes Cost Coverage Apples And Rate Design Oranges

Valpak attempts to justify its proposal for extraordinarily high percentage rate increases for the Standard Mail Regular subclass by noting that the rates designed by Postal Service witness Kiefer (USPS-T-36) include a 215.6 percent increase for NFM parcels entered as Mixed ADC/BMC and entered at the DBMC. Valpak Initial Brief at IV-3. Valpak asserts that, if such large rate increases are embedded in the Postal Service's request, then Valpak's rate design, with similar rate increases, should also be acceptable. *Id.*

This argument fails because it ignores the context of the percentage changes. Valpak cannot support a wholesale reallocation of institutional costs by pointing to rate impacts for low-volume categories that result from the needed re-categorization of mail pieces, and pretending that those percentage changes are acceptable under any set of circumstances. Postal Service witness Kiefer's rate design de-averages the current non-letter rate category into Flats, NFMs and Parcels categories, in order to ensure that the revenue from these pieces cover their costs. Without this re-categorization, NFMs and some parcels would continue to enjoy the relatively low rates of automation flats, while being processed as the much more expensive parcels.

By comparison, Valpak's proffered rate design has enormous increases for some Standard Regular pieces, in well-established rate categories, simply because Valpak

advocates a radical reallocation of institutional costs, and not as an effort to ensure that the pieces cover their volume-variable costs. In any event, the circumstances surrounding the percentage changes resulting from re-categorization are grossly different from those surrounding reallocation of institutional costs. The Commission should not give any weight to Valpak's "apples-to-oranges" comparisons of percentage changes.

J. AAPS Barks Up The Wrong Tree On The Issue Of Consideration Of Competition

On the subject of Standard Mail ECR rates and competition, the Association of Alternative Postal Systems (AAPS) argues that the Postal Service has not given appropriate consideration to the impact of its pricing proposals on competitors. AAPS claims that the proposed reduction in the Standard Mail ECR pound rate will produce postage reductions at higher weights and adversely affect competition. AAPS Initial Brief at 2-3. AAPS points to the testimony of Postal Service witness Kiefer (USPS-T-36) that the lower pound rate might encourage some mail pieces to become heavier (Tr. 5/902) and argues that this volume would come from alternate delivery pieces joining shared mail pieces delivered by the Postal Service. AAPS Initial Brief at 3. AAPS goes on to argue at page 5 that Dr. Kiefer's list of considerations when developing ECR flats rates (Tr. 5/909) is silent on the issue of impact on competition. AAPS ignores the fact that consideration of the impact on competition is a task performed by Postal Service rate level witness O'Hara (USPS-T-31) as part of the process of allocating institutional costs among the various subclasses, including Standard Mail ECR, on the basis of a considered application of the § 3622(b) pricing criteria. The record in this docket

demonstrates that Dr. O'Hara gave adequate consideration to competition in setting the Standard Mail ECR cost coverage, which he proposes should be set higher than that of any other subclass except First-Class Mail Letters and Sealed Parcels. See, USPS-T-31 at 17, 29.

K. A Single Note By A Solo Flute Does Not Represent The Rich Sound Of A Full Orchestra

The Flute Network argues that the value of service for Standard Mail is low, based on data it submitted concerning subscribers to its publication. Flute Initial Brief at 29-30. In essence, the Flute Network publication, which is mailed at presort Standard Nonprofit letter rates, invited approximately 6,200 subscribers to inform it of the days when the subscribers received their copies of two issues. It heard back from 228 subscribers for the first issue, and 307 for the second. See Flute Initial Brief at 7-8.

This was not a random sample, as the subscribers who responded to the survey amounted to fewer than five percent of the survey recipients and decided for themselves whether or not to participate. The data gathered concern one single publication and there is no evidence to suggest that the densities and origin-destination mailing patterns are representative of any particular subclass or the postal network as a whole. While the data may provide a basis for concluding that there are opportunities for improving some of the service provided to a single publication, they do not provide the Commission with a sufficient basis for reaching any sweeping conclusions about the degree of timely delivery for the subclass in question or the value of the service actually received by mail within that subclass, within the meaning of § 3622(b)(2). The Postal Service respectfully submits that the survey results should be afforded no material

evidentiary weight in the Commission's cost coverage analysis.

VI. THE PROPOSED RATE DESIGNS OF THE POSTAL SERVICE ADHERE TO THE POLICIES OF THE ACT AND ARE SUPERIOR TO ALTERNATIVES PROPOSED BY VARIOUS INTERVENORS

A number of intervenors criticize the Postal Service's proposed rate and classification changes and offer alternatives for the Commission's consideration. The Postal Service commends the Commission to review the section of its Initial Brief beginning at page 219, which addresses those critiques and explains why these alternative rate design proposals should not be recommended. It is not necessary for this Reply Brief to respond to each and every intervenor argument, as the Postal Service's Initial Brief has anticipated and addressed many of them. Omission in this Reply Brief of discussion of any issues addressed in the Initial Briefs of other parties should not be construed as any indication that the Postal Service necessarily agrees with the views and positions expressed by those parties. Below, the Postal Service responds to various arguments presented in the Initial Briefs of these parties.

A. The Commission Should Dismiss Intervenor Criticisms of the Postal Service's First-Class Mail Rate Design

1. The current docket must be decided under the terms of the Postal Reorganization Act.

The enactment of the Postal Accountability and Enhancement Act, Public Law 109-435, several weeks ago has sparked several parties to make novel suggestions regarding the resolution of issues in the current docket which should be rejected by the Commission. For instance, in the area of First-Class Mail rate design, the American Postal Workers Union, at page 21 of its Initial Brief, encourages the Commission to adopt rate design principles consistent with APWU's reading of new

§ 3622(e). APWU trumpets witness Kobe's rate design as having been executed in a manner consistent with that provision. Whether or not that is the case cannot now be known. If it were so inclined, the Postal Service could declare that numerous aspects of its request were consistent, intentionally or otherwise, with interpretations of the Postal Accountability and Enhancement Act that will emerge from Commission rules and opinions that will be issued in the years ahead. The Commission is bound by §§ 3622(f) and 3632(c) of the Postal Accountability and Enhancement Act to resolve the current docket under the terms of the Postal Reorganization Act. However much credit APWU witness Kobe or any Postal Service witness may consider themselves to be entitled for taking on the intellectually stimulating challenge of trying to design rates in Docket No. R2006-1 that might be consistent with policies that do not apply to this docket, the only reward for pursuit of that objective in this docket can be the satisfaction that comes with the belief that one has achieved that objective.

2. APWU misstates the law, overstates the virtues of the BMM benchmark and contradicts itself.

a. The misstatement.

Proceeding down a false trail at page 12-15 of its Initial Brief, the American Postal Workers Union (APWU) claims that the Postal Service's de-linking proposal would violate the §3623(d) requirement that:

The rate for each such class of mail [for the transmission of letters sealed against inspection] shall be uniform throughout the United States, its territories, and possession.

This claim is founded upon an APWU trifecta: a misunderstanding of the legislative history of the statute, a misreading of footnote 9 of the holding in *Associated Third*

Class Mail Users v. United States Postal Service, 600 F.2d 824, 826 (D.C. Cir. 1979), and a misinterpretation of the Commission's Docket No. MC95-1 opinion.

What emerges from the cited legislative, judicial and Commission references is an affirmation of the intent that the second sentence of § 3623(d) is to bar the establishment of First-Class Mail rates that vary solely on the basis of whether the origin/destination of the mail is in relatively low-cost urban areas as opposed to rural areas. In rural areas, the per-piece costs of mail service, by virtue of the lack of mail density compared to urban areas, was expected to be much greater and far from self-sustaining. Thus, by operation of the second sentence of § 3623(d), First-Class Mail rates may not vary solely on the basis of whether a letter originates from or is destined to addresses in -- to pick some random examples -- such urban centers as Kansas City or St. Louis, or on rural routes near Rockport or New Madrid.

The First-Class Mail rates proposed by the Postal Service in this docket are designed to have uniform application throughout the postal system, within the meaning of § 3623(d). The proposed rate schedule does not vary by State or region, U.S. territory or possession. No First-Class Mail rates are proposed to vary on the basis of whether a mail piece's origin address or its destination address is urban or rural, densely or sparsely populated, or is located in a particular State, territory or possession, or is associated with a post office that is not self-sustaining. Accordingly, the proposed rate schedule complies with the second sentence of § 3623(d).

Section 3623(d) does not require that all First-Class Mail be charged the same rate, irrespective of weight, shape, origin-destination pattern, or degree of

postal cost avoidance resulting from mailer preparation. If that were the case, there could be no First-Class mail worksharing rates, no zone-rated Priority Mail, no First-Class Mail additional-ounce rates, and no subclass distinctions based on whether one First-Class Mail piece was a postcard and the other was a letter.

The second sentence of § 3623(d) also does not require that all rates within First-Class Mail, or any of its subclasses (Cards and Priority Mail included) be designed on the basis of a particular linkage to the flagship rate applicable to the first-ounce of a letter-shaped piece in the Letters and Sealed Parcels subclass, or to a rate that is commonly paid for mail originating in or destined to rural addresses. Whether the rate design for single-piece and workshare First-Class Mail is “linked” or “de-linked,” within the meaning of USPS-T-32, the Letters and Sealed Parcels subclass cost coverage and the rate design that allocates institutional cost contribution within the subclass must reflect consideration of the policies in § 3622(b). Nothing in the snippets of legislative history cited in the APWU Brief, or in any related judicial or administrative interpretation, provides any basis for concluding that the First-Class Mail rate design methodology employed by the Postal Service in Docket No. R2006-1 is not consistent with § 3623(d).

b. The overstatement.

APWU witness Kobe’s (APWU-T-1) proposal for retention of the BMM benchmark for First-Class Mail workshare rate design relies on the following premise, which she takes as axiomatic:

Regardless, there is another reason for using the BMM letter as the benchmark. When looking at a very heterogeneous pool of mail, such as that of First Class letters, it is the only way to make certain that two

mailers with identical pieces of mail are paying the same contribution to overhead costs, irrespective of whether they workshare.

APWU-T-1 at 15. However, at pages 21-23 of their Initial Brief, the National Association of Presort Mailers and the National Postal Policy Council (NAPM/NPPC) list five ways in which the incumbent BMM benchmark “does not achieve a uniform per-piece contribution to institutional costs,” as claimed by witness Kobe. To that list, the Postal Service would add a sixth reason:

- The mailer of a high-cost single-piece letter would pay a lower contribution to overhead costs than the mailer of a high cost presort letter.

Assume, hypothetically, that each piece of BMM saves the Postal Service four cents per piece (in sorting costs) when it is presorted. If, in accordance, the presort discount is set at four cents (based on a 100 percent passthrough), then indeed such a mail piece will make the same contribution to institutional costs irrespective of whether it is presorted. APWU witness Kobe’s premise holds in this instance.

But assume that another piece that is higher-cost than BMM is also eligible for conversion to presort. Further assume that this second piece, when presorted, saves the Postal Service 4.75 cents. Such a piece would then contribute 0.75 cents more to institutional costs when presorted than when entered as single-piece (assuming the discount, based on BMM, is four cents). Witness Kobe’s premise no longer holds.

Her presumption of contribution uniformity from the BMM benchmark is fundamental to APWU-T-1 — but also fundamentally flawed. Indeed, APWU characterizes the matter as “central”:

Thus, the central consequence of the Postal Service proposal to de-link Single Piece and Presort letter rates would be the creation of different and unrelated rates for identical First Class letters that differ only due to worksharing.

APWU Initial Brief at 8. But non-uniformity is the (unavoidable) consequence of witness Kobe's proposed BMM-benchmark methodology, as well. In a similar vein, APWU claims:

As a result of the de-linking, or de-averaging, proposed by the Postal Service in this case, presort letters will no longer contribute the same amount to institutional costs as they would have made without worksharing.

Id. at 7. Again, this is erroneous. Under a BMM benchmark, presort letters will not necessarily contribute the same amount to institutional costs as single-piece letters that are, in all respects, the same other than that they are not presorted. In fact, these single-piece letters will only contribute the same amount if they avoid for the Postal Service the exact same costs as BMM benchmark mail. In effect, witness Kobe's premise applies only to the BMM benchmark mail (and other mail pieces which coincidentally avoid the exact same cost for the Postal Service as BMM) — which represents probably only a small share of all the pieces eligible for conversion from single-piece to presort (or for reversion from presort to single-piece). See, Tr. 38/12942 *et seq.*

The reason for the failure of witness Kobe's premise is single-piece First-Class Mail heterogeneity. Not only does single-piece mail, in its breadth, display a wide variety of physical and cost-affecting characteristics, but the subset of single pieces that are *at the margin* of converting to presort are also non-uniform in their

characteristics.¹ There is not just *one* type of single-piece letter that is ready to convert to presort. Rather, there are many such types of mail. As put by NAPM/NPPC, “No presort benchmark can yield uniform per piece contribution to cost from a mail class as heterogeneous as First-Class Mail as long as its rate structure is so heavily averaged.” NAPM/NPPC Initial Brief at 3 (emphasis in original). The Postal Service submits, furthermore, that *any* degree of mail heterogeneity, even the slightest amount, will render *any* benchmark useless, including BMM, if the goal is to ensure absolute contribution uniformity from two mail pieces that are in all respects the same other than that one is presorted and the other is not.

The Postal Service’s de-linking proposal will maintain “uniform” rates, within the meaning of § 3623(d). Its goal is uniform unit cost contributions, on average, between single-piece and presort. APWU claims that the Postal Service’s de-linking proposal is “unfair” because, for one reason, it would “require clean business mail such as BMM to make a greater contribution to overhead than very similar letters that are presorted.” APWU Initial Brief at 15-16. This viewpoint is one-sided, as it only considers the case of *clean* mail (and BMM represents *very* clean mail indeed). What APWU ignores, as explained above, is that under a BMM benchmark, some *not-so-clean* presorted mail will make a greater contribution to overhead than very similar letters that are single-piece. Neither this circumstance nor the APWU’s is inherently unfair. They are both the unavoidable consequence of mail heterogeneity.

¹ As the presort market matures, the Postal Service believes that the relative heterogeneity of mail pieces at the margin of presorting is increasing.

In setting presort rates, absolute contribution uniformity among like mail pieces (other than that one is presorted and the other is not) cannot be the goal in the face of mail heterogeneity. Unavoidably, some presorted pieces will contribute more to institutional costs than like single-pieces, while other presorted pieces will contribute less to institutional costs than like single-pieces. The Postal Service's proposal to de-link presort from single-piece First-Class Mail letters, as offered in USPS-T-32, is an attempt to account for the diversity of mail (e.g., both *low-cost* and *not-so-low-cost*) that can be either presorted or entered as single-piece. The aim is also to avoid the pitfalls of any benchmark which purports to represent the most *low-cost* mail, and therefore probably understates cost savings to the Postal Service from presorting for more pieces than it overstates cost savings. The tendency of this shortcoming was highlighted by Pitney-Bowes witness Panzar: the BMM benchmark "is likely to lead to discounts too low to result in an efficient allocation of mail processing activity." PB-T-1 at 37. Dr. Panzar reiterated this under cross-examination:

I think the previous benchmark was bulk metered mail. It's clear that's not at the margin. That's way inside the margin....That makes it too clean a benchmark to use.

Tr. 26/9307.

At page 3 of its Initial Brief, APWU suggests that the proposed de-linking of First-Class Mail single-piece and presort rate design would result in a higher than necessary, and unfair rate for single-piece First-Class Mail letters. However, this allegation is refuted by the Postal Service's request in this docket. The proposed single-piece letter rate for the First-Class Mail Letters and Parcels subclass leads to

an average increase of 7.7 percent, which is less than the proposed average systemwide increase of 8.5 percent. Exhibit USPS-31D. The 42-cent rate would result in an overall increase in the basic First-Class Mail rate below the rate of inflation over a ten year period. USPS-RT-10 at 8, n.3; Tr. 32/10707.

Beginning at page 9 of its Initial Brief, APWU asserts that the Postal Service's de-linking rate design proposal "leaves no direct cost or rate relationship between single-pieces and presort mail" and characterizes such action as an attempt to circumvent the Commission's holding in Docket No. MC95-1. APWU's assertions misrepresent the Postal Service's objectives and otherwise are without foundation.

Contrary to APWU's histrionics, the Postal Service's goal of equalizing unit contribution between single-piece and workshare mail ensures that the rate design for the two categories remains inextricably intertwined, even if workshare rate design does not rely on a single-piece BMM benchmark. This objective underscores the Postal Service's continued treatment of single-piece and presort as separate categories within a subclass, not as two separate subclasses, for which independently selected cost coverages would be proposed on the basis of distinct cost and demand differences. As predicted at page 199, fn. 25 in the Postal Service's Initial Brief, APWU's Initial Brief raises the specter of *separate subclasses* for single-piece and workshare First-Class Mail. At page 9, APWU recites the concerns expressed by the Commission in rejecting a Docket No. MC95-1 separate subclass proposal, but APWU points to no Docket No. R2006-1 record evidence which suggests that the Postal Service's de-linked rate design for a decidedly *unitary*

First-Class Mail subclass leads to any *substantial* or *penalizing* or unfair or *inequitable* shift in institutional cost burden to or within First-Class Mail.²

The proposed per-unit contribution for single-piece mail for the Test Year after rates (FY 2008) is 23.8 cents, based on per-unit cost of 27.9 cents. For the Presort category, the proposed per-unit contribution is 23.2 cents, based on a per-unit cost of 11 cents. USPS Library Reference L-129, WP-FCM-12. If these two categories (single-piece and presort) were treated as separate subclasses, it would have been challenging to justify 23 cents in contribution on a product that cost only 11 cents. However, since both of these categories are part of the same subclass, the Postal Service is able to maintain similar per-unit contributions for these two categories of mail.

Another focus of the APWU Initial Brief is that the Postal Service proposed methodology undermines economic efficiency by allowing workshare discounts to exceed costs avoided.

The Postal Service perceives many benefits from de-linking. As Pitney Bowes witness Panzar (PB-T-1) explains, identifying and measuring an appropriate benchmark is both a practical and theoretical challenge (which has not yet been solved). See Tr. 26/9306-09. In light of these challenges, the benchmark problem can well be considered intractable. USPS-RT-18 at 8; Tr. 38/13349. The Postal Service's de-linking proposal would avoid this problem.

Other benefits of the de-linking methodology include that it is easily reproducible from one rate case to the next,³ it is verifiable, and it is transparent. It

² At page 9 of its Initial Brief, APWU also calls the Postal Service's de-linking proposal "unlawful," but cites no particular law in its discussion.

has the advantage of relying on a robust and well-established data source, the Cost and Revenue Analysis (CRA) system. Finally, it has the potential to reduce much of the dissension that has characterized worksharing discussions in the past.

For the reasons stated above, the Postal Service respectfully requests the Postal Rate Commission to approve its proposal in USPS-T-32 for de-linking First-Class Mail presort rate categories from single-piece.

c. The contradictory statement.

After reading the assertion at page 3 of the APWU Initial Brief that workshare discounts in excess of measured cost avoidance undermine the overarching principle of economic efficiency which, in combination with APWU's aforementioned interpretation of 3623(d), prohibits workshare discount passthroughs greater than 100 percent, the Postal Service prepared itself for an APWU confession explaining why its own witness Kathryn Kobe's (APWU-T-1) First-Class Mail rate design -- which includes discounts in excess of cost avoidance -- should be rejected by the Commission for violating the vaunted principles of Efficient Component Pricing and the uniformity requirement that APWU reads into § 3623(d). Instead, at page 20 of its Brief, APWU decides to have it both ways. This feat is accomplished by APWU appending the "as nearly as practicable" clause from § 3621 of the Postal Reorganization Act into the Efficient Component Pricing criterion that APWU has wedged somewhere into the pricing criteria in § 3622, and declaring that witness Kobe's inefficient workshare discounts comply with the newly defined policies of the

³ This does not mean that there must be rigid adherence to the formula. As with all postal ratemaking, all other relevant factors must be considered, and effects can be tempered.

Act. The only guidance APWU offers for interpreting its new “*economically efficient as nearly as practical*” pricing criterion is to have us infer that any deviations from efficiency proposed by APWU witness Kobe for whatever reason she may articulate legally comply with APWU’s enhanced version of § 3622, and that any deviations from efficiency proposed by Postal Service witness Taufique, because they deviate from witness Kobe’s, fall outside the range of being “*economically efficient as nearly as practical.*”

For rates to be “*economically efficient as nearly as practicable,*” this new criterion either has to trump all of the non-(b)(3) factors listed in § 3622 or it has no special weight at all. APWU cannot have it both ways. In the end, given APWU witness Kobe’s determination that § 3622(b)(4) considerations of “rate shock” trump APWU’s concerns about efficient pricing, it is clear that APWU preaches one thing and practices another. In selecting an approach that considers efficiency among a host of other relevant pricing factors, Postal Service witness Taufique (USPS-T-32) proposes rates for First-Class Mail that are in accord with long-standing practice and that warrant being recommended by the Commission.

3. GCA’s myopic focus on Efficient Component Pricing in rate design should be rejected.

In its Initial Brief at 11-20, the Greeting Card Association makes two claims: that the Postal Service’s proposed de-linking rate design methodology would result in First-Class Mail rates that are inefficient and unfair. Notwithstanding Postal Service rebuttal witness Robinson’s explanation (Tr. 32/10697) that efficiency is not necessarily the overarching goal of rate design, GCA fails to appreciate, or at least acknowledge, that the First-Class Mail rates following from a BMM benchmark are

also not necessarily efficient. As explained, *infra*, at VI.A.2.b., owing to mail heterogeneity, the BMM benchmark ensures efficiency only for pieces that are indeed bulk metered mail. For all other pieces (other than those that, by coincidence, avoid the exact same costs for the Postal Service as BMM), avoided costs to the Postal Service from presorting will either exceed or fall short of the discount benchmarked to BMM. This necessarily implies some inefficiency. Pitney Bowes witness Panzar makes a similar point. See PB-T-1 at 37, where Dr. Panzar states that the BMM benchmark “is likely to lead to discounts too low to result in an efficient allocation of mail processing activity.” Therefore, GCA’s claim at page 15 of its Initial Brief that “no efficiency-related purpose is served” by the Postal Service’s de-linking proposal is unsubstantiated.

GCA is similarly short-sighted with respect to its analysis of fairness and equity. This analysis is launched from the false premise that “[an] elementary component of fairness is like treatment of like mail.” GCA Initial Brief at 19. But as the Postal Service explains, *infra*, at VI.A.2.b., “non-uniformity is the (unavoidable) consequence” of a BMM-benchmark methodology (or of any benchmark methodology). No benchmark can ensure contribution uniformity from two mail pieces that are in all respects the same, other than that one is presorted and the other is not. For example, a mail piece that is *higher-cost* than BMM will contribute more to institutional costs if it is presorted (and gets a discount benchmarked to BMM) than if it is single-piece. As the Postal Service explains, *infra*, at VI.A.2.b., this is not inherently unfair (as would be suggested by GCA’s premise). Rather, it is the unavoidable consequence of mail heterogeneity. The Postal Service’s proposal to

de-link presort from single-piece First-Class Mail rates is an attempt to account for this heterogeneity, *i.e.*, the diversity of mail that can be either presorted or entered as single-piece. It is not necessarily any less fair or more fair than the incumbent BMM methodology.

GCA also avers that, under the Postal Service's de-linking proposal, "the fairness of the rate schedule would be diminished by according only workshared mail the benefit of cost-favorable intrinsic features significantly present in single-piece mail as well." GCA Initial Brief at 20. This really is a bit of a tautology. If the favorable cost characteristics are "significantly present" in single-piece mail, then they will be reflected in the rates, especially considering that the aim of the Postal Service's proposal is to obtain similar unit contributions from the single-piece and presort rate categories. Rates that reflect cost causation can hardly be called unfair.

At pages 13-14 of its Initial Brief, GCA argues that in designing rates, "there is no plausible reason for the Commission to begin with an inherently inefficient costing step and then (try to) 'adjust away' its undesirable consequences by tinkering with final rates." Thus, according to GCA, the Commission should start the rate design process by determining what rates would satisfy GCA's Efficient Component Pricing test and then determine whether the non-cost pricing criteria of § 3622(b) suggest alternative outcomes. However, beyond the requirement that the rate design for a subclass -- as a whole -- satisfy the requirement in § 3622(b)(3) that sufficient revenues be generated so as to meet or exceed the volume variable costs for that subclass, Congress has not imposed any of the remaining § 3622(b) criteria as the second most important guideline. Nor is there a basis for imposing

Efficient Component Pricing to determine “presumptively valid” rates, to be adjusted only if the remaining § 3622(b)(3) non-cost criteria are deemed to carry sufficient weight to warrant a deviation from ECP. There is no basis for reading such a process into the Postal Reorganization Act or concluding that it would be consistent with past Commission practice. While the Commission values efficiency as a factor in rate design, it also has consistently recognized that § 3622(b) requires the consideration of a host of factors, none of which is required to take a back seat to consideration of efficiency. See PRC Op. R97-1 at 475; PRC Op. R2000-1 at 235-36, 331, 349-50, 399-400, 439-40, and 449.

At page 19 of its Initial Brief, GCA argues that the Postal Service’s proposed de-linking of Single Piece and Presort for purposes of rate design is unfair because it would secure lower rates for a mailing with a minimum quantity of 500 pieces, but would fail to recognize, through a lower rate, the same characteristics in a mailing of 490 physically indistinguishable pieces. This assertion is puzzling since such discrimination -- affording discounts to mailings of 500 pieces but not 490 pieces, is embedded in the current DMCS and has been for decades. GCA may be offended by the piece minimums required to qualify for bulk First-Class Mail workshare discounts and GCA may be offended by witness Taufique’s de-linking rate design proposal, but there is no basis for declaring the latter to be the root of the former.

4. Major Mailers Association (MMA) strong support for delinking undercuts their challenges to Postal Service cost methodology.

For the reasons set out herein, the Commission should recommend the discounts and resulting rates proposed by the Postal Service for First Class presort mail. The discounts and rates proposed by the Postal Service are part of the Service's innovative proposal to "delink" the rates for First Class presort letters from the rates applicable to First Class single piece letters. MMA strongly supports the Postal Service's delinking proposal for several reasons, including, first and foremost, delinking will result in fair and equitable rates, not just for First Class presort letters but also for single piece letters; notwithstanding its name, delinking will **preserve** the existing relationship between single piece and presort letter rates for the foreseeable future; delinking offers the Commission and affected mailers a welcome opportunity to mute the intense controversy that has been the unfortunate hallmark of the existing cost savings methodology, especially reliance on use of the Bulk Metered Mail benchmark.

MMA strongly supports the Postal Service's rates:

Even if the Commission ultimately decides that it cannot recommend rates based on delinking in this proceeding, there still is more than ample record evidence that the specific presort discounts and rates proposed by the Postal Service are fully justified under a more traditional cost savings analysis.

MMA Brief at 1. See *a/so*, Brief at 7.

Despite its strong support for Postal Service rates, however, MMA simply cannot stop itself from hedging its bets and putting into its Initial Brief additional arguments regarding several cost methodology issues. And so, we find ourselves,

once again, rehashing the same old costing issues at the behest of a party who supports the delinking proposal.

a. The Existence of BMM and Its Appropriateness As the Benchmark in a Non-Delinking Framework Should No Longer Be An Issue

Returning to the same trough once again, MMA claims that BMM does not exist and demands that BMM be repudiated. These arguments were not convincing to the Commission in previous dockets -- and despite the Commission choosing BMM as the appropriate benchmark in Docket No. R2000-1 and not reconsidering that decision since then, MMA insists upon revisiting the issue again.

MMA's stubbornly-held position that BMM letters do not exist has not been substantiated by any current field observations.⁴ While the new delinking approach does not require the use of a BMM letters benchmark, it is worth noting, again, that the Commission-approved benchmark for First-Class Mail letters has been BMM letters in each of the past three litigated dockets (PRC Op. R2000-1 at para. 5089; PRC Op. R97-1 at para. 5089; and PRC Op. MC95-1 at para. 4302). In Docket No. R2000-1, the Commission categorically stated the following in its Opinion and Recommended Decision.

"The Commission continues to accept bulk metered mail as the appropriate benchmark for determining the worksharing cost savings for First Class Mail. The Postal Service provides evidence that at least some BMM does exist in the mailstream. The Commission also views a benchmark as a "two-way street". It represents not only that mail most likely to convert to worksharing, but also, to what category current worksharing mail would be most likely to revert if the discounts no longer outweigh the cost of performing the worksharing activities".⁵

⁴ Docket No. R2006-1, MMA-T-1, Appendix 1 pages 3, lines 11-13.

⁵ PRC Op. R2000-1, para. 5089.

In the face of such conclusions by the Commission, and in the face of repeated observations by postal witnesses confirming the existence of BMM in this and prior cases, it is surprising that witness Bentley could continue to hold his view. In fact, as reported in his rebuttal testimony, in September 2006 – as well as on other, numerous occasions -- the Postal Service letter cost witness Abdirahman personally observed hundreds of trays of BMM at the Southern Maryland processing plant. USPS-RT-7 at page 5.

Unlike witness Bentley, Pitney Bowes Inc witnesses Panzar (PB-T-1) and Buc (PB-T-3) both reject the BMM letter benchmark from a theoretical perspective. Neither Witness Panzar's nor Witness Buc's positions, however, have been substantiated by any current field observations.⁶ Even if the Commission does not adopt delinking, these unsubstantiated views would not warrant departure from Commission findings in past cases supporting BMM benchmark.

b. The Postal Service's Cost Pool Classifications Serve the Purpose of Distinguishing Cost Differences Between Levels of Presortation and Should Be Adopted

In their never-ending reach for larger and larger presort discounts, MMA and Pitney Bowes seek expansive cost pool classifications under the delinking proposal, even though MMA points out that an advantage of the delinking proposal is the reduced level of concern regarding the classification of cost pools for purposes of establishing the differences in unit costs between presort levels. To wit:

Similarly, the impact of cost pool classification is reduced significantly. No longer does the Commission have to determine which cost pools are directly impacted by worksharing and which are not, a decision

⁶ Docket No. R2006-1, PB-T-3, page 12, lines 1-7.

which is contentious simply because cost data show that **all** of the cost pools have lower costs for workshared letters than they have for the non-workshared benchmark. See MMA-T-1, Appendix 1, p. 7. Under delinking, it simply does not matter whether a specific cost pool is impacted by worksharing.

MMA Initial Brief at 13-14.

The Postal Service whole-heartedly agrees. The CRA has already determined the differences between the costs of workshared and nonworkshared First-Class Mail. Thus, it is somewhat confusing to see MMA note that “the evidence indicates that the cost pools that the Postal Service would prefer to exclude from the cost savings analysis **always** exhibit lower costs for workshared letters than for nonworkshared letters.” MMA Initial Brief at 31. In a delinking environment, if the cost pools for workshared letters exhibit lower costs, workshared letters would already have been given the benefit of those lower costs by the CRA. Furthermore, MMA repeatedly fails to comprehend that the cost pools excluded from the Postal Service’s analysis of the cost difference between presort levels were excluded because they were not modeled.

In Table 2 of Appendix 1 of his testimony, MMA witness Bentley cites the REWRAP cost pool costs as an illustration of a cost pool that the Postal Service inappropriately classified as fixed. Witness Bentley asserts that the lower REWRAP costs for workshared letters proves that REWRAP costs vary by presort level and therefore should be part of the cost savings analysis. The MMA Initial Brief continues by saying:

Mr. Bentley illustrated this point with the REWRAP cost pool costs. The REWRAP cost pool measures costs to repair letters that become damaged during automated processing. The Postal Service

has classified these costs as “fixed” with respect to presort level and merely *assumed* that they are unrelated to worksharing.

The USPS position is patently unreasonable. The probability that a piece of mail will be damaged increases with the number of times it must be handled during processing. Therefore, it seems logical that workshared letters that do not receive individual processing until further “downstream” than single piece letters should incur lower REWRAP costs. Moreover, the facts support Mr. Bentley’s conclusion on this score. See MMA-T-1, App I at 7-8, Table 2.

MMA Initial Brief at Footnote 24.

The presort automation letters which consistently show lower REWRAP cost pool costs are, in fact, an indication that the Cost and Revenue Analysis (CRA) has already credited presort automation letters for lowering this cost pool. What witness Bentley is demanding is no less than double counting for activities which CRA had already taken into account for presort automation letters

MMA rightly states that in a delinking framework, “The Commission need only decide which cost pools vary based on the degree of presort.” MMA Initial Brief at 13-14. However, MMA witness Bentley defers to Pitney Bowes witness Buc in shifting the cost pools to create larger cost differences between presort levels. MMA states:

Under USPS witness Abdirahman’s delinking analysis, cost pools are either modeled and, therefore, deemed proportional, or “fixed.” Since Mr. Abdirahman readily admits that the “fixed” cost pools could be proportional, there is much less cause for controversy over which cost pools are proportional to presort level. Mr. Abdirahman clearly states at Tr. 5/580,

The ‘fixed’ cost pools represent tasks that have not been modeled. It is possible that some costs within those cost pools vary for mail of different presort levels, but I have not studied them.

Pitney Bowes witness Buc thoroughly analyzed all cost pools and concluded that more than 70% of the cost pools *not* reflected by the models were still affected proportionally by presorting.

MMA Initial Brief at 23.

In its unquestioning support of Pitney Bowes witness Buc's reconsideration of cost pool classifications, MMA further states:

In this regard, Pitney Bowes witness Larry Buc provides a complete and comprehensive analysis for each cost pool. See PB-T-2 and Library Reference PB-LR-L-1. See Appendix I to this brief for the cost pool classifications based on Mr. Buc's analyses. MMA witness Bentley relied upon Mr. Buc's analysis and we urge the Commission to accept it as well.

MMA Initial Brief at 13-14.

MMA's blind faith in Pitney Bowes witness Buc's analysis is misplaced, for witness Buc conducted no "analysis" of cost pools, much less a "complete and comprehensive analysis for each cost pool." Witness Larry Buc provided self-serving cost pool classifications in PB-LR-L-1 that differ from those relied upon by the Postal Service and the Commission in past dockets. Not surprisingly, Witness Buc classifies the vast majority of cost pools as proportional, even though the tasks represented by many of those cost pools are not included in the mail flow models. He arbitrarily classifies the majority of the cost pools as modeled/proportional without presenting any supporting evidence. Witness Buc acknowledges that he relies on his so-called "Thought Experiment" for the cost pool changes. When the Postal Service inquired whether witness Buc had, in fact, attempted to model the costs for the cost pools that he proposes to shift to the "proportional" classifications, witness Buc

replied, “I have not modeled them but I have provided multiple reasons why they are proportional”.⁷

In fact, witness Buc provided no justification for classifying these cost pools as proportional, despite the Postal Service's inquiries.⁸ Instead, he chose to use the costs that were modeled as distribution keys for the costs he did not model; an activity that he, himself, stated was inappropriate. (Tr. 20/7349). Witness Buc's cost pool reclassification proposal – which was simply a this-is-to-this-as-that-is-to-that distribution, hardly a “complete and comprehensive analysis for each cost pool” -- misses the point of why the cost pool classifications in the letter models were necessary in the first place. As witness Abdirahman repeatedly explained, cost pools are classified as proportional because the activities, and the costs thereof, captured within those cost pools ***are understood to vary in known ways with the presort level, i.e.*** the more finely presorted a piece is, the less the cost of processing in a given cost pool. Witness Buc's “thought experiment” and other cost pool analysis neither present a mail flow model depicting these extraordinary changes, nor does it provide reasons why these cost pools are proportional **and vary within each presort level.**

MMA's reliance on Pitney Bowes witness Buc's cost pool classifications is somewhat puzzling given that MMA acknowledges that, “Nevertheless, MMA does and the Commission should recognize that issues that are absolutely critical to derivation of representative, reliable cost savings under the traditional approach are less controversial under delinking precisely because the impact of cost pool

⁷ Docket R2006-1, Tr. 20/7314

⁸ Docket No.R2006-1, Tr. 20/7290

classification is reduced significantly”, MMA Initial Brief at 23. But, even after stating that the classification of cost pools is of diminished significance under the Postal Service’s delinking proposal, the MMA Initial Brief continues,

Finally, there is no harm in leaving the cost pools in the analysis. If the costs are not affected by worksharing, as the Postal Service claims, the costs will be similar and would have no impact on the derived unit cost savings. The bottom line is that the **only** relevant difference between the letters passing through each of these cost pools is that one letter is workshared while the other is not. Therefore, the only reasonable explanation is that worksharing lowers the costs within what the Postal Service can only **speculate** are “nonworkshare-related” cost pools.

For the foregoing reasons, the Commission should adopt MMA’s and Pitney Bowes’ position regarding the classification of cost pools. All cost pools should be included in the analysis of cost savings so that the computed cost differences between workshared letters and its nonworkshared benchmark can reflect all relevant cost differences between workshared and non-workshared letters.

MMA Initial Brief at 33.

It is difficult to determine the origin of MMA’s understanding of and position with regard to the classification of cost pools, but one thing is certain: witness Bentley simply accepted and relied upon witness Buc’s drastic and unsupported cost pool classifications without any historical or factual backing.

The Commission’s analysis in Docket No. R2000-1, where cost pool classifications were debated at length, supports the Postal Service’s approach, rather than the flawed approaches advocated by witnesses Buc and Bentley. While it is no longer necessary to maintain three separate cost pool classifications in the delinking framework, the Commission’s analysis from Docket No. R2000-1 can easily be used to determine which cost pools should be classified as proportional and which cost pools should be classified as fixed. If a given cost pool contains

tasks that are included in the mail flow models, that cost pool is classified as proportional. If not, that cost pool is classified as fixed.

The Postal Service therefore recommends that the Commission adopt the USPS cost pool classifications as presented in USPS-LR-L-48 and reject the convoluted cost pool classification proposals described above.

c. The Postal Service's Reconsideration of the Relevance of Delivery Cost Savings To the Presort Cost Differences Reflects a More Reasoned Approach to Cost Analysis and Should Be Adopted

Despite its professed support for the delinking proposal, MMA cannot help itself but to strive for even greater differences between presort levels by demanding that the Commission retain the use of the Delivery Point Sequencing (DPS) percentages and the derivative cost differences by presort level, even in the face of Postal Service testimony that such differences were spurious. MMA states,

In a very strange about face, the Postal Service backed away from its 10-year old consistent position that the degree of worksharing favorably impacts delivery costs.⁹ Not only does this position make little sense, the Postal Service has provided absolutely no evidence to support its contention that the Commission should likewise change its position with regard to the relationship between worksharing and delivery costs. The Postal Service's view should be categorically rejected because the Service has failed to meet its burden of proof. MMA Initial Brief at 43

MMA has put its finger precisely on the issue: there is "absolutely no evidence" to support the continued reliance on the delivery cost differences by presort level. Nevertheless, Pitney Bowes and MMA both argue for inclusion of delivery cost savings by rate category, even though MMA admits that the differences are tiny:

⁹ MMA notes that even APWU and OCA did not accept the Postal Service's position on delivery cost savings.

Finally, MMA urges the Commission to continue to include delivery cost savings in any derivation of delivery cost savings. Under delinking, the impact of delivery cost savings is significantly diminished compared to measuring cost savings from a non-workshared, controversial benchmark.¹⁰ When measuring the cost savings simply due to the degree of presortation, the cost savings analysis reflects only the very small differences in the DPS percentages (DPS %) among the presort categories, too small to be controversial.¹¹

MMA Initial Brief at 24.

The use of acceptance rates and the DPS percentages which “fall out” of the models as a by-product to de-average delivery unit costs differs from the use of the acceptance rates to de-average mail processing unit costs. With delivery, there is no evidence that the costs would differ by presort level (other than machinable and nonmachinable differences). With mail processing, costs will differ because presort mail can avoid entire processing steps depending on the level to which it is presorted.

As ample evidence on this record shows, if a mail piece is presorted to 3-digits, it will avoid an outgoing primary and/or secondary operation (and perhaps even more steps), even if that mail piece is processed both on automation and in manual operations (which is where the acceptance/reject rates come into play). By definition, it is therefore known that these presorted mail pieces will avoid some mail processing costs. There is no comparable intuitive presort cost savings associated with the delivery function. A given mail piece does not avoid manual carrier casing

¹⁰ In the past, the delivery cost benchmark has always been a workshared category, such as Nonautomation or NAMMA letters. MMA maintains that in order to isolate workshared cost savings, the benchmark should **not** also be a workshared category.

¹¹ Incremental cost savings among the Automation presort categories range from just 0.08 to 0.24 cents. See MMA-T-1, p. 16, Table 6.

specifically due to the fact that it is presorted to a given level: it avoids those costs if it enters the delivery unit mixed with other DPS mail. Whether or not that happens depends on whether it is successfully processed through automation from beginning to end. While the assumptions and inputs in the cost models may lead one to believe that the DPS percentages vary by presort level, there are no data that conclusively demonstrate that this is true – and neither Pitney Bowes nor MMA provided any data, simply assumptions and “common sense.” The only way the truth could be known regarding these assumptions would be if automation presort mail were isolated and processed through several operations in order to determine if the amount of rejects increases as the number of handlings increases. There is no evidence on this record suggesting that such studies have been conducted.

During the proceedings of this docket, Chairman Omas asked witness Abdirahman if the Postal Service’s refusal to use acceptance rate differences as evidence of delivery cost differences did not also mean that the mail processing costs were suspect. Tr. 35/12053-12054. As noted above, and as witness Abdirahman noted, the only thing known is that, by definition, presorted mail will skip entire mail processing steps, whether or not those mail pieces are processed manually or on automation. Skipping processing steps is the primary source of the cost savings, not the acceptance percentages. With delivery costs, mail pieces do not avoid costs solely because of their presort level. The only way mail pieces will skip the carrier casing step is if they are barcoded and processed successfully in automation incoming secondary operations. The Postal Service really does not have

any data – nor does Pitney Bowes or MMA -- that indicate what the DPS percentages by rate category actually are.

d. MMA's calculation of delivery costs is flawed.

Finally, on an issue related to the calculation of delivery cost savings, the Postal Service, in its initial brief, began its discussion (at pages 257-261) of certain unit delivery cost issues with a quote from MMA witness Bentley, which the Postal Service proceeded to challenge:

There can be no argument that Postal Service data indicate that Presorted letters cost, on average, 3.38 cents less to deliver than single piece letters.

MMA-T-1 at 16. In its initial brief, MMA has made a significant modification:

USPS delivery cost data show that after collection costs are removed, Presorted letters cost, on average, 3.77 cents less to deliver than Single Piece letters.

MMA Brief at 46. The Postal Service is gratified that MMA has finally recognized the inaccuracy of the previous statement. However, MMA still erroneously advocates that the 3.38-cent figure be used as the basis to derive unit delivery costs by rate category. *Id.* at 46-47. The flaws inherent in that approach were fully articulated in the Postal Service's initial brief at pages 257-261), and nothing in MMA's brief suggest any basis to resurrect the discredited approach of attempting to develop a pseudo-cost difference per originating piece of 3.38 cents, when the actual cost difference per originating piece remains 0.99 cents.

e. MMA's Challenge to RBCS Is Unfounded and Should Be Rejected.

MMA further criticizes the Postal Service's approach to cost analysis for workshared First-Class Mail letters, stating:

Another source of controversy involves the Postal Service's reliance upon mail flow models of doubtful accuracy because, among other things, they rest upon inappropriate, unsubstantiated assumptions about how efficiently and effectively letters are processed within the Remote Bar Code System (RBCS).

MMA Initial Brief at 12.

MMA witness Bentley looked at the unit costs derived by the mail flow models for nonprebarcoded BMM and concluded that they

have always been significantly **lower** than its CRA-derived counterpart. On the other hand, the unit costs derived by the mail flow models for prebarcoded Automation letters have always been significantly **higher** than its CRA-derived counterpart. There can be no doubt that the models exhibit a consistent and reliable bias that impacts the results depending upon whether a letter requires or can bypass the RBCS.

MMA Initial Brief at 35, emphasis original.

Further, "Mr. Bentley concluded, it was obvious that the mail flow cost model simulations for the nonprebarcoded letters requiring RBCS processing were too low. " *Id.* at 35. However, witness Bentley does not present any new RBCS-related data on the record, but instead, throughout his testimony and library references, relies on USPS-supplied data. Nevertheless, he repeatedly criticizes the accuracy of that data which he has chosen to use in his own analysis. While witness Bentley talks about how the Postal Service data overstate or understate certain RBCS costs, his analysis relies only on inappropriately dissecting RBCS costs at the component level.

An examination of costs at the operations level reveals that the results are not as clear cut with regard to the direction of the model's overstatement or understatement of costs.

Table 1

First-Class Metered Mail Letters Costs

Operation - Cost Pool	Cost Sheet Value	Cost Pool Value	Difference
ISS/OCR	1.162	1.146	0.016
RCR, REC, LMLM/LD15	0.134	0.378	(0.245)
OSS-BCS/DBCS	0.097	?.???	?.???

MMA-LR-1, pages 4 and 5

Table 1 compares the values shown for the relevant CRA-derived cost pools (MMA-LR-1, p. 4) to the model-derived costs shown in the cost sheet (MMA-LR-1, p. 5). As the models are structured, RBCS is defined to include the ISS, RCR, REC, OSS, and LMLM operations. As shown above, the ISS cost pool value is fairly close to the modeled cost sheet value. The LD 15 operations (RCR, REC, and LMLM) appear to understate the cost pool value. As has been stated on many occasions, however, the cost pool values are for all single-piece metered letters, not just BMM letters, which are considered to be homogenous trays of mail with machine printed addresses. As was noted often in this and previous dockets, metered letters in general, however, could have handwritten addresses, which could explain the discrepancy between the cost sheet and cost pool values. Finally, the OSS costs are imbedded in the BCS/DBCS cost pool such that those costs cannot be compared and there is not a separate OSS cost pool value. Since OSS is part of

RBCS, it is not possible to conclude that the model as currently is structured, understates or overstates the RBCS costs.

The RCR finalization rate, however, can be used to illustrate the benefits of RBCS. The finalization rate, the rate at which the Postal Service successfully reads the address in order to apply a barcode to non-barcoded single-piece cards and letters was initially 25 percent when RBCS was first deployed in 1992 and is now approaching 80 percent. Table 2, taken from the rebuttal testimony of postal witness Abdirahman, clearly demonstrated how the Postal Service and the mailing community continue to reap the benefits of the RBCS investment.

Table 2

Summary of Historical USPS RCR Finalization Rates

Years	RCR Finalization Rates
2002	68.30%
2003	70.50%
2004	75.57%
2005	78.40%

Tr. 35/11964.

Table 8 of MMA's Brief infers the following conclusions: The unit cost derived of the mail flow models for nonbarcoded BMM has always been significantly lower than its CRA-derived counterpart. On the other hand, the unit cost derived by the mail flow models for prebarcoded automation letters has always been significantly higher than its CRA counterpart. The clear connection asserted in MMA's initial brief is disingenuous and misleading. First, the Postal Service's direct case in this docket does not present BMM or MML costs. Second, the model-derived cost of BMM in

USPS-LR-L-141 and all previous cases is not used for anything by the Postal Service in this docket. Third, the CRA-derived BMM unit cost is never used in isolation. For benchmarking purposes, a combination of CRA-proportional cost pools and the workshared related fixed cost pools are used. Fourth, the model cost is only for BMM letters but the CRA cost includes BMM letters and metered bundles. Therefore, one would not expect to see a CRA proportional adjustment factor of 1.0

On footnote 29 on page 35, the MMA brief states “He has also testified that the BMM model and a model for metered mail letters (MML) would be identical”. MMA again is twisting the Postal Service’s witness’s testimony to suit its own conclusions. The Postal Service has explained on many occasions that metered mail letters must first go through cancellation and meter preparation operations before going to Outgoing ISS operations while BMM letters are forwarded directly to Outgoing ISS sortation equipment. MMA’s brief also fails to mention that automation costs presented in their Table 8 all reflect problems related to auto and non-auto cost identifications as discussed by the Postal Service in its response to POIR NO.1, Question 1a in Docket No. R2005-1.

The MMA brief presents Tables 9, 10 and 11 to highlight the problems with the RBCS. It is worth noting that the figures are close in magnitude. Second, the automation mail and nonautomation mail pieces are not processed through the exact same operations and, as a result, they are not expected to have identical costs. Third, the cost models that yield these results are simplified representations of the mail processing network. They are the result of the best available data and apply methodologies that have been relied upon in the past several cases. Fourth, the

data contained in Tables 9, 10 and 11 include costs from USPS-LR-L-141, which separates auto and nonauto costs, and from USPS-LR-L-110, which combines auto costs and nonauto costs. This factor alone throws a huge doubt on the conclusions reached by the MMA in criticizing the RBCS operations.

In Table 11 in the MMA Initial Brief, MMA compares the unit costs of BMM, NAMMA, Nonauto and Auto MAADC mail both before and after application of CRA adjustment factors, and states:

It seems terribly illogical that the BMM model-derived cost adjusts upward by 56% while NAMMA and NonAutomation, which are **very similar**, do not. On the other hand, according to the Postal Service, Auto MAADC letters also inch up by the same 1.3%. It is patently impossible that **prebarcoded** Auto MAADC letters cost virtually the same to process as **nonprebarcoded** NAMMA and NonAuto letters. MMA Initial Brief at 42.

However, MMA conveniently chooses to forget that the single piece metered letter proxy that is used for BMM letters contains costs for both machinable letters and nonmachinable letters. BMM, in contrast, is generally regarded to be machinable. The proxy costs also contain cancellation and meter prep costs. That is why the BMM proxy cost and the NAMMA cost are so different.

It is also worth noting that there is only one nonautomation rate category. Nonautomation letters are heavily more presorted to the three- and five-digit levels than are automation MAADC letters. The mail pieces are not processed through the exact same operations and, as a result, they are not expected to have identical costs. USPS automation technology has been focused on applying barcodes to nonbarcoded pieces. Thus, the cost difference between the two should be shrinking.

MMA's methodology inappropriately advocates the use of two CRA adjustment factors when reconciling model-derived costs to the CRA numbers. Despite warnings from the Postal Service witnesses that the auto and nonauto cost splits are not valid, MMA witness Bentley persists in tying the modeled costs, which are based on combined auto and nonauto costs, to two separate CRA cost numbers. He then compounds the problem. Since he dislikes the results the model produces, he also applies to the modeled costs for Nonauto a CRA adjustment factor based on the MML costs. Neither the Postal Service nor the Commission, however, has ever used MML or BMM costs to make such adjustments to nonautomation presort letters costs, and this step in witness Bentley's analysis is nonsensical. But once he develops his adjusted Nonauto costs, he backs the Nonauto costs out of the total Presort costs to get an adjusted "Auto" cost that he can use to develop a CRA adjustment factor for the modeled auto costs. MMA-T-1, Appendix I, pages 15-17.

After these many gyrations, it seems that it would have been easier for witness Bentley to simply agree with the Postal Service that there are not valid estimates of the auto and nonauto costs in isolation rather than inventing cost adjustments simply to achieve his desired cost results.

- f. The Costs To Mailers of Qualifying for Workshare Discounts, While Relevant to Consider Adoption of the Workshare Opportunities, Are Irrelevant To Consider In Setting Discounts

Testimony presented by MMA witnesses and reiterated in the MMA Initial Brief emphasized the cost to mailers of complying with postal regulations regarding workshare programs. Specifically, the MMA Initial Brief states:

MMA rebuttal witnesses David Gorham and Mary McCormack described in detail just how difficult it is for First Class workshare mailers to earn discounts. In order to qualify their mail for discounts, First Class workshare mailers must meet numerous, increasingly complex and costly eligibility requirements.

MMA Initial Brief at 8.

Although the Postal Service is not unaware of the expenses incurred by mailers in order to comply with postal regulations, and while the Postal Service acknowledges and applauds the mailing community for its investments in technological and process changes that assist the mailing community and the Postal Service to improve efficiency, there is certainly significant, if not voluminous, testimony on the record in this and previous dockets clarifying that the appropriate basis for worksharing discounts is the **Postal Service's** costs avoided, not the mailers' costs incurred.

5. Expansive Application of Efficient Component Pricing is Not the Panacea that Pitney Bowes Would Suggest

Pitney Bowes has a section in its initial brief which urges the Commission to “embrace an expanded application of the principles underlying Efficient Component Pricing to better align prices with costs.” Pitney Bowes Brief at 18-25. While this matter has already received much attention in this docket, at least one more caution is in order.

Pitney Bowes, for example, stresses the importance of changes “at the margin.” *Id.* at 22-23. But whether there actually are many mailers “at the margin,” that is, mailers who can actually change the shape, or the weight, or the cube of

their mailpiece, is an empirical question. Prof. Panzar acknowledges that the whole goal of improving productive efficiency is only advanced if mailer can and will change their behavior in response to the “efficient” rates. Tr. 26/9157, 9161-62. Traditional worksharing has been focused on areas where experience has shown that mailers can and do adjust their mail preparation practices, as Prof. Panzar suggests. But expanding to other types of mail characteristics should not be assumed to be able to generate cost-saving behavioral changes of the same magnitude. And in the absence of such changes, ECP produces minimal benefits at the cost of potentially major disruptions.

For example, equalizing unit contribution across pieces of all weights, shapes, and cubes, would no doubt create distortions in the rate schedule. The example at the bottom of page 22 of the Pitney Bowes brief actually exemplifies the types of counterproductive distortions that could result from attempting to do. If we switched to the same contribution per piece for all pieces, this would mean that the pound increment would decrease, thereby giving mailers an incentive to increase weight (and therefore cube), compared to today, thereby (if there were mailers positioned to respond accordingly) increasing Postal Service costs. The Commission should not adopt the expansive application of ECP that Pitney Bowes proposes.

6. The OCA cannot have it both ways regarding additional-ounce data.

In defense of its proposal to eliminate most of the First-Class Mail additional - ounce rate structure, at page 96 of its Initial Brief, the OCA accuses the Postal Service of not having responded to the Postal Rate Commission’s Docket No. R97-1 suggestion that it develop information regarding the impact of additional weight on

the cost of processing First-Class Mail pieces. Once the instant docket is concluded, the OCA would do well to acquaint itself with Docket No. R2000-1 USPS Library Reference I-91, as well as Docket No. R2001-1 USPS Library Reference J-58, which served as the basis for the Postal Service's proposal in that docket, continued here, to initiate First-Class Mail additional-ounce rate reductions.

Next, overlooking the details of the testimony of Postal Service witness McCrery (USPS-T-42), the OCA argues that there is no weight-based justification for charging additional-ounce rates for letter-shaped mail weighing up to six ounces, because the Postal Service plans to deploy 617 DIOSS-EC machines capable of processing pieces that weigh up to six ounces in weight. However, the OCA points to no evidence that the machine throughput for six-ounce pieces would bear any resemblance to the throughput for one-ounce pieces. The fact that a relatively small number of such machines will be deployed by the test year and that they could reduce the dependence on manual processing of thick, heavy letters does not mean that automated processing of such letters will be the same as it is for First-Class Mail letters currently run on automation, the overwhelming majority of which are one-ounce.

The OCA cannot have it both ways. It cannot erroneously argue that no advances have been made toward a better understanding of the impact of weight on the cost of processing First-Class Mail letters since Docket No. R97-1 and then leap to the conclusion that if such data existed, they would show no difference in the cost of sorting one-ounce and six-ounce letters.

7. Mr. Carlson's belated concerns about shape-based rate design deserve no consideration.

Intervenor Douglas Carlson “[s]upports shape-based rates philosophically and economically . . . [,] but concludes that the time to recommend them is not now. Carlson Initial Brief at 12. Beginning at page 12 of his Initial Brief, Mr. Carlson argues that all plans for implementing shape-based First-Class Mail rates should be curtailed for two reasons. First, is his new-found belief that the general public has no capacity to use common measuring devices and/or request assistance from postal mail acceptance personnel. The second is based on his misunderstanding of the testimony of Postal Service operations witness Marc McCrery.

Declining the opportunity afforded by the Commission’s rules to present testimony on the subject for inclusion in the evidentiary record, Mr. Carlson waits until his Initial Brief at page 12 to offer testimony about what he claims is “commonly” enclosed in a #10 envelope and what the resulting thickness of the resulting mail piece might be. He continues by asserting that using “a ruler or similar measuring device” for “determining whether an envelope is thicker than ¼-inch is not easy.” Carlson Initial Brief at 12. Postal Service witness Taufique (USPS-T-32) recognizes that some additional complexity will arise from his shape-based rate design. In all of his belated concern over the inability of the general public to use rulers or similar measuring devices, Mr. Carlson neglects the fact that, reliable and ready as always, postal window clerks and bulk mail entry unit postal clerks will be available to accept and measure mail pieces and make postage determinations for customers, as has always been the case.

Grasping at another reason to delay the pursuit of shape-based First-Class Mail rate design, Mr. Carlson focuses on the proposed ¼ -inch thickness

demarcation between letters and flats and questions why a letter-shaped piece greater than ¼-inch thick should be defined as a flat for ratemaking purposes. In his mind, that piece “can be processed on automated equipment with ‘extended capabilities’” as described in the Postal Service’s response to DFC/USPS-29. Mr. Carlson’s reliance on the response to DFC/USPS-29 as support for his assertion that thick letters can routinely be processed on automation overlooks witness McCrery’s rebuttal testimony about the limited availability of such extended capabilities. See Tr. 34/11464-66, where witness McCrery makes clear that only 617 out of approximately 5,200 DBCS machines are expected to have expanded capabilities by the middle of 2007, and where he testifies about the diminished machine throughputs resulting from the processing of thicker pieces. Thus, contrary to the assertion at page 13 of Mr. Carlson’s Brief, the Postal Service’s proposal is anything but arbitrary.

Mr. Carlson argues at page 14 of his Initial Brief that any transition to shape-based rates must mitigate rate shock for customers who mail lightweight parcels, but he ignores the fact that by passing through only a portion of parcel costs resulting from shape-based de-averaging, Postal Service First-Class Mail rate design witness Taufique has done just that.

Mr. Carlson expresses concern that the record lacks sufficient evidence that the public is able to comprehend rudimentary shape-based distinctions and possesses “appropriate measuring equipment.” He calls for market research to determine conclusively whether the general public has the requisite acumen with which to use rulers to measure envelopes and packages. The Postal Service,

however, encourages the Commission to join it in presuming that the general public possesses such measuring skills and is capable of seeking guidance from their local customer-friendly postal mail acceptance personnel, if not the publicly available Domestic Mail Manual.

8. The alternative Forever Stamp classification proposal should be rejected.

a. Any consideration of *Forever Postage* is premature.

Regarding the Postal Service's proposed Forever Stamp classification, intervenor Douglas Carlson argues that, if it is not adopted on the basis of his substantially modified terms, then "the Commission should not recommend the 'Forever Stamp' classification at this time." Carlson Initial Brief at 2. As explained below, Mr. Carlson's Forever Stamp misgivings are without merit.

It is clear that Mr. Carlson wishes the Board of Governors had authorized and the Postal Service had proposed an alternative Forever Stamp concept, one with a purpose broader than increasing convenience for senders of basic First-Class Mail letters after an omnibus rate change. He clearly prefers what could fairly be described as *Forever Postage*, a stamp which would be intended for use on all classes of mail at a postage value equivalent to the basic First-Class Mail letter rate prevailing at the time of use. His proposed changes to DMCS § 241 reflect as much.

In Mr. Carlson's view, such a material modification of the Postal Service's Forever Stamp proposal should be recommended regardless of whatever the financial consequences to the Postal Service might be. The Postal Service submits that revision of the Forever Stamp concept -- which is intended to benefit basic rate First-Class Mail users -- to the much more expansive notion of *Forever Postage*

intended to benefit users of all mail to which stamps may be affixed -- is a matter that merits very careful study and an informed judgment, as opposed to mere wishful thinking. The Board of Governors has directed postal management to proceed cautiously in this area. The Postal Service seeks the Commission's approval of a classification consistent with the Board's directive. Mr. Carlson's arguments summarily dismiss any notion that actual use and administration of the Forever Stamp proposed by the Postal Service should inform any decision to significantly expand its intended purpose. As the entity that would bear the burden of administering the Forever Stamp, as the entity that would endure any financial risk associated with its use and/or misuse, the Postal Service, understandably, has a different view.

After reviewing the Postal Service's proposed Domestic Mail Manual language reflecting its intended implementation of DMCS § 241, Mr. Carlson argues at page 4 of his Brief that:

Now the Postal Service's proposal is aligned with . . . [his]. Why the Postal Service does not believe that . . . [his] DMCS language is superior to the language it has proposed is unclear.

Mr. Carlson misses the point. The two proposals clearly are not aligned. The distinction between a Forever Stamp and *Forever Postage* is not insignificant. Concurrence with Mr. Carlson's proposal that the intended use of the Forever Stamp be unlimited from the outset would require the Postal Service to hope that the yet unknown financial consequences of such an expansion are not so adverse as to require a restraining classification change in the future. If such a change is deemed necessary, it would require re-educating the mailing public so that it "un-learned"

Forever Stamp uses that once were explicitly encouraged. Enforcement of a modified use policy, if deemed necessary, would surely undermine the goodwill generated by the initial policy. At a time when such long-term issues need not be decided, the Postal Service -- as reflected in its proposed DMCS § 241 -- prefers to retain the ability to make an informed long-term judgment regarding "liberalization" of the intended purpose of the Forever Stamp. Should the Postal Service's proposed Forever Stamp classification be adopted and experience suggests a future change in the direction of liberalizing its intended use, the Postal Service would be in a position to make an informed, less risky judgment about what additional consequences it was ready to assume, when it was ready to assume them, and could request that a DMCS change be approved and implemented without squandering customer goodwill.

At page 10 of his Initial Brief, intervenor David Popkin bristles at the notion that the Postal Service will merely *tolerate* uses of the Forever Stamp for purposes other than the for payment of initial-ounce First-Class Mail letter postage. However, the concept of such tolerance is not new. The Postal Service *tolerates* the use of Priority Mail flat rate stamps affixed to Parcel Post and Express Mail packages which are presented for mailing. These stamps have a rate category specific purpose. They get used for other purposes. Such other uses are *tolerated* by the Postal Service at the face value of the stamp, similar to the way in which the Postal Service proposes that the use of Forever Stamps will be *tolerated* on Parcel Post and Express Mail and Priority Mail, and be given credit at the prevailing First-Class Mail letter rate at the time of use.

Mr. Carlson's proposed DMCS language is consistent with the Postal Service's interpretation of its own DMCS § 241 proposal only insofar as both proposals intend to credit users of Forever Stamps with full postage value equivalent to the basic First-Class Mail letter rate at the time of use, when the stamps are affixed to mail as payment for other than the basic rate First-Class Mail postage. While limiting the intended purpose of the Forever Stamp in its proposal, the Postal Service recognizes that there will be a postal customer learning curve. On balance, the Postal Service has determined, as a matter of customer goodwill, that it would rather tolerate Forever Stamp uses other than the one which is intended, and reinforce its public information and educational efforts to minimize such use, rather than penalize mailers whose application of the stamp is not consistent with its intended purpose. Considerations of administrative ease also compel the Postal Service to adopt a policy under which all Forever Stamps of a particular vintage are treated equally by customers, acceptance clerks, revenue-protecting letter carriers, and postal revenue data collection personnel.

At page 155 of its Initial Brief, the Office of the Consumer Advocate expresses concern that if postal window clerks and letter carriers are not sufficiently aware of postal policy on "tolerated use" of the Forever Stamp, mail could be rejected or refused pickup. Not to diminish the legal significance of the Domestic Mail Classification Schedule, but the reality is that the postal window clerks and carriers rely primarily, if not exclusively, on the text of the implementing regulations in the Domestic Mail Manual for resolving rate and classification issues. No party has argued that the proposed DMM language is unclear or that it is inconsistent with

the proposed DMCS. And, when the proposed DMM language unambiguously and succinctly states the intended purpose of the Forever Stamp and how other uses are to be tolerated, and will serve as a core training guide, there is no basis for arguing that window clerks and letter carriers will be confused or take action that will frustrate customers.

The Postal Service does agree with Mr. Carlson that “the Commission should recommend DMCS language that clearly articulates the parameters of the “Forever Stamp” proposal” See Carlson Initial Brief at 4. The Postal Service submits that it has clearly articulated those parameters in its proposed DMCS § 241: the stamp is intended as payment of postage for the initial ounce of a First-Class Mail letter.¹² As is the case for countless other classifications and rate categories, the Postal Service proposes to leave the details of implementation and enforcement, including policies related to other uses of the Forever Stamp, to the more commonly accessed and more widely disseminated implementing regulations in the Domestic Mail Manual and other guidelines that it may publish.

At page 4 of his Initial Brief, Mr. Carlson argues that, if the Commission adopts DMCS § 241 as proposed by the Postal Service, postal customers will be left to sift through the record of Docket No. R2006-1 to determine which uses of the

¹² And, as indicated, at p.191, n. 21 of the Postal Service’s Initial Brief, the Postal Service’s proposed policies regarding other uses have been published in the Federal Register and restated on the record in this docket. Any recommended decision adopting DMCS § 241 as proposed by the Postal Service is expected to be based on the implicit expectation that the proposed DMM policies will be implemented and that any subsequent prohibition or limitation on the use of the Forever Stamp requires an explicit DMCS change. The Postal Service fully recognizes that any attempt to later unilaterally prohibit a use that is either currently proposed to be intended or tolerated would only serve to generate unpleasant consequences that the Postal Service has every incentive to avoid.

Forever Stamp will be tolerated. Mr. Carlson strains to avoid any acknowledgment of the existence of the Domestic Mail Manual, its primacy as an interpretive guide to the DMCS, and the likelihood of its availability for reference by postal customers like himself. His argument is made all the more absurd by its premise that postal customers who purchase Forever Stamps from postal window clerks, and want to know how and when to use them, will research the Docket No. R2006-1 evidentiary record, rather than ask questions of those Forever Stamp-trained window clerks.

There is no denying that, because the Forever Stamp classification proposal was included in the Postal Service's request shortly before the request was filed, the refinement of implementation policy (which ordinarily plays out off-the-record) was observed through snapshots revealed during discovery.¹³ However uncertain the policy outcome may have seemed while it developed, that process has no impact on how the Forever Stamp would be presented and explained to the public on the basis of proposed DMCS § 241 and proposed DMM 604.1.10. The dust has settled. The road ahead is clear.

b. Implementation date concerns are misguided.

Speaking of the road ahead, the concerns of Messrs. Carlson and Popkin about the implementation date and the sale of Forever Stamps are misguided as

¹³ Parties who characterize the Postal Service's policy refinements as "relenting" to external pressure, as Mr. Popkin does at pages 7-8 of his Initial Brief, appear to forget that the Postal Service made clear from the outset that it intended to give value to uses of the Forever Stamp that were beyond its intended purpose. See, e.g., the response to interrogatory DBP/USPS-340 (revised October 11, 2006). The Postal Service responded to discovery by giving updates of its internal deliberations while they were underway until final policy determinations emerged. The final result had been championed internally within the Postal Service from the start, but required consensus among numerous stakeholders before it could be ratified and published in the draft DMM regulations.

well. Assuming the approval of DMCS § 241 as proposed by the Postal Service, and the selection of an implementation date by the Board of Governors, the terms of proposed DMCS § 241 become effective on that implementation date. If that date coincides with the implementation date for the new basic First-Class Mail letter rate, then -- under the terms of DMCS § 241 -- the stamp which assumes the designation of the Forever Stamp on that date must be sold at the prevailing rate -- the same rate as the new basic First-Class Mail letter rate stamp. This, the Postal Service intends to do.

In lieu of testimony, Mr. Popkin argues that the Postal Service should do what he says Canada Post is about to do, sell its inaugural version of its Forever Stamp at the current basic letter rate before new rates take effect next year. Popkin Initial Brief at 9. However, there is no record evidence of whatever the financial impact may be to Canada Post or how it might translate on the basis of American postal economics and finances.

Mr. Carlson argues that the Postal Service cannot sell Forever Stamps before the prevailing basic First-Class Mail letter rate changes to the Docket No. R2006-1 rate implemented by the Board of Governors, unless it sells those stamps during that period at the current 39-cent prevailing rate. Mr. Carlson's burning desire to purchase Forever Stamps at 39 cents appears to be based upon the premise that proposed DMCS § 241 would take effect before any other changes to the current DMCS, including any change in the currently prevailing 39-cent First-Class Mail letter rate. His argument overlooks the fact that the Postal Service is authorized to sell postage stamps of a given design at any denomination or designated value

today, including a denomination or value that may be equivalent to any future basic First-Class Mail letter rate, as long as that denomination or designated value is made clear to the public.

The Postal Service submits that it is authorized to inform the public, before the implementation date of any Docket No. R2006-1 rates and classifications, that certain existing postage stamps will take on a designated value or significance when Docket No. R2006-1 rates and classifications become effective. Whatever designation such stamps may or may not have had before Docket No. R2006-1 rates and classifications take effect, they may be given specific designations the instant that those new rates and classifications are implemented.

For purposes of the following discussion, all case outcomes and dates are illustrative and hypothetical. Assume a March 2, 2007 recommended decision in this docket, which approves the Postal Service's First-Class Mail rate and classification proposals, Forever Stamp included. It seems beyond dispute that the Postal Service could choose the next day to begin selling a non-denominated postage stamp valued at the recommended 42-cent rate, similar to its long-standing practice, without indicating at that time whether that stamp might later take on a special status. Also assume a decision by the USPS Governors in April 2006, approving that recommended decision and the establishment of a May 6, 2006 implementation date by the Board of Governors.

Under this scenario, the DMCS § 241 classification language does not take effect until May 6, 2006. Thus, no stamp has a Forever Stamp status conferred on it by that provision of the DMCS until May 6th, whether that stamp is sold for the first

time on May 6th, the day before, a week before, or a month before. Assume also that, soon after the Governors decision, the Postal Service announces that a particular 42-cent non-denominated stamp currently available for purchase will -- on May 6th -- take on the status of the Forever Stamp, when DMCS § 241 takes effect. From May 6th forward, the prevailing First-Class Mail letter rate would be 42 cents. And, consistent with then newly effective DMCS § 241, the newly anointed Forever Stamp will be sold at that prevailing rate. The Postal Service and the public have managed to adapt to the wrinkle introduced by the Breast Cancer Awareness semi-postal stamp. There is no reason to suppose that the Forever Stamp, as proposed by the Postal Service, will generate any unmanageable complications.

The Postal Service does not read 18 U.S.C. § 1721 in conjunction with proposed DMCS § 241 as barring it from declaring -- before May 6th -- that a particular non-denominated stamp with a value equivalent to the Forever Stamp rate, will serve as the Forever Stamp effective May 6th.

In conclusion, it is hoped that the Commission will avoid a Forever Stamp recommendation at odds with the Postal Service's modest proposal, which is well-supported on the record and enjoys the support of the Board of Governors.

9. GCA's nonmachinable surcharge testimony proves that nothing plus nothing equals nothing.

a. There is no need to rebut the absence of substance.

GCA argues in its Initial Brief at pages 73-76 that the testimony of witness Liss (GCA-T-4) should be accepted by the Commission because it stands un rebutted in this case. However refreshingly different the subject matter of witness Liss' testimony may be, GCA's argument fails to recognize that the testimony offers

nothing of consequence to the record, and that there is no need for rebuttal testimony on an issue that is so plainly immaterial to ratemaking. Nevertheless, GCA attempts to persuade the Commission that witness Liss demonstrates “two propositions of basic importance” in this docket: (1) that the square shape is highly favored because of its distinctive and aesthetically attractive design; and (2) that a surcharge for square cards could lead to a reduction in mail volume.

The first proposition has been shown to be hollow, as even witness Liss admits that the rectangular shape is also considered aesthetically attractive and an important shape in the history of architecture and design. Tr. 28/9498-9500.¹⁴ Thus, GCA is left to argue that square cards are favored simply because they are “distinctive.” Surely, there are many mailpieces of different shapes and sizes that are also considered “distinctive,” but are justifiably subject to additional postage because of their unique size or shape.

Witness Liss’ second proposition also adds nothing of consequence to the record, as it is simply a recognition that the demand for square cards is downward-sloping. Witness Liss’ testimony offers no quantitative measure of this demand, or the own- or cross-price elasticity for square or rectangular cards. For these reasons, the Commission should ignore witness Liss’ testimony on the aesthetics of square cards.

- b. The GCA square card experiment adds no value to the record.

¹⁴ Similarly, GCA’s suggestion that the Commission should rely upon the outcome of the LOUIE Awards should be ignored. GCA Initial Brief at 75.

In its Initial Brief at page 79, GCA argues that the object of GCA witness Morrissey's (GCA-T-3) square envelope test "was to examine the degree to which square envelopes can not be processed on Postal Service automated cancellation and sorting equipment." However, as Postal Service rebuttal witness Laws (USPS-RT-16) explains, witness Morrissey's experiment did not achieve its objective. It cannot be used to show the *degree* to which square envelopes are processed on Postal Service equipment, because it does not show:

- the percentage of test pieces that were rejected on the first pass on an Automated Facer Canceller System (AFCS); or
- the number of pieces that required manual facing and/or one or more additional passes on an AFCS or other piece of canceling equipment;
- the number of pieces I.D. tagged on an AFCS or DBCS, but rejected within subsequent automated mail processing steps due to low aspect ratio and the propensity of pieces to tumble; or
- the number of pieces barcoded on a DBCS, but rejected within subsequent automated mail processing steps due to low aspect ratio and the propensity of pieces to tumble; or
- the number of pieces that were successfully processed throughout the entire automated mailstream without the manual handling of rejects.

Tr. 21/7780-81. The GCA experiment only shows how many envelopes eventually received a machine-printed cancellation mark or a manual cancellation mark, and an orange fluorescent I.D. tag. Yet, GCA witness Morrissey uses these observations to state that square cards display a much higher *degree* of machinability than flats, entail "some" greater need for manual cancellation, an "immaterial" amount of additional sorting, and "are both cancelled and processed as letters – apparently with a favorable if not ideal level of success as regards machine sorting." *Id.* at 8, 9.

The GCA experiment does not support any of these assertions. Accordingly, it provides no basis for the Commission to recommend modification of the Postal Service's proposed rate structure for single-piece First Class Mail or retention of the

current nonmachinable surcharge for low-aspect-ratio pieces, such as GCA contends. *Id.* at 9. The GCA experiment does *not* show that square envelopes display a much higher degree of machinability than flats; it does not demonstrate whether the nonmachinable surcharge applicable to square envelopes should be maintained; in fact – it does not show anything of value at all.

GCA argues that the Postal Service suggests that the GCA experiment should be discounted “because it did not embody procedures impossible to carry out within the statutory time for a rate case.” GCA Initial Brief at 80. This is entirely incorrect. The GCA experiment should be discounted because it does not show what GCA claims that it shows. To establish the degree to which square envelopes can or cannot not be processed on Postal Service automated letter mail processing equipment, one would have to conduct an observed test of the transportability of such mail pieces as they move on either postal canceling and/or sorting equipment.

As the Commission will recall from an earlier controversy surrounding the nonstandard/nonmachinability surcharge, the mail transport systems on currently operational letter cancellation and sorting equipment have been designed on the basis of the long-standing definition of what constitutes a standard-size machinable letter shape. See Docket No. R2000-1, USPS-RT-15 at 31, 35. GCA argues at page 80 of its Docket No. R2006-1 Initial Brief that it would be necessary to observe automated cancellation *and* sortation to assess the machinability of low-aspect-ratio pieces. However, given the commonality of transport mechanism specifications of cancellation and sortation equipment, as discussed in the above-

referenced Docket No. R2000-1 rebuttal testimony, it is only necessary to observe one or the other to assess machinability.¹⁵

Interestingly enough, such a comprehensive and scientific test was in fact conducted *at the request of GCA* by USPS Engineering. GCA correctly observes that the USPS Engineering test examined the culling and cancellation operations, and provides no data regarding automated sorting. GCA Initial Brief at 80, n. 59. But GCA misses the point. Transportability of mail pieces on automated equipment belts and trays -- either before and after an attempt is made to cancel postage or to read the address, or before the piece reaches a sortation bin -- is what determines machinability, not whether the piece manages to remain stable during the millisecond during which postage is being canceled or the optical character reader or barcode sorter are attempting to resolve an address or spray a barcode or I.D. tag. As can be seen at Tr. 21/7692-98, the USPS Engineering test provides an extensive discussion of the limited ability of postal mail processing equipment transport systems to successfully handle square envelopes. Why GCA would choose to disregard the results of this test, not bring these test results of the Commission's attention, or even acknowledge their existence, and instead hastily construct a test which shows nothing of import, remains a mystery.

¹⁵ Also, contrary to the assertion at page 80 of GCA's Initial Brief, geographic scope would not be necessary, since most mail processing plants throughout the nation cancel and process such letters on the same equipment.

B. Standard Mail Rate Design Issues

1. Intervenors' attempt to disparage the Postal Service's Standard Mail rate design for NFMs and parcels fails to diminish the need to properly categorize and appropriately price these pieces.
 - a. There's a pachyderm in the living room: What intervenors do not dispute about the Standard Mail rate design for NFMs and parcels.

In the briefs that challenge the Postal Service's rate design for Standard Mail NFMs (not flat-machinables) and parcels, intervenors ignore the proverbial pachyderm in the living room and even seem to accept that it is there. The intervenors implore the Commission to grant greater rate mitigation. They vigorously attack the reliability and relevancy of the cost, volume and revenue data that support the rate design.

None of the intervenors' briefs contest the Postal Service's proposal to reclassify nonletters into flats, NFMs and parcels. They do not dispute that pieces to be reclassified as NFMs and some parcels currently enjoy the relatively low automation flats rates even though they are processed and/or delivered as parcels.¹ No intervenor questions the basic fact that pieces processed and/or delivered as parcels cost significantly more than pieces processed as flats. They do not disagree that these pieces currently do not adequately cover their costs, and that the cost burden is shared disproportionately by the much higher volumes of auto flats.² Nor do they dispute that NFMs cost more to process and deliver than flats, and parcels cost more than NFMs.

¹ In fact, when PSA and PostCom assail the NFM and parcel cost data, they cite the mismatch between revenues recorded in the RPW system and the costs recorded in the IOCS system. See Initial Brief of the Association for Postal Commerce and the Mailing and Fulfillment Service Association ("PostCom Brief") at 26-27; Initial Brief of Parcel Shippers Association ("PSA Brief").at 26-27. See *also* discussion *infra*.

Taken together, that's quite a pachyderm that intervenors ignore when presenting their arguments.

Instead, intervenors clamor for further rate mitigation, claiming rate shock and that the data that underlies the Postal Service's rate design is unreliable or irrelevant. Their arguments fail.

- b. Although intervenors do not deny that the NFMs and parcels should be rate categories separate from flats, they ignore this reality when arguing rate impact.
 - i. In pursuing lower percentage increases, PostCom, PSA, and DMANF inappropriately use the current price of auto flats as the main reference point when setting NFM and parcel rates.

PostCom, PSA and DMANF³ all claim rate shock when discussing the proposed NFM and parcel rate structure. PostCom Brief at 18; PSA Brief at 24-25; DMANF Brief at 9-10.⁴ They argue that the Commission should greatly mitigate Postal Service proposed rates. *Id.* PSA recommends that the rates should be limited to 30 percent increase over the current auto flat rate (PSA Brief at 24) and PostCom recommends that the mitigation should be close or equal to the non auto flat rate, an approximately 37% increase. PostCom Brief at 18.⁵ All argue that the Commission's exclusive

² No intervenor has challenged Postal Service witness Kiefer's statement that NFMS and parcels do not currently adequately recover their costs. See Rebuttal Testimony of witness Kiefer (USPS-RT-11 at 6, 7).

³ DMA Nonprofit Federation ("DMANF").

⁴ DMANAF bases its argument for rate mitigation, in part, on the fact that the Postal Service rate design does not reflect actual processing cost of Nonprofit Standard Mail. The argument is surprising since nonprofit costs are by law irrelevant to the rate design. Instead the rates for nonprofit are set to yield per-piece revenues that are 60 percent of commercial revenues.. See 39 U.S.C. § 3626(a)(6). DMANF's argument should be disregarded

⁵ The Postal Service cannot help but note that the request for the Commission to mitigate rate increases to "only" 30 to 37 percent is a tacit admission by PostCom and

reference point for developing the rate design should be the current auto flat rate and any increase above that rate should be limited.⁶

The intervenors' approach to rate design for the NFMs and parcels contrasts sharply with Postal Service's, as demonstrated through the direct and rebuttal testimonies of witness Kiefer. He based the rates on a reasonable consideration of available cost data which reflect the processing and delivery costs of NFMs and parcels.⁷ USPS-T-36 at 23. The cost data for the mail flows clearly show that NFMs and parcels should have higher rates that reflect their processing and delivery handlings. USPS-RT-11 at 6, 7. See also USPS-LR-L-45. He then took a number of steps to significantly mitigate the rate impact. USPS-T36 at 23-24. While the intervenors do not contest that NFMs and parcels follow a distinctly different and far more costly mail flow than flats, they invite the Commission to simply cap the increase relative to the price of flats without consideration of the costs. The Postal Service respectfully requests that the Commission decline the invitation.

- ii. PostCom's brief lacks support for its proposal to set NFM rates at the non-automation flat rate which is founded on confusion about the terms "non-automation" with "non-machinable" and the related mail flows.

PSA that the cost data supports price increases that are even higher than their proposals.

⁶ As an alternative to request for mitigation from the auto flat reference point, PostCom also proposes that the NFMs rates be set at the non auto flat rate. See PostCom Brief at 18.

⁷ Witness Kiefer used the non machinable parcel costs to develop NFM mail processing costs because of the similarity of mail flows. See USPS-T36 at 23.

PostCom's belief that it would be more reasonable for NFMs to pay the non-automated flat rates, rather than the proposed NFM rates,⁸ simply indicates that PostCom does not understand the difference between the words "non-automation" and "non-machinable." The reason the non-automated flats rates are 40% lower than the proposed rates for NFMs is because a non-automation flat is a flat that is not barcoded, but can still be processed in large part on the AFSM-100 flats sorting equipment and be delivered in flats bundles within delivery. An NFM (non flat-machinable) cannot or will not be processed on flats sorting equipment (hence the name) and is seldom delivered as a flat.⁹ If PostCom had understood these definitions, it would not have made the statement that "as a result of the formal elimination of the caseability requirements and the retention of the deflection test, there is no discernable difference between a bundle of non-automation flats and a bundle of non-machinable NFMs (less than 6 ounces) from either a cost or operational perspective,"¹⁰ because this statement makes no sense at all.

- iii. Function should not follow form: DMANF's admonition that the Postal Service should deploy processing machines that accommodate a wider array of flats would promote inefficiency and higher costs.

DMANF attacks the recategorization efforts by assailing the narrowing of the definition of auto flats to those pieces that can be most efficiently processed on the "new" flat sorting equipment rather than designing equipment that can sort more types

⁸ PostCom Brief at 18.

⁹ Since NFMs are typically small, many of them are also not machinable on the Postal Service's Parcel Sorting Machines either.

¹⁰ *Id.* at 29

of flat mail. DMANF Brief at 4, 10. It objects that pieces that cannot be sorted on the “new” equipment should not have to pay a higher price.

DMANF’s argument would upend one of the basic tenets of postal rate design embraced by both Commission and the Postal Service—that rates should promote the efficient handling of mail. As witness McCrery testified, the AFSM 100 (presumably the “new” flat sorting equipment that DMANF scorns) is vastly superior to the UFSM 1000. USPS-T-42 at 14 and 15. Although the UFSM1000 can handle a wider variety of flats, it does so at a far less efficient rate. *Id.* To design flat rate eligibility on the basis of a far less efficient mail flow would only increase the cost of flats to the detriment of all flat mailers, including DMANF’s constituency.

- iv. PostCom mischaracterizes witness McCrery’s reliance on testimony from prior cases about the incompatibility of NFMs with existing processing equipment.

In its initial brief, PostCom asserts “Moreover, Mr. McCrery’s explanation of the alleged incompatibility of NFMs with existing processing equipment (see USPS-RT-14 at 10) finds no support in the testimony from the earlier cases upon which he relies.” PostCom Initial Brief at 24, fn. 14.

This statement is incorrect. On page 10 of USPS-RT-10, Postal Service McCrery is continuing a discussion on how the 1998 FSM 1000 automation flat definition resulted in mail pieces being categorized and prepared in a manner that is inconsistent with how such pieces were being processed – causing significant negative impacts on postal operations. To support his statement, he refers to the earlier testimonies of Postal Service operations witness Kingsley. Witness Kingsley’s statement from Docket No. R2001-1, describing the reasons why NFMs are seldom actually processed on the FSM

1000, and the Postal Service's intent to address the underlying classification problem, is reproduced below:

Prior to implementation of the residual shape surcharge, many, if not all, of 10 these pieces were prepared as machinable parcels. As machinable parcels, these pieces were processed through the Bulk Mail Centers on parcel sorters and sorted to 5-digit locations. These parcels are now "disguised" as packages of flats and many of them can no longer be processed directly to 5-digit on BMCs' parcel sorters. To compound the matter, plants generally do not sort parcels on the FSM 1000, and therefore must sort these pieces manually or on the SPBS to the 5-digit level. The irony of this situation is that mailers are paying less postage but their pieces are usually incurring more handling. The reasons that these parcels are not sorted on the FSM 1000 vary, but the primary ones are the incompatibility with the flats mail stream and the impact on downstream delivery operations. It is difficult to sort and handle the smaller, thicker, more rigid parcels with larger, thinner, more flexible flats. Parcels also lose orientation when sorted into flat trays and can fill a tray with only a few pieces if they fall on end. This necessitates very frequent sweeping and increases flat tray usage. Although these pieces may be prepared as packages of flats, employees in both processing and delivery offices, for the most part, continue to treat and handle them as parcels. While this expanded definition may reflect the physical capabilities of the FSM 1000, it is not congruent with the manner in which field sites are actually using the machine. Future Postal Service efforts are likely to address this anomaly.

Docket No. R2001-1, USPS-T-39, at 19

- c. PSA's and PostCom's attack on the reliability and relevancy of the underlying data has no merit.

PSA and PostCom also support their rate mitigation argument by denigrating the quality of the data that witness Kiefer relied upon when he designed the NFM and parcel rates. They argue that there is no CRA cost data for NFMs. Instead these pieces suffer from a data mismatch: these pieces are counted as parcels in IOCS and flats in RPW. PostCom Brief at 26-27; PSA Brief at 26-27. They also disparage witness Miller's cost data which "modeled the mail processing costs for [NFMs]" but were based upon questionable mail flows. PostCom Brief at 26; PSA Brief at 27.

Furthermore, they also state that witness Loetscher's Non-Letter Redefinition Study (USPS-LR-L-33) is flawed, its results are therefore unusable and irrelevant, and witness Kiefer's rate design is suspect because it relied on the study's results. PostCom Brief at 19-25; PSA Brief at 28.

- i. Contrary to intervenors' contention, lack of CRA data should not be used to undermine the NFM rate design.

The Postal Service admires the gutsiness (and circularity) of PSA and PostCom's argument that the lack of CRA data should lead to rate mitigation. The argument boils down to this: Because of miscategorization of NFMs, there are no CRA data for NFMs. And because there is no CRA data, there are no "reliable" cost data. And because there are no "reliable" cost data, the NFMs should not have to pay rates that adequately cover their processing and delivery costs. And they have not been adequately covering the costs because they have been miscategorized.

As discussed below and in the Postal Service's Initial Brief,¹¹ reliable cost data supports the Postal Service NFM rate design. The Postal Service has already taken into consideration the quality of the available data when it greatly mitigated the rates. In any event, those who benefited from the misclassification should not now be able to use the mismatch in the data systems to support further unwarranted mitigation.

- ii. Witness Kiefer appropriately relied on witness Miller's library reference to develop his rates for NFMs.

PSA and PostCom's principal criticism of witness Miller library reference, USPS-LR-L-45, is that the accuracy of his modeled cost estimates for NFMs is flawed because

¹¹ See Postal Service Brief at 311 to 314.

it is based upon mail flows that, according to witness McCrery, cannot be mapped until the Postal Service issues its final DMM regulations on the mail preparation requirements for NFMs. PostCom Brief at 26; PSA Brief at 27. As a preliminary matter, both PSA and PostCom make the same mistake: witness Miller did not model the cost estimates of NFMs. His library reference was designed for another purpose. Witness Miller constructed USPS-LR-L-45 to simply show that when a flat-shaped mail piece is not processed in the flats mail stream (for example, because it is too thick, or too rigid; see USPS-T-36 at 21), additional costs are incurred. On that point, there can be little doubt. Parcels cost more than NFMs, which cost more than flats. The results show that as a mail piece moves from a strictly flats mail flow to a hybrid mail flow to a parcel mail flow, the mail processing unit cost estimates continually increase. Contrary to what PostCom and MFSA would have the Commission believe, USPS-LR-L-45 does contain reliable mail flow data.

PostCom is correct in that the percentages of NFMs that are processed in each mail flow are unknown. That information could be used to develop an aggregate NFM cost estimate using the data in USPS-LR-L-45. This library reference, however, was not created for that purpose. But, witness Kiefer did not rely on aggregate cost estimate of NFMs to design his rates. Instead he used the costs of estimates from non-machinable parcels because NFM mail flows are expected to parallel non-machinable parcel mail flows. USPS-T-36 at 23. Witness Kiefer obtained the mail processing cost of non-machinable parcel from witness Miller's cost study, USPS-LR-L-45. See WP-STDREG-0621, Inputs worksheet, where the costs of non-machinable parcels and hybrids (NFMs) are identical.

It should be noted that witness Miller did not receive one interrogatory concerning USPS-LR-L-45 in this case. It is surprising that PostCom has waited until the briefing stage to criticize the contents of USPS-LR-L-45. The Commission should ignore those comments.

- iii. Witness Kiefer appropriately relied on witness Loetscher's study for volumes, not for rate design.

PostCom argues at length that the flaws in witness Loetscher's Non-ECR Nonletter Redefinition Study (USPS-LR-L-33) tarnish the rate design and, therefore, additional rate mitigation is warranted. The study's purpose was to estimate the test year volume of flats, NFMs, and parcel pieces, volume that currently is in the nonletter category. In particular, PostCom cites the differences between the study's definition of the new classifications and the proposed preparation rules for the DMM in a pending Federal Register Notice. PostCom's Brief boils down to trying to attack the rates because it finds that the study's volume (hence, revenue) estimates might be less than perfect: "The fundamental problem in introducing different preparation rules...is that the Postal Service introduces further migration of volume among NFM presort levels, rendering the NFM revenue estimates even more unreliable and the rates inexplicable." PostCom Brief at 27-28.

PostCom's reasoning repeats the same mistake that it made in its argument about the use of witness Miller's library reference, discussed above. Had the Postal Service derived a unit cost estimate for NFMs, it would have needed a volume estimate. But Postal Service did not develop a unit cost estimate of NFMs. Instead, it relied on separate cost data from nonmachinable parcels. See discussion *supra*. Therefore, there is no direct link between the study's results for NFM volumes and witness Kiefer's

rate design. Contrary to PostCom contention, any minor inaccuracies that might exist in the study's volumes are not material to the validity of the rate design.

Witness Kiefer used witness Loetscher's nonletters redefinition study to develop volumes by new rate category for the purposes of estimating the revenues generated by his overall rate design, but not to design the rates. See USPS-LR-L-36, WP-STDECR.XLS, WP-STDECR-26); Tr. 5/1030-1, 1016. Thus, even if witness Loetscher's study differs in some minor ways from the proposed implementation rules, these differences would only affect the projected revenues from witness Kiefer's NFM rate design, and would not in any way invalidate his proposed rates.

iv. Witness Loetscher's Non-ECR Nonletter Redefinition Study is not flawed.

The Non-ECR Standard Mail Non-Letter Redefinition Study (USPS-LR-L-33), sponsored by witness Loetscher (USPS-T-28) is not flawed. This study was intended to get reasonable estimates of the volumes of pieces currently categorized as flats that are processed and/or delivered as parcels, and it achieved its purpose. It produced unbiased estimates for the classifications it was designed to measure. To the extent that proposed definitions differ from those used in the study, this should not discredit the study.

On pp. 21-22 of its brief, PostCom embarks on an extensive argument about differences between the proposed definitions as they exist today and when the study was done. There are, however, only two differences.

The first difference is the maximum rigidity test. The Non-Letter Redefinition study used the following definition:

When a flat-sized mail piece is placed on a flat surface and extended unsupported 5 inches off that surface, the corner opposite the bound, folded, or

final folded edge must be able to be deflected at least 2 3/8" when manual force is applied without damage to the mail piece. If bending a box or sleeve leaves a crease in the mail piece, the piece fails this test. If a piece is marked, "do not bend" or something similar, the piece also fails this test. If a piece is less than 5 inches long, the piece is only extended as far as practical before the test is applied.

The proposed definition from Federal Register #71 on September 27 is:

a. For pieces 10 inches or longer:

1. Place the piece with the length perpendicular to the edge of a flat surface and extend the piece 5 inches off the surface.
2. Press down on the piece at a central point about an inch off the edge of the surface, exerting a steady pressure.
3. The piece is flexible if it can bend at least 2 inches without being damaged.

b. For pieces less than 10 inches long:

1. Place the piece with the length perpendicular to the edge of a flat surface and extend the piece one-half of its length off the surface.
2. Press down on the piece at a central point about an inch off the edge of the surface, exerting a steady pressure.
3. The piece is flexible if it can bend at least 1 inch without being damaged.

For practical purpose, these tests are not significantly different. Both texts extend the piece 5 inches off of a surface. The study definition measures the flexibility by taking the corner of the piece hanging off the edge to see if it can be bent 2 3/8 inches without damage. In the proposed definition, pressure is applied in the center of the piece 1 inch from the edge of the surface and must be flexed either 1 or 2 inches, depending on the length.

PostCom, in its brief, mentions several times that the flexibility is measured at a 'central point'. It fails, however, to mention that the definition says the 'central point' is

one inch off the edge of the surface, which is not much different than bending the corner.

The second distinction between the Federal Register and study definitions is that the Federal Register definition includes the following deflection test (from DMM § 301):

3.3.4 Flexibility

An automation flat-size mailpiece must be flexible (see 1.4) and must meet maximum deflection standards. Test deflection as follows:

- a. For pieces 10 inches or longer:
 1. Place the piece with the length perpendicular to the edge of a flat surface and extend the piece 5 inches off the surface.
 2. The piece is automation-compatible if it does not droop more than 4 inches.

- b. For pieces less than 10 inches long:
 1. Place the piece with the length perpendicular to the edge of a flat surface and extend the piece one-half of its length off the surface.
 2. The piece is automation-compatible if it does not droop more than 2 inches.

[Delete 3.4 to remove the standards for UFSM 1000 flats. Renumber 3.5 through 3.9 as new 3.4 through 3.8.]

This definition would mean that flimsy pieces would be included as NFMs under the Federal Register definitions. Flimsy pieces were not considered NFMs in the Non-ECR Standard Mail Non-Letter Redefinition Study. However, a mailpiece would have to be *extremely* flimsy to be disqualified as automation-compatible. A typical single sheet of paper over 10 inches in length would not fail this test. Indeed, the proposed language is generous. Under current DMM § 301.3.3.4, there is a deflection test under which a piece cannot deflect more than 1 3/4 inches (if the piece is less than 1/8 inch thick) or 2 3/8 inches (if the piece is from 1/8 to 3/4 inch thick).

PostCom argues that the caseability requirement has changed between the Federal Register and study results. This is not true. Caseability is a distinction between Hybrid Flats and Hybrid Parcels but these two categories are combined to create the NFMs rate category so it is irrelevant.

In addition, footnote 10, which appears at page 20 of PostCom's Brief, is simply wrong (as is footnote 13 at page 23). In it, PostCom asserts that "the Non-Letter Redefinition Study apparently fails to characterize the full range of Standard Mail non-letters . . . apparently omit[ting] (1) mailpieces that are not caseable (e.g., that are rigid with one dimension greater than six inches), but are less than .75 inches thick); and (2) mailpieces that are caseable, but are more than .75 inches thick.

These two examples were included in the study sample. The response to POSTCOM/USPS-T28-3b, filed on August 29, 2006, outlines the categories where these pieces would fall, depending on other characteristics. It is interesting to note that PostCom did not designate this response for inclusion in the record, but attempts to use the absence from the record to their advantage.

Furthermore, the study was NOT a snapshot on one day. Forty-nine delivery units were sampled for one day each from January 7 through January 31 2005. Tests were taken on all delivery days from Monday through Saturday. USPS-LR-L-33 page 6 (The date of the test is included in columns 18-23 of the file cleandata_final.prn, submitted in USPS-LR-L-33). The survey sample includes 1,743 Non-ECR non-letter Standard pieces and produces unbiased results with a reasonable level of confidence.

PostCom complains about what the study did not measure, specifically processing method and distribution across presort or drop entry level. PostCom Brief at

24-25. The study, however, was designed to measure the physical characteristics of Standard Mail non-letter pieces. The determination of how and why individual pieces are processed is made by Operations and Engineering personnel. The purpose of the study was to provide such personnel with estimates of the proportion of non-letter pieces with the physical characteristics that they have determined are relevant to the efficient processing of this mail. The fact that the study did not present estimates on how the pieces were processed is irrelevant for evaluating the study and its intended purpose.

Likewise, in the study, pieces were measured at destination. As such, it was not possible to measure the presort or dropship characteristics of the sampled pieces. The presort and dropship characteristics of NFM pieces were imputed using the presort and dropship distributions of pieces that most closely resemble the characteristics of NFMs (USPS-LR-L-33 at page 13). Although this methodology does not explicitly measure the presort and dropship characteristics of NFM mail, it provides the best possible estimates of these characteristics.

Accordingly, the study produced unbiased estimates for the categories as they were defined at the time. In essence, PostCom's complaints are analogous to criticizing a refrigerator because it does not brew coffee.

Finally, the practical consequences of PostCom's criticism of the Loetscher study are significant and seem to have eluded PostCom. PostCom would have the Commission deem a study of volumes to be non-credible and therefore irrelevant because the Postal Service, in its normal course of business and almost a year and a half later, issues implementing regulations that differ slightly from the study parameters.

The corollary to this argument then is that the Postal Service must match its DMM to the study parameters. This would negate the ability of mailers and their representatives such as PostCom, from having input into the implementing regulations. PostCom has routinely taken the opportunity afforded through the notice and comment to impact implementing regulations in ways that benefit its members and the Postal Service. It strains credulity that they now would want such a rigid principle, that a study's results are invalidated if the DMM implementing regulations vary in any way. One can only surmise that it has not thought through the practical implications of its position.

2. Intervenors have failed to provide an adequate justification for diverging from the Commission's practice of not passing through 100 percent of Standard Mail drop-ship cost savings, nor have they justified expanding the size or scope of the Postal Service's proposed drop-ship discounts for parcels and NFMs.

PostCom and MFSA (hereafter "PostCom") in their joint initial brief argue that the Commission should set destination entry discounts for Standard Mail letters, flats and NFMs equal to 100 percent of the Postal Service's estimated cost savings per pound. PostCom Brief at 9-11. PostCom's argument is not adequately supported on the record.

PostCom cites witness Pursley's testimony (PostCom-T-2 at 3) as justification for increasing the drop-ship discounts. Pursley's own testimony recites the recent history of Commission decisions on this very subject.¹² In the last three omnibus rate cases, the Commission has recommended Standard Mail drop-ship discounts that never exceeded 85 percent of avoided costs.¹³ In contrast, the Postal Service's proposed passthroughs

¹² PostCom-T-2 at 3-4.

¹³ The Commission recommended passthroughs ranging from 73 to 78 percent in Docket No. R2000-1; 85 percent in Docket No. R2001-1; and 76 to 79 percent in Docket No. R2005-1. *Id.*

in this proceeding would range from 85 percent to 87 percent. *Id.* Thus a clear history has been established of less than 100 percent passthroughs for Standard Mail dropship discounts and the Postal Service proposal is consistent (albeit on the high side) of recent Commission recommendations. Therefore, the burden is on PostCom to establish compelling reasons why the Commission should depart from its past practice. PostCom fails to do so.

PostCom first argues that “both the Postal Service and the Commission have indicated their preferences for 100% passthroughs of avoided costs in determining destination entry rates, provided that such passthroughs are consistent with other pricing goals.” PostCom Brief at 9. By this sweepingly general statement, PostCom sweeps under the rug the plain fact that the Postal Service has generally proposed and the Commission recommended passthroughs less than 100 percent for these specific discounts.

The reasons for this deviation from 100 percent passthroughs for worksharing cost savings in this instance are well documented on the record. USPS-T-36 at 14, footnote 6; Tr. 5/912. The lower passthrough has been proposed and recommended because, under the Standard Mail rate design, pieces with weights below the break point weight (currently the vast majority of Standard Mail pieces) receive a discount that is calculated, not on the weight of the mail piece itself, but based on the break point weight, 3.3 ounces.¹⁴ To set the passthrough for such pieces at 100 percent of avoided costs for 3.3 ounce pieces would not pass through 100 percent of the true avoided costs

¹⁴ Standard Mail billing determinants for FY 2005 show that only about 18.1 billion out of 100.9 billion Standard Mail pieces are pound rated. The same data show that Standard

as PostCom would have us think. Rather it would pass through more than 100 percent of the true avoided costs.¹⁵ Of course, this would be fine with PostCom, but it doesn't square very well with PostCom's supposedly pure desire for 100 percent passthroughs for avoided costs. PostCom's proposal is self-serving, doesn't square with its proclaimed desire for 100 percent passthroughs, is inconsistent with the evidence on the record and with past Commission practice, and is based on no supporting evidence of its own. It should be rejected.

PostCom's brief also cites witness Glick's testimony that increasing the passthroughs would encourage palletization by maximizing the amount of mail prepared on destination pallets. Brief at 9. Witness Glick testifies that the Postal Service would like to have more mail on pallets. PostCom-T-1 at 3. This is true enough. Glick also cites Postal Service data that show that a higher percentage of drop-shipped mail is entered on pallets than non-drop-shipped mail. Id. at 3, fn. 3. In a classic example of post-hoc erroneous reasoning, PostCom's brief draws the conclusion, without any evidence whatsoever on the record, that because drop-shipped mail tends to be more highly palletized, more drop-shipping will produce more palletization. PostCom fails to show any causal link between the two phenomena: it could also be argued that mailers that have sufficient address density to palletize, also have sufficient mail to drop-ship. In other words, PostCom can point to no evidence that the 25 percent of Standard Mail that currently does not drop-ship would somehow find the added pieces to make up

Mail letters average 0.75 ounces per piece and piece-rated nonletters 1.88 ounces per piece. (USPS-LR-L-77, Standard_BDs_with RSS.xls, page G-5, P.5).

¹⁵ For that matter, given the low weight of letters, the Postal Service proposal may also effectively exceed 100 percent passthrough, but the PostCom proposal would

pallets of mail if only the drop-ship discounts were higher.¹⁶ More data is needed on the record before PostCom's supposed "palletization benefit" of increasing drop-ship discounts can be used to justify even greater passthroughs, especially given the other concerns about the passthrough with respect to the minimum-per-piece pricing structure. The record lacks any such data. PostCom's argument is without merit.

PSA also encourages the Commission to increase the drop-ship discounts proposed by the Postal Service, specifically arguing for higher DMBC discounts for parcels and enhanced drop-ship discounts for NFMs parallel to the enhanced discounts proposed by witness Kiefer for parcels. PSA Initial Brief at 29-30. Like PostCom, PSA has failed to adequately justify going beyond the Postal Service's proposals.¹⁷

PSA's brief offers no compelling rationale why the DBMC discount should be increased. It simply observes that witness Kiefer has not increased the drop-ship discount for DBMC parcels as much as for DSCF and DDU parcels. While this is an interesting observation, it does not in itself justify increasing the DBMC discount.

PSA's brief also quotes witness Glick's testimony arguing that many Standard Mail parcels are origin entered today and argues that further enhanced DBMC discounts

exacerbate that unavoidable situation that is a by-product of the minimum-per-piece price structure.

¹⁶ According to FY 2005 billing determinants, 25.6 billion pieces out of 100.9 billion total Standard Mail pieces are not drop-shipped. (USPS-LR-L-77, Standard_BDs_with_RSS.xls, page G-5, P.5). With such a high percentage of Standard Mail that is already drop-shipped (75 percent), the Commission should seriously consider whether raising the drop-ship discounts will encourage the few remaining holdouts to join the drop-shipping majority, or whether increasing the discounts would only produce greater rewards for those already drop-shipping their mail. It should be noted that Standard Mail is materially different than Periodicals, where incentives are designed to encourage palletization and dropship in combination.

would further encourage cost saving behavior. PSA Brief at 30. PSA conveniently ignores the obvious fact that the Postal Service proposal for DMBC pieces already represents a significant increase in the drop-ship discount compared to today's rates. Today, Standard Mail Regular DMBC parcels receive a discount of 10.5 cents off the applicable pound rate. Under the Postal Service's proposal, the DMBC discount would increase to 16.3 cents, an increase of almost 33 percent. See Attachment A, page 13. PSA offers no record evidence that a 33 percent increase in the drop-ship discount is inadequate to signal to origin-entry parcel mailers that they should drop-ship to DMBCs and that PSA's proposal would somehow shake these parcel mailers loose from their current behavior, while the Postal Service's proposals would not. Nonetheless, the expanded discounts proposed by witness Kiefer are only feasible if the overall price level for parcels is increased. That is, unless the base price for parcels is increased significantly, which, incidentally, is opposed by PSA, then the larger discounts for dropshipping are not practical. PSA can't have it both ways; if parcels are to receive larger discounts, they must be off of a higher base than today. The Commission should follow the Postal Service's balanced approach to the overall pricing for Standard Mail and recommend the separate price structure, including the relatively larger discounts for dropshipping.

PSA's brief also argues that NFMs be given the same enhanced drop-ship discounts as parcels. To support its position, it quotes witness Kiefer's testimony out of context: NFMs, like parcels, "generally are more costly to transport and move about due

¹⁷ PSA supports the Postal Service's enhanced drop-ship discounts for parcels generally; it only seeks additional enhancement for DMBC parcels and extension to NFMs.

to their larger size” and so would likely save more. PSA Brief at 30. This quoted portion of witness Kiefer’s testimony specifically refers to parcels, not NFMs. See USPS-T-36 at 19. PSA conveniently ignores other parts of witness Kiefer’s testimony where he describes NFMs as “small.” See USPS-T-36 at 10, 22 (twice) and 23 (twice). PSA utterly fails to demonstrate via record evidence that NFMs should be accorded the same enhanced drop-ship discounts as larger (and therefore, more costly to transport and move about) parcels. In fact, the evidence on the record just cited unequivocally supports the Postal Service’s position rather than PSA’s position. PSA’s position lacks record support. It should be rejected.

3. AAPS’ and NAA’s argument that the anti-competitive impact of the minor reduction in the ECR pound rate lacks merit and is self-serving.

The Postal Service has proposed a minor reduction of 0.3%, or 0.2 cents in the ECR pound rate in this proceeding (from 64.3 cents to 64.1 cents).¹⁸ AAPS argues that this reduction in the pound rate will produce postage reductions for higher weight ECR pieces and adversely affect competition.¹⁹ AAPS Initial Brief at 2-3. NAA joins in this

¹⁸ The tiny proposed reduction in the ECR pound rate comes “on the heels” (Docket No. R2005-1, Opinion and Recommended Decision, para. 5028) of a 5.4 percent increase in the pound rate (from 61.0 cents to 64.3 cents per pound) in Docket No. R2005-1. Docket No. R2005-1, Attachment A, page 16. The proposed pound rate in this proceeding, 64.1 cents, is therefore a full 3.1 cents, or 5.1 percent, higher than the pound rate in effect less than one year ago.

¹⁹ AAPS couches its criticism of the pound rate reduction within a larger baseless assertion that the Postal Service has not given appropriate consideration to the impacts of its Standard Mail pricing on competitors. In so doing, it ignores the testimony of witness Kiefer to the contrary indicating that rates were developed with the impacts of rates on competitors and competition in mind. See Tr. 5/900, 921, 1084-6. AAPS bases its argument on a mischaracterization of witness Kiefer’s partial list of pricing

criticism, and adds that the Postal Service has not justified its reduction in the pound rate. NAA Initial Brief at 19-22. Both of these arguments lack merit.

The claim that witness Kiefer's tiny reduction in the pound rate leads to reductions in postage rates is simply wrong and misstates the plain facts on the record. Witness Kiefer proposes to increase the ECR flats piece rate by a minimum of 1.4 cents.²⁰ Coupled with a pound rate reduction of only 0.2 cents, the heaviest possible Standard Mail ECR piece (weighing 16 ounces) would actually experience a net postage increase of 1.2 cents (1.4 cents piece rate increase minus 0.2 cents decrease). Lighter weight pieces would experience postage increases of at least 1.2 cents.

Taken together, the Postal Service's piece and pound rate proposals lead to postage increases, not decreases. The anticompetitive pound rate arguments made by AAPS and NAA are obviously false, as anyone who is willing to consult the actual rate proposals can verify. (See Attachment A, pages 19 and 20; see also USPS-LR-L-36, WP-STDECR.xls, WP-STDECR-17 for origin-entered flats).

AAPS and NAA disingenuously point to proposed rate changes for DDU entered mail to buttress their failed arguments. It is true that for some drop-shipped flats rates might decrease under the Postal Service's proposals—but it is clear that any rate reductions are due entirely to higher drop-ship discounts, not due to a reduction in the

considerations provided in response to NAA/USPS-T36-4, claiming this “appears to be a comprehensive list” of the factors considered. AAPS Brief at 5. But nowhere in witness Kiefer's response does he claim that his enumeration of considerations is either comprehensive or exhaustive. A cursory glance at the record will reveal that witness Kiefer considered other factors including, without limitation, impacts on mailers' costs (Tr. 5/1079-80); economic signals sent by prices (Tr. 5/1143, 1158); and effect of prices on mailer behavior (USPS-T-36 at 13-14, 19, 20, 21). Simply put AAPS' claim is baseless and unsupported.

pound rate.²¹ Neither AAPS nor NAA acknowledge this obvious fact, much less explain why it is anticompetitive in any way to pass along higher worksharing cost savings through higher discounts.²² Presumably, AAPS and NAA think it only fair to raise the pound rate so as to prevent mailers from enjoying the increased savings from drop shipping their ECR mail. Such a position is completely self-serving and wholly without merit.²³

4. Careful analysis of the conflicting views of cost shifts relating to possible DAL conversions indicates that the NAA proposal to reduce the rate differential between High Density and Saturation flats is not cost justified.

The Saturation Mailers Coalition and Advo, in their joint brief (hereinafter SMC Brief) highlight the DAL cost estimates and rate design for Saturation flat mail presented by their witness Crowder in SMC-RT-1, in contrast with those presented by NAA witness Ingraham in NAA-T-2. SMC Brief at 45-48. Of course, one of the primary differences between the two witnesses is that, despite presenting alternative rates, witness Crowder does not actually propose them (instead accepting the rates proposed

²⁰ For Saturation flats. The piece rate increases for other flats are higher. See Attachment A, page 19.

²¹ Compare origin-entered flats, all of which experience rate increases with destination-entered pieces, some of which may experience rate decreases. USPS-LR-L-36, WP-STDECR.xls, WP-STDECR-17

²² Witness Kiefer's proposed discounts do not even include a 100 passthrough of avoided costs. The postage reductions for heavier drop-shipped pieces would be even greater at 100 percent passthrough.

²³ NAA also argues that the proposed reduction in the pound rate has not been justified on the record, but there is clear record support for a lower pound rate, and sufficient precedent for the Postal Service seeking a lower pound rate. See, for example, the cost data supplied in response to NAA/USPS-1 showing that ECR flats costs do not increase appreciably with costs for the first half-pound; also, MC-95-1, USPS-T-18 at 15; R97-1, USPS-T-36 at 31; R2000-1, USPS-T-35 at 19; R2001-1, USPS-T-31 at 11; and the discussions contained therein. See, also, SMA-RT-1 at 14-16 for some arguments why the pound rate should be even lower than the Postal Service's proposal.

by the Postal Service), while Dr. Ingraham affirmatively proposes recommendation by the Commission of his alternative rates.²⁴ Although the testimony of witness Crowder correctly identifies what appears to be at least one flaw in the testimony of Dr. Ingraham as it specifically relates to DALs and DAL costs, her approach is not necessarily perfect either. Consequently, the SMC Brief may be putting too much weight on her results.

It is perhaps useful to begin this discussion by noting that both witnesses Crowder and Ingraham assume a conversion scenario from DALs to on-piece addressing. (Dr. Ingraham actually assumes two scenarios, but since he favors his partial-conversion scenario over the no-conversion scenario, it seems reasonable to focus this discussion solely on the partial-conversion scenario. See NAA Brief at 19.) Therefore, what we will call the Crowder scenario assumes a 50 percent conversion rate to DALs, but also assumes that all city carrier and rural carrier costs associated with handling DALs would disappear in the same proportion as DALs, with no consequent cost effects on the (formerly) host flats. SMC Brief at 46-47. In contrast, what we will call the Ingraham scenario assumes 75 percent of DALs will convert, but

²⁴ Specifically, Dr. Ingraham is proposing (relative to the Postal Service's proposal) to increase the origin-entered piece-rated Basic flat rate by 0.3 cents, lower the corresponding High Density flat rate by 1.2 cents, and increase the Saturation flat rate by 0.2 cents, as well as adjust the DAL surcharge from 1.5 cents to 1.4 cents. Under his proposal, the rate difference for these flat pieces between High Density and Saturation would be 0.8 cents. Alternatively, also relative to the Postal Service's proposed rates, witness Crowder's set of alternative rates for origin-entered piece-rated flats would increase the Basic rate by 0.6 cents, lower the High Density rate by 0.8 cents, and also lower the Saturation rate by 0.8 cents. Under her proposal, the difference between the corresponding High Density and Saturation flat rates would be 2.2 cents, which would remain the same as in the Postal Service proposal.

also assumes a cost reduction of only 80 percent of that figure (60 percent = $.75 \times .80$)).
NAA Brief at 16-17.²⁵

One immediate difficulty with the Crowder scenario, as pointed out at page 17 of the NAA Brief, is that witness Crowder's assumption of complete proportionality between DAL volume reduction and the associated costs for both city and rural carriers is not exactly congruent with the position taken by Postal Service witness Kelley. The transcript pages cited in the SMC Brief (at 46) for Mr. Kelley do not support the view that *totally* proportional reductions in city carrier costs can be expected, only that *nearly* proportional reductions seem reasonable. See, e.g., Tr. 12/3514-16. Moreover, as discussed in the SMC Brief at 46-47, even witness Crowder agrees that the situation with respect to rural carriers is more complicated. While the reasonable expectation exists that some type of arrangements will be made on rural routes (*id.*), it may be premature to assume that those new arrangements will have absolutely no cost consequences. Therefore, to the extent that Dr. Ingraham uses somewhat less-than-proportional cost savings, there may be merit to that approach, although the exact figure he uses (80 percent) may not be accurate either.

Witness Crowder, however, correctly seems to identify one flaw in Dr. Ingraham's methodology. Her point is that, since Dr. Ingraham is trying to isolate the flat costs such that no costs associated with the DALs are intermixed and thereby distort the rates for

²⁵ In terms of cost and rate differences between High Density and Saturation flats, it is perhaps useful to note that the Postal Service's original filing did not disaggregate Non-Saturation delivery costs between Basic and High density, but such a disaggregation was provided by witness Kelley upon request. Both witness Ingraham ((NAA Brief at 6-7) and witness Crowder (SMC Brief at 47, n. 20) use the disaggregated High Density delivery costs, so any differences in their unit cost estimates between the two density

flats without DALs (an objective seemingly confirmed by the NAA Brief at 12), he should have excluded the costs of the DALs remaining under his scenario from the unit cost calculation of flats. SMC Brief at 46. Dr. Ingraham appears to have left 40 percent of the DAL costs identified by witness Kelley (which is what is left under the Ingraham scenario when a 75 percent reduction in DALs leads to a 60 percent reduction in costs) in his calculation of unit costs for saturation flats.²⁶ If those costs are truly associated with DALs, then they should properly have been excluded by Dr. Ingraham, as witness Crowder and SMC contend.

But there is an additional wrinkle. Since 75 percent of the DALs have disappeared through conversion to on-piece addressing under the Ingraham scenario, it seems likely that, in that instance, 75 percent of the costs of handling the DALs would likewise have been eliminated. Otherwise, the elimination of some DALs would have caused an increase in the cost of the other DALs that remain, when nothing relating to the residual DALs would have changed, and that would make no sense at all.

Therefore, Dr. Ingraham's 60 percent figure must logically be the net result of a 75 percent reduction in the cost of handling DALs, and an offset of a 15 percent increase relating to the handling of the flats that previously were host pieces. Consequently, under the Ingraham scenario, witness Crowder appears to be correct that it would be inappropriate to include all of the remaining 40 percent of the estimated DAL costs with the flat costs. But witness Crowder does not seem to have taken account of the fact

levels should not be the result of the prior aggregation of High Density and Basic delivery costs in the Postal Service filing.

²⁶ Actually, Dr. Ingraham omitted some mail processing costs and in-office costs from his analysis, but it appears from note 16 on page 17 that NAA is not contesting witness

that it likewise seems plausible to suggest that 15 percent of that 40 percent (i.e., 3/8ths of the 40 percent amount) properly may be included in the numerator of the unit flat costs that Dr. Ingraham is trying to calculate under his scenario, if such costs truly relate to the flats and not the remaining DALs.

Obviously, this wrinkle does not apply in the Crowder scenario, in which she has assumed direct proportionality of cost reductions to DAL reductions. Under that circumstance, the issue of what to do with any “leakage” would not arise. But, as noted above, the assumption of absolutely zero leakage is a fairly ambitious one, even if limited to city carrier routes. The result of that assumption, however, is that in witness Crowder’s cost model, the unit cost of handling saturation flats is totally unaffected by the proportion of those flats that are accompanied by DALs. The 50 percent conversion assumed for her scenario is only applied for evaluating achievement of the institutional cost contribution target. SMC Brief at 47.

To summarize, Dr. Ingraham’s cost proposals resulting from his 75 percent DAL conversion scenario appear to understate the unit cost difference between ECR Saturation and High Density flats, even relative to his own assumptions and objectives. In that case, his rate proposals are likewise necessarily flawed as well, as they would shrink the rate difference between High Density and Saturation from 2.2 cents under the Postal Service’s proposal to 0.8 cents under his proposal. The Postal Service agrees with the position stated in the SMC Brief (at 48) that the NAA proposal to reduce the rate difference between High Density and Saturation flats down to 0.8 cents is not cost justified.

Crowder’s assertion that those costs should be included as well, so it seems reasonable

Witness Crowder (whose alternative rates retain the 2.2 cent difference between High Density and Saturation flats, in accordance with her higher estimate of the corresponding unit cost difference) correctly excludes costs known to be associated with DALs from the unit costs of flats, but whether she has been able to take account of all the possible effects that might influence the unit costs of the flats themselves is not as clear as it could be. Fortunately, she is advocating recommendation of the Postal Service's proposed rates, so the matter is not as critical to her ultimate proposal as it is to Dr. Ingraham's.

In any event, the conflicting state of the record underscores the difficulty of achieving anything approaching a precise quantification of net savings from potential DAL conversions, when there is no firm estimate of what the conversion volume will be, or exactly what operational procedures will be utilized on city and rural routes to handle flats that were formerly DAL host pieces and now utilize on-piece addressing. All of the above scenarios are based on assumptions, none of which individually seem entirely implausible, but most of which conflict and between which there is no necessarily satisfactory resolution. These circumstance favors retention of the cost analysis and rate design associated with the "neutral" assumption of no conversion, embodied in the Postal Service's proposals. Hopefully, more information will be available to address these matters in the future.

for discussion purposes to work with the scenario as described in the text above.

5. The heavy letter weight limit is the direct result of operational realities.
 - a. Raising the Standard Mail Regular and ECR 3.5 ounce breakpoint to either 3.7 ounces or 4.0 ounces results in damaged mail, damaged equipment, and operational inefficiencies.

As was stated in its initial brief, the Postal Service is always looking for new ways to grow the mail, and adjustments to the automation mail weight limit have been considered in the past. Postal Service Initial Brief at 284. Though the majority of the Postal Service's DBCS equipment (over 5,000 machines) was designed to optimally handle a mix of mailpieces which on average weighs less than 3.5 ounces,²⁷ the Postal Service recognized that expanding the number of pieces that could be handled on automation equipment would benefit both customers and the Postal Service. This is why a "Heavy Letter" test was conducted to determine the maximum letter weight that could be handled by the majority of our machines, without causing detrimental consequences in mail processing. Tr. 11/3214; Tr. 34/11529-11530. The test recommended that any proposals to raise the weight limit above 3.5 ounces should be rejected as impractical given the current configurations of USPS mail processing equipment. Tr. 11/2846. As witness McCrery explained, raising the weight limit above 3.5 ounces causes detrimental consequences to the mail base as whole, by damaging mail processing equipment, creating down time, and causing jams that damage mail pieces. Tr. 34/11530.

²⁷ See Tr. 34/11527-11528

As much as PostCom would like to argue otherwise, the results of this test are still valid. There have been no changes to the base DBCS equipment fleet to invalidate these conclusions – the mail processing equipment configurations that existed during the test still exist today. See Tr. 34/11464.

- b. The 3.5 ounce breakpoint is operationally superior to all other alternatives.

PostCom urges the Commission to recommend that standard mail rates apply to letters up to 3.7 ounces. PostCom Initial Brief at 17. Such a recommendation would cause severe operational problems. As witness McCrery stated, raising the weight limit creates an incentive for mailers to create and mail pieces at the new weight limit. See Tr. 34/11482. Saturation mailers could present entire saturation mailings at 3.7 ounces. See Tr. 34/11482. The Heavy Letter test results specifically state that test decks of 100% 3.7 ounce mail caused excessive amounts of damage to the equipment. Tr. 34/2846. It is true that, in the test, the 2% seeded decks of 3.7 ounce mail processed extremely well and were no cause for concern. Tr. 11/2846. However, it is unlikely that a saturation mailer, or a mailer who currently feels that the current weight limit constrains his use of the mail as a marketing medium, would be satisfied with a rule that only allowed 2% of his total mailings to be 3.7 ounces. The Postal Service has learned through testing and experience, that 3.5 ounces is the ideal breakpoint. See Tr. 34/11488.

It is impossible to establish a weight limit on automated equipment such that there is a certainty that all pieces below the limit will process well and pieces above the limit will process poorly. Tr. 39/13440. A combination of various characteristics will

allow some mailpieces above 3.5 ounces to process well, and others below 3.5 ounces to process poorly. Though the Postal Service wishes it could identify these combinations of characteristics and create mailing standards to capture them, it is not possible to develop mailing standards that could accurately and adequately encapsulate every various combination of characteristics. See Tr. 34/11491. The 3.5 ounce limit was established by considering the letter mail base in general, with a goal of establishing an overall automated letter mail stream that has a high probability of processing at an acceptable throughput and jam rate.

Because some pieces over 3.5 ounces cause problems, while others run well, the weight of a letter in the field is determined by looking at container labels and through experience, not by using a weight detector or scale. See Tr. 11/ 3215-3216. This allows Postal Service operations the necessary flexibility to process the maximum amount of letters on automation, and prevent “bad” letters from entering automation.

- c. The Postal Service is not attempting to arbitrarily constrain the use of the mail.

Though PostCom’s speculations on the use of the word “preemptive” in the Heavy Letter report are interesting, the conclusion that PostCom reaches, namely, that the use of the word indicates that the Postal Service was predisposed to conclude that 3.7 ounce pieces would not provide acceptable results, is without merit. PostCom Initial Brief at 16. As stated on the first page of the test report, though the purpose of the test was to determine the feasibility of raising the weight limit for automation compatible mail from 3.3 to 3.5 ounces, preemptive testing on 3.7 ounce mail was done for future reference. Tr. 11/2845. Witness McCrery explained during his August 17, 2006

appearance at the Commission that “preemptive” in this instance simply meant that the Postal Service decided to use this testing opportunity to gain a better understanding of the ability to process letters heavier than 3.5 ounces, rather than wait for another request. See Tr.11/ 3212-3213. No where did he suggest that the Postal Service was predisposed against the limit.

If PostCom believes there is some unreasonable bias against raising the heavy letter weights, this is simply not true. As was explained above, the Postal Service conducted the Heavy Letter test specifically to determine the maximum letter weight that could be handled by the majority of our machines, without causing detrimental consequences in mail processing. In the field, the Postal Service takes every opportunity to make sure pieces that can run on automation are run on automation. The Postal Service has taken the operational constraints it has regarding heavy letters to its limits. Refusing to accept these operational realities, PostCom now urges the Commission to recommend changes that would interfere with the reasonable judgment of the Postal Service to manage postal operations, that would take away operational flexibility, and that would lead to less efficient and more costly handling of the mail. The Commission should reject PostCom’s proposals.

C. The Postal Service's Rate Proposal for Periodicals Is Superior to All Alternative Proposals.

In its Initial Brief, the Postal Service supported its Periodicals rate proposal, and addressed the alternative proposals by intervenors. Postal Service Brief at 343-56, 360-67. In this brief, the Postal Service responds to additional arguments raised in intervenor briefs.

1. The Commission should select the Postal Service's Periodicals Outside County proposal because it would drive out costs while having a balanced impact on mailers.

Five intervenors and the Postal Service directly address the three comprehensive Periodicals Outside County rate proposals filed by the Postal Service, the Magazine Publishers of America and the Alliance of Nonprofit Mailers (MPA/ANM), and Time Warner, Inc (TW). Time Warner and U.S. News & World Reports, L.P. (USNews) support the Time Warner proposal. MPA supports its own proposal. But American Business Media and the McGraw-Hill Companies, Inc., representing a large number of small and medium size publications, join with the Postal Service in generally supporting the Postal Service's proposal. McGraw-Hill Brief at 1, 27; ABM Brief at 5, 26.

All of the proposals would improve the efficiency of the Periodicals Outside County subclass, and drive out costs. See Postal Service Brief at 343-46. It is clear from the record, however, that the Postal Service proposal is the most balanced one, in terms of the impact on the full variety of Periodicals mailers. *Id.* at 346-49. Therefore, the Postal Service urges the Commission to recommend the Postal Service's proposal.

2. The Postal Service's proposal is responsive to the Commission's conclusions from Docket No. C2004-1.

Time Warner argues that only its rate proposal "is responsive to the Commission's Order in Docket No. C2004-1," while the Postal Service's proposal is not. TW Brief at 9, 13. The Postal Service strongly disagrees. The Postal Service has made innovative proposals to improve the efficiency of the Periodicals rate structure, including replacing the pallet discounts with a container rate, and extending dropship discounts to editorial pounds.

The Postal Service has been responsive to the Commission's findings in Docket No. C2004-1. At the conclusion of the proceeding, the Commission issued Order No. 1446.²⁸ That Order maintained the status quo, and specifically did not find the alternative rate structure proposed by Time Warner to be superior to the current rate structure. See Order No. 1446, Appendix B at 7. The Commission did, however, seek some movement toward a more cost-based rate structure, suggesting three options. One option would implement Time Warner's proposed rate structure, but with only partial recognition of cost differences and/or costs. Time Warner appears to have adopted this approach.

The Postal Service has, on the other hand, adopted the Commission's second alternative, "gradually making changes over time," with "one or more changes per rate

²⁸ Order No. 1446 was not issued until October 21, 2005. Thus, Time Warner's claim that the Postal Service did not do anything in response to the Order in Docket No. R2005-1 (TW Brief at 8) is nonsensical, since Docket No. R2005-1 was filed on April 8, 2005, more than six months *before* Order No. 1446 was issued.

or classification case.”²⁹ In the first year since this Order was issued, on October 21, 2005, the Postal Service has implemented a new sacking rule, and has proposed a new container rate, along with other incentives for comailing and dropshipping. The Postal Service agrees with the Commission that “[g]radual introduction of changes would allow focused evaluation of the benefit of specific changes as against their impact on Periodicals mailers.” *Id.* at 47. Given the recent improvements in Periodicals palletization and dropshipping emphasized by witness Taufique (Tr. 39/13454), and the low cost coverage for Periodicals, the Postal Service believes that the sacking rule and the pricing improvements proposed in this docket are all that should be implemented in the immediate future. The results should then be evaluated in order to determine the next steps.

As witness Taufique stated, the Postal Service’s proposal “is a logical continuation of [the Postal Service’s] philosophical approach to provide modest incentives for improvement in preparation, while avoiding large rate impact for non-participants.” Tr. 39/13455. The Postal Service strongly believes that this approach is necessary to balance movement toward more efficiency for Periodicals with the public policy goal of maintaining the broad dissemination of varied editorial matter throughout the nation. As the Commission concluded in Docket No. C2004-1:

Maintaining diversity within the Periodicals subclass is in the public interest and consistent with the policy of binding the nation together. Diversity among Periodicals promotes debate and a well-informed citizenry, attributes of a vibrant and robust democracy.

²⁹ Tr. 39/13534. The third option in Order No. 1446, which has not been pursued in Docket No. R2006-1 by any party, would provide mailers a choice between two rate schedules, one retaining the current rate structure, with another incorporating the full Time Warner approach or something similar.

Order No. 1446, Appendix B at 19.

3. The Postal Service's proposal is consistent with the results of the 24-piece per sack rule implemented in May, 2006.

MPA's brief accuses Postal Service witness Tang of failing to adjust for the impact of the 24-piece sack minimum rule in her analysis of the impact of the Postal Service's proposal on co-palletization incentives. MPA further concludes that the Postal Service would have proposed "more far-reaching improvements in incentives" if it had considered the impact of the 24-piece rule. MPA Brief at 54. This conclusion is, however, incorrect; instead, the Postal Service endorses its original proposal, and does not agree that consideration of the 24-piece rule would support greater incentives.

The 24-piece rule was not implemented until after the Postal Service prepared its Periodicals proposal in this proceeding, and filed its Request.³⁰ Thus, when witness Tang analyzed the impact of her proposal on 12 publications in her direct testimony, the impact of the 24-piece rule could not be considered. However, during the litigation of this case, the Postal Service has re-evaluated the impact of its proposal. As stated in witness Taufique's rebuttal testimony, this further evaluation:

shows the incentives under the proposed rates would be at least comparable, if not bigger, for these current co-palletization participants. Moreover, in her later response to MPA/USPS-T35-28(c), the updates from the source confirm that it 'may overstate the number of containers for the twelve publications in the 'after' scenario, because the container count reflects the containers for the entire co-palletized pool, while the piece count reflects only one publication.' While it appears difficult, if not impossible, to isolate container count of a specific publication from the entire mailing in the after-copal scenario, the 'after-copal' postage has probably been overstated because of the inflated container count. A reasonable conclusion is that the actual after-copal postage would have

³⁰ The Postal Service filed its Request on May 3, 2006, more than a week prior to the implementation of the 24-piece sack minimum rule on May 11, 2006. Tr. 7/1704.

been lower; hence the incentives offered under the proposed rates would have been even larger.

Tr. 39/13456. The Postal Service thus has no reason to increase the incentives from what it deemed justified when it filed its Request.

4. The Commission should recommend the container rate, along with the corresponding classification language, as proposed by the Postal Service.

The Postal Service's proposal for a new container rate, along with appropriate classification language, was the subject of considerable discussion in several intervenor briefs. For the reasons discussed below, the Commission should not be persuaded by intervenor arguments against the container rate, and various applications thereof, and should recommend the container rate and the classification language proposed by witness Tang. USPS-T-35 at 15.

- a. The proposed container rate offers consistent and straightforward incentives.

MPA and USNews both express concern that the Postal Service's proposed container rate "would create a postage disincentive for preparation of mail on 5-digit pallets." MPA Brief at 55; USNews Brief at 6. MPA admits that "the amount of the disincentive appears modest when expressed on a per-piece basis." MPA Brief at 55.

It is useful to step back and understand that the purpose of the container rate is to encourage mailers to more efficiently utilize containers. For many publications, this would mean a movement to palletization; for others, where palletization is not practical, it would mean an incentive to use as few sacks as possible. Tr. 7/1735; Postal Service Brief at 343-44. Even if the container rate theoretically, or in limited practice, were to provide a disincentive for preparing 5-digit pallets, the most likely general effect would

still be for mail to move from sacks onto pallets. In this regard, the purpose and effects of the Postal Service's rate proposal should be viewed in their totality as balanced and efficient, without isolating the possible consequences of any specific rate element.

In any case, the Postal Service disagrees that mailers would move mail from 5-digit pallets to 3-digit pallets in response to the proposed container rate. 3-digit pallets are permitted only for limited ZIP Codes for which they are deemed to have value. Moreover, any incentive from the container rate for using 3-digit pallets could be offset by increased postage from other rate elements. Tr. 7/1689.

- b. The impact of the container rate on small publications and the Outside County portions of Within-County publications will be blunted in the future.

MPA defends its proposal by overemphasizing its projected rate increases compared to the largest increase (43.7 percent) reported for the Postal Service's proposal in response to Presiding Officer's Information Request (POIR) No. 19. MPA Brief at 69.³¹ Witness Taufique, however, explains that this largest increase, along with the small number of other increases that exceed the maximum MPA increase, are

³¹ MPA echoes the concerns of several Commissioners about the impact of the container rate on small sacks. MPA Brief at 56-57. However, as witness Tang noted, mailers would never be required to make the one-piece destination-entry sacks about which there was concern. Moreover, mixed ADC sacks provide an easy option for increasing the number of pieces per sack. Tr. 7/1889. MPA is also misleading, to say the least, in claiming that ABM witness Bradfield "conceded that the USPS rate design is 'more destructive' because of its higher maximum increases for small publications." MPA Brief at 69. Witness Bradfield did not use the word "destructive." Instead, in comparing the increase for one publication (the Postal Service's 43.7 percent increase outlier) with the maximum 22.6 percent under the MPA proposal, witness Bradfield stated that "Common sense would say 40 is worse than 20. The problem here is that these are averages for everybody. In the MPA proposal, we're very pleased with [what] it does for our comailed and copalletized titles, but those titles that are forced to remain in sacks, and there are many, would be hurt badly." Tr. 35/12098.

outliers, limited to the Outside County portion of mailings that predominantly receive preferred Within County rates. Tr. 39/13539-40. This is noteworthy because the passage of postal reform should serve to moderate the effect of the Postal Service's proposal on such publications.

Specifically, the recently enacted Postal Accountability and Enhancement Act (PAEA) makes two changes to 39 USC § 3626 that will benefit the Outside County portion of Within County mailings and therefore blunt the effect of the rate increase in this case. First, it expands the eligibility for Within County rates to include some previously Outside County pieces by addressing the “wandering routes” issue discussed by NNA witness Heath. See Postal Service Brief at 23. Second, under the Act small publications with an outside county circulation of 5,000 or lower will be given a rate preference. See PAEA, § 1003 (new 39 U.S.C. § 3626(g)(4)). These changes should allay concerns about the impact of the container rate on small, predominantly Within County publications.

- c. NNA’s argument that the container rate is not “properly presented” to the Commission with respect to flats tubs, unsacked bundles, and containers entered in rolling stock finds no support in the Act.

While several parties express concern about the application of the container rate to situations not involving a sack or a pallet, NNA goes farther than any other party in arguing that the application of the container rate to Outside County mailings entered in flats tubs, rolling stock, or as unsacked bundles would violate the Act. NNA Brief at 22-25. Though it does not propose a specific remedy, it appears that NNA is arguing that

DMCS 421.35 must, under the Act, specifically exempt such mailings if it is to be recommended by the Commission.³²

NNA's argument that the container rate cannot be applied to such mailings because it has not been "properly presented" to the Commission under § 3622 finds no support in the Act and conflicts with the record. As discussed in the Postal Service's Initial Brief, there is substantial record evidence justifying the application of the container rate to all Periodicals Outside County mailings, and not just those involving sacks or pallets. Tr. 7/1648, 1656-57, 1677, 1740, 1756, 1770, 1839; Postal Service Brief at 351. The Commission, furthermore, has the authority to recommend that the rate apply to all such mailings, including mailings entered in flats tubs, unsacked bundles, and in rolling stock, through the Postal Service's proposed classification language, which, by its terms, would permit that result. Nothing in the Act contravenes that authority.

- i. The lack of cost studies applicable to flats tubs and unsacked bundles does not preclude the application of the container rate to them.

NNA argues that the container rate cannot apply to these mailings because the Postal Service has no cost studies for such mail. NNA Brief at 23-24. NNA believes that applying "a postage charge upon mail without presentation of information on the costs created by that type of mail is fundamentally beyond the authority of the Postal Service," (and, by extension, the Commission). *Id.* This proposition is, however, wholly unsupported by the Act and ignores the practicalities of postal ratemaking.

³² This is in contrast to the McGraw-Hill position, which states that the Commission should recommend classification language that exempts unsacked bundles from the container rate, but without suggesting that doing so is compelled by the Act. McGraw-Hill Brief at 15-16.

Cost data are, of course, critical in the development of rates under the Act, at both the subclass and rate category level. To claim, however, as NNA does, that the Act precludes the imposition of a rate upon a specific type of mail (in this case, Periodicals Outside County mail entered in a flats tub or in unsacked bundles) in the absence of a quantitative study that specifically measures the cost of such mail is simply unsustainable. Nowhere does the Act demand such a granular level of costing data.³³ This is demonstrated by the fact that, taken at face value, NNA's position would seem to invalidate the use of proxies, and would seem to require that specific cost studies be conducted to specifically support every single rate cell in every subclass of mail. As the courts have recognized, however, ratemaking is not an exact science, but involves the balancing of numerous considerations, which are not capable of perfect quantification. See *Association of American Publishers, Inc. v. Governors of the United States Postal Service*, 485 F.2d 768, 773 (D.C. Cir. 1973). Under the Act, these considerations include both cost, and noncost, factors.

The Commission is therefore free to consider evidence other than cost data in determining whether a rate should apply to such mailing scenarios. Here, the Postal Service has presented cost data specifically discussing the application of the container rate to the vast majority of Periodicals Outside County mailings, namely, those entered in sacks and pallets. USPS-LR-L-85, Table 1; USPS-T-35 at 5-6.³⁴ It has also

³³ The case law that NNA cites provides no support whatsoever for the proposition that it is peddling. Indeed, NNA speaks of those cases as establishing the Commission's important role in applying the criteria of § 3622 and in the "attribution and assignment of costs." NNA Brief at 23. While this is true, it is besides the point, since attribution and assignment is a process that occurs at the subclass level.

³⁴ As witness Tang noted, cost data were "used as a reference but not as the primary basis for the 85-cent container rate." Tr. 7/1648. The rate is instead primarily a price

presented reasons why the container rate should apply to all other potential Outside County mailing scenarios, including the entry of mail in tubs or unsacked bundles. Tr. 7/1648, 1656-57, 1677, 1740, 1756, 1770, 1839. The Act does not foreclose the Commission from relying on such evidence, in the exercise of its reasoned judgment, in recommending the Postal Service's proposed classification language.

- ii. NNA confuses the DMCS and the DMM in its arguments concerning mailings entered on rolling stock.

NNA also argues that applying the container rate in situations where Outside County mailings are presented in containers provided by the mailer on rolling stock would violate the Act since the Postal Service has not “contemplated” a recommended decision from the Commission with respect to such mailings. NNA Brief at 24. NNA’s position here is simply wrong.

The Postal Service has proposed classification language that is broad enough to allow for the imposition of the container rate on such mailings. USPS-T-35 at 15. This classification language, which states that the rate shall be applied “as specified by the Postal Service,” is consistent with the definitional nature of the DMCS, whose purpose is to establish the general terms and conditions by which mail is classified. See PRC Op., MC95-1 at II-20; PRC Op., MC88-2 at 9. It is also consistent with numerous other provisions in the DMCS recommended by the Commission in the past and approved by the Governors.

There is substantial record evidence justifying this classification language, and describing why the container rate should apply to all Periodicals Outside County

signal, designed to encourage efficiency while protecting smaller publications, rather than as a means of recovering actual container costs. Tr. 7/1648; 1859-60.

mailings. Furthermore, in its response to Presiding Officer's Ruling No. 30, the Postal Service stated that it "understands the need for the Commission to know how the Service plans to apply the container rate" (Tr. 7/1617), and its intentions on how the container rate will generally be applied are clear on the record. The fact that the classification language does not specify every possible application of the rate does not deprive the Commission of the authority to recommend it. Nor must that classification exclude, as a matter of law, any particular container from being subject to the rate.

- d. NNA's belief that the container rate should not apply to flats tubs and unsacked bundles because doing so sends a "negative" price signal for moving away from sacks distorts the purpose of the container rate and is unsupported by the record.

NNA, citing the testimony of witness Heath, argues that applying the rate to flats tubs and unsacked bundles would be "contrary to the clear intent of both the pricing witness and the operational witness: to discourage the use of sacks." *Id.* at 25-27. McGraw-Hill, meanwhile, argues that the container rate should not apply to mail that is in unsacked bundles. McGraw-Hill Brief at 15-16.³⁵

It is too strong for NNA to assert that the "clear intent" of the container rate is to "discourage the use of sacks." Instead, as witness Tang notes, the discussion of the container rate in her testimony does not suggest that its primary purpose is to eliminate

³⁵ McGraw-Hill speaks of "dispensing with any requirement that very small volumes of periodicals mail be entered in sacks or any other container." McGraw-Hill Brief at 15-16. The DMM currently allows for the entry of unsacked bundles. DMM 707.23.4. Other methods of "uncontainerized" entry are, however, not currently allowed. Tr. 11/3273-74. It is not clear whether McGraw-Hill is advocating that the Postal Service amend the DMM to allow other methods of "uncontainerized" entry beyond that provided for in the DMM. To the extent it is, it cites to no record evidence that discusses this position, so it must be disregarded by the Commission. Instead, McGraw-Hill's brief should be read solely as arguing that the container rate should not be applied to

the usage of sacks. Tr. 7/1735. Rather, its purpose is to send an appropriate price signal to encourage the more efficient utilization of containers, whether they are sacks, pallets, flats tubs, or some other entry method. For some publications, this would mean a movement to palletization. For other publications where palletization is not practical, it would encourage mailers to use as few sacks as possible, or as few tubs as possible.

NNA is, of course, correct in its belief that flats tubs and unsacked bundles do, in certain circumstances, provide benefits over sacks. It does not stand to reason, however, that these alternative methods of entering Outside County mail should be exempted from the container rate. The rate may have efficiency benefits not confined to the predominant sack/pallet scenario. For instance, witness Heath himself admits that applying the container rate to flats tubs (which are, after all, containers) should encourage the more efficient use of those containers by mailers already using them. Postal Service Brief at 352. Nor does the record indicate that the container rate, applied in a manner consistent with the Postal Service's Response to Presiding Officer's Ruling No. 30, will prove to be a material financial disincentive for mailers to move from sacks towards flats tubs or unsacked bundles. *Id.* at 352-356. It is preferable to apply the rate to all mailings at the outset, and allow the Postal Service and mailers to gain experience with applying and responding to the rate, before prematurely burdening the classification language with a number of exemptions.

unsacked bundles. Such a reading appears consistent with McGraw-Hill's conclusion to its brief. McGraw-Hill Brief at 27.

5. USNews does not provide a sufficient basis to discredit the division of publications into large, medium, and small, based on mailed circulation.

USNews identifies one “small” publication, the New York Daily News, that qualifies as small because of its mailed circulation, but really has mostly nonmailed circulation, and is a large business that does not need any unusual protection from rate increases. It also suggests that there may be other similar “small” publications. USNews Brief at 8. Nonetheless, there is no record evidence to suggest that more than a few “small” publications actually have large total circulation.

6. Zones 1&2 is the appropriate benchmark for dropship discounts.

Witness Glick argues that using non-dropshipped Zones 1&2 as the benchmark for Periodicals pound dropship discounts is inadequate, and proposes higher dropship discounts by changing the benchmark. MPA Brief at 36. The Postal Service disagrees. Zones 1&2 is the appropriate benchmark to use for the following reasons.

First, the existing rate structure already has zoned pound rates from Zones 1&2 to Zone 8. To the degree that mailers switch from farther out zones to zones closer to the destinations by dropshipping, they skip zones and their postage will be reduced by shifting to lower-zone rates. What witness Glick proposes is not a true dropship discount, but rather a deaveraging of the rates. Finally, witness Tang explains the conceptual and technical problems with trying to reflect in rates the non-transportation destination entry cost savings relative to the mail processing costs of Zones 1-8, rather than Zones 1&2. Tr. 7/1692-94.

Second, the current dropship profile shows that over 62 percent of Outside County Periodicals mail is already dropshipped. Tr. 39/13454, Table 1. This existing dropshipping would inevitably lead to significant revenue leakage, with no new cost savings, caused by the higher discounts offered to already dropshipped mail. Witness Glick has not proven that such revenue leakage would be offset by cost decreases not reflected in the larger dropshipping discounts, when more mailers choose to dropship. Nor has he proven that, simply because mailers of nondropshipped mail are in all zones, the shifts would come uniformly from the zone distributions already exhibited by the nondropshipped mail. For that reason, creating a benchmark that reflects the range of zones of nondropshipped mail would create a nonsensical starting point, which likely would not reflect the zone distribution of the mail that shifts to dropshipping.

Third, given the already low cost coverage for Periodicals, and other constraints, the Postal Service believes it is very important to encourage mailers to change behavior and adopt more efficient mail preparation and mailing practices. In this docket, the Postal Service proposal incorporates quite a few changes to the fundamental rate design, such as the container rate and different treatment of editorial pounds. MPA's proposal would increase dropshipping discounts beyond the appropriate amount proposed by the Postal Service, in a subclass of mail where the markup is too small to give away larger discounts to mailers who are already dropshipping.

MPA cites the Efficient Component Pricing Rule (ECPR) to justify giving discounts to Periodicals mail that is already efficiently prepared. MPA Brief at 60-63. But MPA ignores the low markup and other important ratemaking objectives relevant to

Periodicals pricing. These factors provide significant constraints on the application of the ECPR to Periodicals.

7. MPA's assertion that witness Tang incorrectly calculated the DSCF advertising pound rate is erroneous.

On Page 59 of the its brief, MPA states that when calculating the DSCF advertising pound rate, witness Tang incorrectly subtracted the DSCF handling cost avoidance (net of DADC container handling cost avoidance), rather than the entire DSCF container handling cost avoidance. As a consistent methodology used in previous dockets, witness Tang's methodology is not a mistake. The DSCF handling cost avoidance is the cumulative cost savings, relative to Zones 1&2 handling costs. Since the DSCF dropship pound rate is calculated by adding on the additional cost savings from DADC, only the difference between DADC and DSCF cost savings should be counted. As explained and illustrated in her response to MPA/USPS-T35-27 (e), witness Tang listed the calculation and pointed out that the 0.3-cent DADC dropship was double counted in Mr. Glick's calculation. Tr. 7/1715.

8. MPA/ANM and TW have not provided any conclusive evidence which demonstrates that the Periodicals Outside County cost estimates by rate category provided by witnesses Glick and Stralberg are more accurate than those developed by witness Miller.

In their briefs, both MPA/ANM and TW claim that witness Glick and witness Stralberg, respectively, have developed an "improved" cost methodology and cost model upon which the Commission should rely when calculating the Periodicals Outside County flats mail processing unit cost estimates by rate category. MPA/ANM Brief at Section V; TW Brief at Section III. The Postal Service discussed this issue in its Initial

Brief at pages 356-60, and provides additional discussion below. In general, neither MPA/ANM nor Time Warner provide evidence which conclusively demonstrates that their revised Periodicals Outside County flats cost models (which significantly expand the mail processing unit cost difference between nonautomation 5-digit flats and nonautomation carrier route flats) result in more accurate mail processing unit cost estimates by rate category. The Postal Service continues to recommend that the Commission rely on the USPS-LR-L-43 estimates when developing the Periodicals Outside County rate design.

- a. MPA/ANM and Time Warner provide no sound basis for including arbitrary incoming secondary factors in the Periodicals Outside County cost model.

In response to an MPA interrogatory, witness McCrery estimated that 44.7 percent of non-carrier route incoming secondary flats were processed manually, and stated that this figure came from MODS and FLASH data. Tr. 11/2853. Contrary to what MPA/ANM and TW would have the Commission believe, witness Miller's rebuttal testimony was not an attempt to "attack" witness McCrery's response.³⁶ Rather, his testimony simply clarifies how the data provided by witness McCrery are used, what

³⁶ MPA/ANM argues that witness Miller's rebuttal testimony violates "due process" and constitutes improper rebuttal since it "attack[s]" witness McCrery's estimate of the number of flats that receive incoming secondary sorts. MPA Brief at 44. Leaving aside the fact that the 44.7 percent was not part of witness McCrery's direct testimony, as MPA/ANM asserts, but was instead provided in cross-examination, this ignores the fact that witness Miller is simply arguing that, however witness McCrery's figure might be used for operational purposes, the figure is not suitable for use in amending the cost models (MPA/ANM, on the other hand, seems to believe that simply because the Postal Service collects data for a certain purpose, such data is *ipso facto* suitable for use for cost modeling purposes). In any event, MPA had a full opportunity to test witness Miller's rebuttal testimony through adversarial means, Tr. 33/11025-58, so its "due process" rights have been fully complied with.

they actually mean, and why they are unsuitable for use in the USPS-LR-L-43 cost models. Tr. 33/10994; Postal Service Brief at 357. Given that the Postal Service's goal is to process more flats on equipment, the manual FLASH volumes (which are generally regarded to be overstated, Tr, 33/10996) are not as important as the MODS data because the Postal Service can gauge performance by monitoring how many additional flats are processed on equipment from year to year.

In Attachment 2 of his rebuttal testimony, witness Miller demonstrates why witness McCrery's estimate should not be the basis for including arbitrary incoming secondary factors. Tr. 33/11023. These data were not provided as an improved estimate for the Periodicals Outside County flats cost model. As witness Miller describes, if these data could be used for anything, it would be to evaluate all flats in total. Such a comparison, however, is not entirely possible since the data for some flats mail types, such as First-Class single-piece flats, are not available. Tr. 33/10997-98.³⁷

Both MPA/ANM and TW attempt to make an issue of the fact that some flats volumes were not included in witness Miller's Attachment 2. MPA Brief at 39; TW Brief at 35. While witness Miller acknowledged that this was the case during hearings, the

³⁷ Both MPA/ANM and TW attempt to cloud this issue by pointing out that the AFSM100 costs for First-Class Mail single-piece flats are higher than those for the presorted flats categories. MPA Brief at 38 n.26; TW Brief at 37 n.29. One possible reason that the single-piece AFSM100 costs are higher than the AFSM100 costs for presorted flats may be the fact that single-piece flats are not presorted at all and are therefore processed through a greater number of processing steps, whether those step are performed on equipment or manually. In fact, the USPS-LR-L-53 cost pool values for the AFSM100, UFSM1000, and manual operations for First-Class Mail single-piece flats are all higher than the corresponding cost pool values for First-Class Mail presort flats, Periodicals Outside County flats, and Standard Mail Regular flats. The specific magnitude of the cost pool values is therefore meaningless in this regard. It is entirely possible that the percentage of single-piece flats processed in manual incoming secondary operations is higher than that associated with the other presorted flats categories.

incorporation of these volumes is still insufficient to support reliance on the 44.7 percent figure. See Postal Service Brief at 358. In addition, the bulk of these volumes would be carrier route mail pieces in broken bundles. It is especially interesting that Time Warner would attempt to highlight this omission, given that witness Stralberg has indicated he believes the bundle breakage factors used in the cost model are too high. See TW-T-2 at 22.

Both MPA/ANM and TW describe the 44.7 percent figure as if it is a cost model input. It is not. Given that it is not a cost model input, both witness Glick and witness Stralberg had to incorporate arbitrary factors into their cost models. They have never provided any qualitative or quantitative basis for the factors they use, but appear to feel that their usage is justified because the incorporation of these factors moves the manual incoming secondary percentage closer to the 44.7-percent figure. The incorporation of such arbitrary factors into a cost model would set an unwise precedent, however, and should not be supported. As the cost models in USPS-LR-L-43 are currently structured, they reflect rate category cost differences associated with known cost drivers that can be quantified, such as AFSM100 compatibility, the container of entry, the presence of a barcode, and the presort level. By incorporating arbitrary factors into the cost model, the cost relationships between some rate categories could become skewed in unknown ways. The Postal Service believes that arbitrary factors should not be included in the cost model for the sole purpose of increasing the percentage of mail processed in one manual operation and therefore recommends that the Commission rely on the USPS-LR-L-43 estimates.

- b. The Commission should reject MPA/ANM and Time Warner's cost pool classifications.

Both the Commission and the Postal Service have in past cases relied upon a conservative cost pool classification methodology. Under this methodology, a cost pool is classified as "proportional" if it represents a task included in the mail flow model and "fixed" if it represents a task not included in the mail flow model. In the instant proceeding, both MPA/ANM and TW propose more liberal cost pool classification schemes. MPA Brief at 41-42; TW Brief at 45-46.

One justification that has been used to rationalize more liberal classifications is the possibility that employees are clocked into the wrong operation numbers when they are sampled. *Id.* As witness Miller pointed out in his rebuttal testimony, this situation could occur, but it is unlikely that any such occurrences would be one-sided (i.e., would always tend to understate proportional costs). Tr. 33/11002. For example, it is also possible that an employee could be clocked into an operation associated with a proportional cost pool when, in reality, he or she should have been clocked into an operation associated with a fixed cost pool. In other words, to the extent any such problems occur, they may very well balance out.

- c. Flats prepping costs should not materially affect the rate category cost relationships.

Both MPA/ANM and TW have provide modified versions of the Periodicals Outside County flats cost model in which a portion of the flats "prepping" tasks are classified as proportional. MPA Brief 39-40; TW Brief at 30-33. The prepping task is associated with operation 035, the one operation mapped to the 1FLATPRP cost pool. As witness Miller pointed out in his rebuttal testimony, the AFSM100 Automatic

Induction (AI) modification is going to reduce 035 costs and thus reduce the prepping cost difference between carrier route and non-carrier route flats. Tr. 33/11004. After the modifications are complete, the tasks required to process a non-carrier route bundle will be similar to those required to process a carrier route bundle; employees will unbundle the mail pieces and dispose of the packaging materials.

MPA/ANM and TW attempt to obscure this issue by pointing out that the non-carrier route flats prepping tasks are covered by the flats mail processing cost model, while the carrier route prepping tasks are not. Regardless of which employees will perform these tasks, prepping costs will be incurred. As witness Miller pointed out in his rebuttal testimony, the extent to which the prepping costs for carrier route presort flats are included in the current delivery unit cost estimates is unknown because a Standard flats ECR delivery unit cost estimate has been used as a proxy for Periodicals Outside County carrier route flats. Tr. 33/11003-04.

Witness Miller concludes that now is not the time to allow flats prepping costs to inflate rate category cost differences. The Postal Service is clearly moving in a direction in which the non-carrier route and carrier route prepping cost difference will shrink. Furthermore, even if a party wanted to include such an adjustment, it would not be entirely possible. As witness Miller pointed out, the AFSM100 AI DAR provided limited visibility concerning the prepping costs savings; consequently, no modification was made to the 1FLATPRP cost pool. Tr. 33/11005. Classifying a portion of this cost pool as proportional is therefore not necessarily accurate.

- d. Selective cost pool adjustments should be rejected.

Witness Miller demonstrates how the selective analysis performed on the non-MODS ALLIED pool should be discouraged since similar cost pool analyses (such as on the OPBULK and OPPREF cost pools) could produce countervailing results. Postal Service Brief at 360. MPA/ANM and TW both attempt to confuse this issue in their briefs by stating that some bundle sorting costs are known to be container-related. MPA Brief at 42 n.33; TW Brief at 47. While this may be true, the opening units are the entry points for containers at postal facilities, and a portion of the container costs in those cost pools are not related to bundle sorting. Consequently, a modification like that described by witness Miller would still be warranted if the logic of witness Glick and witness Stralberg were to be adopted.

- e. Witness Stralberg's bundle breakage criticisms are unfounded.

Witness Stralberg also proposes that some bundle breakage assumptions in the cost models be modified. TW Brief at 39-40. In essence, witness Stralberg proposes that manual bundles would not break during their initial handling, but would only break after reaching their next sortation level. As witness Miller pointed out in rebuttal, however, witness Stralberg has incorrectly characterized manual bundle sorting operations. Manual bundle sorting operations are typically performed by multiple employees that sort bundles into nearby containers from conveyor belts onto which pallets and sacks of mail have been dumped. Tr. 33/11009. The Postal Service therefore believes that witness Stralberg's modification results in a mischaracterization of bundle sorting activities.

9. MPA's argument that its proposed 5-digit pallet discount will not do much harm is unconvincing.

MPA's brief argues that "the minimal volume currently entered on 5-digit pallets should allay any concerns about leakage." MPA Brief at 76. But for Periodicals, with its very low markup, any revenue leakage is significant. Moreover, the Postal Service is not only concerned about the size of the leakage. With a very thin margin, Periodical rates need to focus on promoting behavior change which helps to reduce costs and improve Periodicals efficiency. As Postal Service witness Taufique stated:

Our focus is on changing the behavior that needs to be changed, and your [MPA's] focus seems to be on behavior that is already efficient.

Tr. 39/13475. MPA's 5-digit pallet discount proposal would shift the focus of incentives away from where they are most needed, in a class of mail for which the markup is too small to give away larger discounts to mail which is already on 5-digit pallets. Tr. 39/13455-56.

10. The Postal Service's proposed Ride-Along rate properly follows the accepted ratemaking approach.

MPA argues that the Ride-Along rate should be held below what the traditional rate design approach would produce. MPA Brief at 59. However, witness Taufique explains that the Ride-Along rate is distinct from other Periodicals rates, and should be set based on the same ratemaking approach as used in previous cases. Tr. 39/13462-63.

11. The Postal Service proposal does not generally reduce dropship or comailing incentives.

USNews claims that the Postal Service proposal reduces dropship and comailing incentives for some publications. USNews Brief at 4-5. Because of the wide variety of

publications using the Outside County subclass, with respect to weight, editorial percentage, and zone distribution, it should be expected that any proposal might reduce the incentives for some publications, for certain desired behaviors. But the Postal Service proposal is focused on those publications that are not already dropshipping, and should increase dropship incentives for those publications. Specifically, the Postal Service proposal promotes dropshipping by applying the dropship discounts to editorial pounds, and increasing the per piece discounts substantially. Tr. 39/13540-41.

12. The Commission should reject McGraw-Hill's preference for a lower editorial pound rate.

McGraw-Hill agrees with the Postal Service that “the Postal Service proposal better fosters wide dissemination and diversity of editorial content.” McGraw-Hill Brief at 15-17. The Postal Service recognizes this concern and has been mindful of the small and high-editorial publications which are not destination-entered. In fact, in her rate proposal, witness Tang made an adjustment of \$0.013 to bring down the unzoned editorial pound rate, “in order to make sure that the ECSI value from editorial pounds is recognized and reflected in rate design”. USPS-T-35 at 8. The Postal Service believes that this adjustment results in an appropriate editorial pound rate, and therefore does not support McGraw-Hill's proposal that the editorial pound rate be reduced further. *Id.* at 16.

13. The record does not support the cost benchmark change proposed by witness Glick.

MPA/ANM argue that the Commission should deviate from prior accepted rate design by changing the cost benchmark for nonautomation carrier route flats rate category from the nonautomation 5-digit to automation 5-digit, despite acknowledging

that there is no requirement that nonautomation carrier route flats bear barcodes. MPA Brief at 34. MPA/ANM claim that the carrier route mail pieces are more similar to automation 5-digit mail pieces because they both must meet stringent address hygiene requirements. *Id.* According to MPA/ANM, the hygiene requirements are an important cost driver for nonautomation carrier route presort flats, while the presence of a barcode is not. *Id.* at 34-35.

While this may be true for nonautomation carrier route flats, it is not true for automation 5-digit flats. For this latter category, the presence of a barcode is a major cost driver. As MPA/ANM has acknowledged, one reason why mail pieces are entered in the nonautomation rate categories is the mailer's inability to apply barcodes to those mail pieces. *Id.* at 34. One issue that has not been discussed on the record is the extent to which barcodes could be applied to nonautomation carrier route presort flats mail pieces. Without this information, it is not possible to determine how many carrier route presort flats could actually "revert" to the automation 5-digit flats rate category, in the absence of a nonautomation carrier route flats rate category. The Postal Service therefore does not believe that there is an adequate record basis for deviating from the prior accepted benchmark.

14. NNA presents no sound basis to revise or reject the Within County rate proposal
 - a. NNA fails to demonstrate that its Within County rate design is superior to that of the Postal Service.

NNA argues in its Brief that the Commission should adopt the Within County rate design of witness Siwek, who proposes to increase the passthroughs for Carrier Route Basic and High Density and to increase the percentage of revenue to be derived from

the piece rates. NNA Brief at 27-28; NNA-T-3 at 24-28. In particular, NNA argues that witness Siwek's rate design corrects three "deficiencies" that witness Heath asserts are present in the Postal Service's rate design (i.e., that the Postal Service "rel[ies] too heavily on the pound side for revenue," "discourage[es] automation," and "[does] not provid[e] sufficient incentive for high density mail.") NNA Brief at 28.

The Postal Service discussed in its Initial Brief why it chose the piece/pound ratio and passthroughs that it did, and why the fact that the Within County passthroughs are lower than their Outside County counterparts (a point that NNA seems to consider proof positive of the unreasonableness of the Postal Service's proposal) is entirely consistent with accepted rate design. See Postal Service Initial Brief at 360-67.³⁸ It is therefore unnecessary to discuss these points further. Not addressed in the Postal Service's Initial Brief, however, is NNA's claim that witness Tang's rate proposal "discourage[es] automation," and that witness Siwek's alternative rate proposal remedies this problem. NNA Brief at 28. This claim flies in the face of the fact that, under the Postal Service proposal, the automation piece rates would increase by much lower percentages (a median of 26.48 percent) than under witness Siwek's alternative rate design (a median of 85.17 percent). The 5-digit automation flat piece rate would increase by 93.85

³⁸ In particular, the High Density passthrough and rate discount are discussed on page 363 in note 14. There, the Postal Service pointed out that the discount that it has proposed for High Density (1.6 cents) is the same discount as can be found in current rates, and is *higher* than the discount that was recommended by the Commission in the past two non-settled cases. See PRC Op., R2000-1, at 449 (recommending a discount of 1.5 cents); PRC Op., R97-1, at 550 (recommending a discount of 1.4 cents). The Postal Service also pointed out that NNA proposes to increase the discount for High Density by only 0.1 cents, instead seeking to benefit carrier route mail in general by dramatically increasing the size of the passthrough for Carrier Route Basic. Thus, NNA seems most interested in rewarding its members (95% of whom presort to carrier route, Tr. 29/9611) than in providing incentives for new high density mail.

percent under witness Siwek's proposal.³⁹ It thus seems that if any party is "discouraging automation," it is NNA, not the Postal Service.

- b. The Commission is free under the Act to take prior rate increases (or decreases) into account when evaluating a rate proposal.

The rate increase for Within County proposed in this proceeding is largely the result of increased costs measured for the subclass, coupled with application of the "half-markup" rule of § 3626. Witness Tang also noted, however, that this increase is, to a certain extent, balanced by the rate reduction that Within County received in Docket No. R2005-1. USPS-T-35 at 14. NNA takes great umbrage at the notion that the Commission can lawfully take into account the rate reduction that Within County experienced in the last case. NNA Brief at 29. While the Postal Service does not want to belabor this point, it wishes to point out that NNA ignores the fact that, under § 3622(b)(9), the Commission is free to consider any factors that it deems appropriate when issuing a recommended decision on rate and fee changes. In addition, when examining a rate proposal under the "effect on mailers" factor (§ 3622(b)(4)), it is certainly appropriate to take into account the fact that Within County mailers have not had a rate increase since 2002, while rates for all other subclasses have increased. As witness Tang concludes: "[t]he effective overall increase since Docket No. R2001-1 is not as great as the comparison of current to proposed rates in this filing would indicate." Tr. 7/1723. NNA's position is also inconsistent with past Commission practice: the Commission has often looked to the history of rate changes experienced by a subclass

³⁹ The entire postage for a 4-ounce 5-digit automation flat would increase by 37.06 percent under the Postal Service proposal, and by 61.69 percent under the NNA proposal. Tr. 40/13474.

when evaluating a new rate change proposal. See, e.g., PRC Op., R90-1, at ¶ 5231. Clearly, the Commission is free under the statute to consider the fact that Within County mailers have not experienced a rate increase in nearly five years when considering the rate proposal at issue here.⁴⁰

D. Priority Mail Arguments from David Popkin and Douglas Carlson Should Be Ignored

Two intervenors have presented arguments concerning the Postal Service's Priority Mail proposal: David Popkin asserts that the Priority Mail dim-weight proposal needs more detail, and Douglas Carlson makes suggestions concerning the Postal Service's "interconnectivity" study (USPS-LR-L-38) that could result in a higher percentage of distance-related ground transportation costs being allocated to Zones 5-8. The Commission should not allow either argument to influence its recommended decision in this docket.

1. Mr. Popkin's arguments concerning Priority Mail dim weighting would unduly complicate the rate schedule.

At page 16 of his initial brief, David B. Popkin presents an exceptional case for Priority Mail dim-weighting: a "large hoop" measuring 72 inches across (diameter) with a cross-section (circular, presumably) of 3.5 inches in diameter. Such a hoop, as Mr.

⁴⁰ NNA misrepresents witness Tang's testimony, at page 29 of its Brief, concerning whether the Postal Service would take the current increase proposed in this case into consideration when designing future rate proposals. NNA conveniently fails to mention that witness Tang said that the increase proposed here would "*certainly* be taken into consideration" by the Postal Service. Tr. 7/1874 (emphasis added). Thus, NNA's statement about "no guarantees" is patently contrary to the record.

Popkin demonstrates in his footnote 4, will indeed have a dim weight of 84 pounds, resulting in the maximum Priority Mail assessment of 70 pounds.

When presented with a similar case (diameter = 90 inches, circumference of cross-section = 12 inches) in DBP/USPS-399(d), the Postal Service responded, *inter alia*, that such a case is “rare.” See TR Vol. 18C at 6016-6017. Indeed, of the 5,323 Priority Mail parcels sampled as part of the Priority Mail Parcel Size Distribution and Density Study conducted from October 2002 to January 2003, not a single parcel was a hoop, let alone a hoop that is six feet high and six feet across (diameter = 72 inches), which would be larger than a tractor tire. See Docket No. MC 2004-2, USPS-LR-2. The standard Hula Hoop is 33 inches in diameter, coming nowhere close to the one-cubic-foot threshold required for dim-weighting, as it would require a cross-sectional thickness of over two inches to be large enough for dim-weighting -- $(1,728 \text{ in}^3/\text{ft}^3 / 0.785) / (33" \times 33") = 2.02$ inches. The Postal Service is aware of occasionally receiving an automobile tire for shipment, but such objects are believed to be sufficiently heavy (i.e., > 8.9 pounds per cubic foot) to be exempt from dim-weighting.

The rarity of such “parcels” notwithstanding, Mr. Popkin is concerned that “odd-shaped” parcels such as hoops, that are not “compact” (presumably he means contiguous), are not well served by dim-weighting: “These ‘odd-shaped’ parcels would allow for other parcels to be packed with other parcels and not take the space that their dimensional weight might suggest.” Popkin Brief at 16. What Mr. Popkin says for hoops could apply as well to other types of parcels that do not completely fill the space they inscribe, such as u- and crescent-shaped parcels.

Witness Scherer, at USPS-T-33, pages 21-26, considered the special challenges posed by irregularly shaped parcels (of which the “odd-shaped” parcels identified by Mr. Popkin are only a very small subset). In footnote 26, he noted that there are “myriad” types of irregularly shaped parcels, and he implied that creating various measurement categories to represent them would be impractical. In consideration that irregularly shaped parcels typically do not take up transportation container space in relation to their rectilinear, or boxed-in, dimensions, Mr. Scherer proposed a novel 0.785 adjustment factor for the assessment of cubic volume and ultimately the dim weight. This is something that no other carrier in the United States does. With Mr. Scherer’s proposal, the Postal Service will stand out as according more favorable treatment to irregularly shaped parcels than any other carrier.

Apparently this is not good enough for Mr. Popkin. Should, as Mr. Popkin suggests, some kind of special consideration be made for “hoops?” The Postal Service believes that this would be unduly complicated, and would only lead to further confusion. If standalone “hoops,” why not also implements with looped handles, or furniture with looped arms, legs or backs? Shouldn’t the space within the loop be discounted, just as Mr. Popkin presumably would somehow discount the space within a hoop? And where does one draw the line in terms of creating exceptional categories for irregularly shaped parcels? Might not u- and crescent-shaped parcels also deserve special consideration?

Ultimately, the Postal Service believes that for simplicity and ease of implementation, the myriad types of irregularly shaped parcels must be assessed in a single category, and under one set of rules. For some types of irregularly shaped

parcels, such as certain trapezoidal prisms and L-shaped parcels, the result will be quite salutary (see USPS-T-33, at 25). Other types of irregularly shaped parcels, with “hoops” being at the extreme, will fare not quite so well. This is a natural consequence of averaging.

2. Mr. Carlson's two examples form no basis for adjusting witness Nash's estimate of the percentage of distance-related ground transportation costs incurred in connection with air travel.

Witness Nash (USPS-T-16) conducted an analysis to estimate the proportion of distance-related Priority Mail highway transportation costs that are incurred in connection with air transportation. USPS-T-16 at 9-10; USPS-LR-L-38. Prior to this study, traditional Priority Mail rate design had distributed all “distance-related” ground transportation costs to the zones in which trucks are typically used for end-to-end transportation, namely Zones 1 - 4. This design did not consider the fact that some of these costs are actually incurred in connection with air travel, as mail is trucked either to or from an air mail facility. Witness Nash estimated the proportion of distance-related Priority Mail highway transportation costs incurred in connection with air transportation to be 14.13%.

In his analysis, he matched each Priority Mail origin (by SCF) in Zones 5-8 (the zones where Priority Mail generally is transported by air) to a FedEx day air facility using mapping data provided by Network Operations. USPS-T-16 at 10. In Presiding Officer's Ruling No. R2006-1/59, issued August 28, 2006, the Commission ordered the Postal Service to file the underlying "mapping" file under protective conditions. The Postal Service complied and filed a library reference with the file three days later. See

USPS-LR-L-176 (Material Provided by Witness Nash (USPS-T-16) in Response to DFC/USPS-T-16-6 (PROTECTED MATERIAL).

In his initial brief Douglas Carlson represents to the Commission that "[t]he [Postal Service's] objections . . . resulted in production of the file just five days before briefs were due." Carlson Brief at 15. The Postal Service respectfully submits that August 31 is more than five days before December 21. Mr. Carlson had adequate time to prepare rebuttal testimony on this topic, and much more time to prepare his brief. In addition, he could have moved for an extension of time to file a direct case had he so chosen.

In any event, Mr. Carlson merely says that he received two Priority Mail packages which bore indicia indicating that they did not fly from the FedEx origin airport than the file would have suggested. Carlson Brief at 15. On this basis, he writes that he "can only warn the Commission that the data underlying the Postal Service's calculations may be unreliable." *Id.* This conclusion is unsubstantiated.

The mapping data provided to witness Nash came from Network Operations. Of course what actually happens on a day-by-day basis is not always in conformance with a scheme. However, there is no reason to believe that the data are misleading. Moreover, to the extent that there may occasionally be deviations from Network Operations' scheme, the deviations would typically imply a longer inter-SCF truck haul (to or from an air facility) than what was modeled, and the 14.13 percent estimate (as a measure of "interconnectivity") may be a bit low. However, the Postal Service believes it is proper in this case to err, if anything, on the side of conservatism, noting that the current implicit assumption for interconnectivity is zero percent. Witness Nash used the

best data at his disposal to address an issue that heretofore had been left alone because of lack of data. Mr. Carlson has pointed to no basis in the record to adopt an alternative to witness Nash's estimate.

E. Package Services

1. Parcel Post:

- a. UPS does not substantiate its conclusions that the cost model is unreliable or justifies a reduced passthrough for Parcel Select.

In its Initial Brief, UPS argues that it is “simply implausible” and “simply untenable” that witness Miller’s Parcel Post cost model reliably estimates the costs of Parcel Post, and that the only appropriate response is to reduce the passthroughs for Parcel Select to 90 percent. UPS Brief at 20-26. UPS does not, however, substantiate either of these conclusions. It fails to present any record evidence showing that the model inputs it criticizes no longer represent reasonable estimates of the real-world, instead relying solely on the age of those inputs even though witness Luciani himself admits that the age of data by itself is insufficient for concluding that such data is no longer reliable. See Tr. 33/11012; Postal Service Brief at 336.⁴¹ In addition, UPS completely fails to show that to the extent the model estimates do not reflect the real-world costs incurred by the Postal Service in processing Parcel Post—and, as

⁴¹ UPS also argues that witness Kiefer’s use of constraints when designing certain of the Parcel Post rates is “strong evidence that something is awry with the underlying cost model.” UPS Brief at 24. The use of rate constraints indicates no such thing, however. Instead, it indicates that Parcel Post prices to a certain extent are unaligned with costs, a product of the fact that significant deaveraging has occurred in Parcel Post in the past eight years, and there have been no rate cases since Docket No. R2001-1 wherein adjustments to the prices to better reflect costs could occur. This issue should gradually disappear over time through a series of increases that better align price with cost while avoiding inordinate increases for certain rate cells.

discussed below, every model is necessarily a simplified version of reality—the model overstates the Parcel Select cost avoidance estimates, meaning a reduction in the passthrough is the appropriate response. Instead, as discussed by witness Miller in rebuttal, the cost model could just as well understate those avoidances. Tr. 33/11011.

UPS fails to meaningfully address witness Miller’s rebuttal testimony. It starts out by insisting that because witness Miller did not, in its judgment, state with sufficient certainty that the cost model estimates witness Luciani criticizes reflect real-world costs, he has in fact buttressed witness Luciani’s argument. UPS Brief at 21. As even witness Luciani admits, however, every input into the model represents an *estimate*, which may underestimate, overestimate, or exactly estimate the real-world value. Tr. 27/9434. Witness Miller qualifies his language because he recognizes this inherent fact about any model: there are no absolute certainties. To criticize him for doing so is completely unreasonable.

Instead, what is relevant in gauging the reliability of the model is the degree to which a given estimate could be off the mark, and the extent to which the model results are materially affected by any such misestimate. Witness Miller’s rebuttal testimony was designed to do exactly this. It demonstrates that witness Luciani’s conclusions that the cost model is fatally flawed and unreliable, and that the appropriate remedy is to reduce the Parcel Select passthroughs, are wholly unsupported. See Postal Service Brief at 336-37. UPS criticizes witness Miller for employing “convenient ‘hypothetical[s]’” when discussing the fact that certain inputs to the model that witness Luciani criticizes do not have a material affect on the model results. With one exception

(discussed below), however, it does not attempt to show how any of witness Miller's hypotheticals are unreasonable.

The only record evidence that helps one judge the reasonableness of the cost model inputs with actual data supports the view that the model is reliable. PSA witness Zweig shows that the Postal Service's estimate of the number of nonmachinable and oversized DDU parcels, which was criticized by witness Luciani, is reasonable. Tr. 33/11243-44. Also, witness Zweig shows that the cost model's estimate concerning the average number of pieces per container at the DDU is reasonable, Tr. 33/11243, which undercuts UPS' belief that "there are good reasons to believe that a 20% change over 20-plus years [in the pieces per-container at the DDU, which is assumed by rebuttal witness Miller to show that the DDU pieces per container figure in the model does not have a material effect on the cost model results] is drastically understated." See UPS Brief at 22.

Not only does UPS fail to substantiate their criticisms of the Parcel Post cost model, whose reliability is buttressed by the record evidence presented by PSA, it also fails to show if the model inputs it criticizes were updated today, the result would be lower Parcel Select cost avoidance estimates. In rebuttal, witness Miller shows that even if some of the estimates would likely change if updated today, it does not stand to reason that the appropriate response on the part of the Commission is to *reduce* the passthroughs for Parcel Select. To the extent the model is inaccurate, witness Miller notes, it could just as easily understate the cost avoidances associated with Parcel Select. Tr. 33/11011.

For example, witness Miller and PSA witness Glick both discuss the fact that the model may overstate the costs of Parcel Select DDU (and therefore understate its cost avoidance estimate) through its treatment of certain MODS cost pools as fixed, even though some of the costs in those pools may not be incurred by DDU.⁴² UPS seeks to dispose of this point by stating that witness Miller's position is "based on a vague concern that other potential but not yet identified errors in the model may balance out the errors found by witness Luciani." See UPS Brief at 27. This completely ignores the fact that witness Luciani himself admits that DDU parcels may avoid the costs in certain fixed MODS cost pools (Tr. 27/9444, 9466, 9468); thus, it is unclear exactly how witness Miller's concerns are "vague" and "unidentified." Witness Miller's argument about why the Commission should disregard witness Luciani's proposed "interim improvement" to the model is quite logical: absent a comprehensive analysis of how the modeled costs relate to each cost pool, revising the model on the basis of a single, selective cost pool analysis is inappropriate. Tr. 33/11021. Combining witness Luciani's "interim improvement" with a reduced passthrough could, in addition, lead to an inappropriately understated discount for Parcel Select DDU.

In the end, UPS' criticisms of the Parcel Post cost model are simply all smoke and no substance. It seeks to label the cost model as producing "uncertain" cost estimates, justifying the use of reduced passthroughs for Parcel Select, without demonstrating that any of the cost model inputs it criticizes are unreliable estimates of the real-world, leading to overstated Parcel Select cost avoidance estimates. In fact,

⁴² In its Initial Brief, the Postal Service also noted that to the extent the percent of parcels dispatched directly to the delivery unit from the BMC has decreased, the result

the only substantive data on the record supports the reasonableness of the cost model inputs. In addition, witness Miller shows that UPS' argument is unavailing. The Commission should therefore agree with witness Miller's conclusion that UPS' criticisms of the Parcel Post cost model should be disregarded when considering what passthroughs to recommend for Parcel Select.

- b. PSA's argument that Parcel Select should have no window service costs is unsupported.

Parcel Shippers Association challenges the costing for Delivery Confirmation because a small portion of window service costs was included for Parcel Select electronic.⁴³ This is consistent with the fact that some customers might print and adhere an electronic label but submit their items at the window, that customers may come to the window to pick up Parcel Select packages that could not be delivered, and that some customers may enter Parcel Return Service pieces at the window. There is therefore no reason to conclude that this is an error.⁴⁴

- c. PSA witness Finley's suggestion regarding END is not practicable.

Referencing the testimony of its witness Finley (PSA-T-1), PSA "urges the Commission to take the impact of END on preparation and entry costs into account when recommending postal rates for parcels, particularly those entered at DBMCs."⁴⁵ However, as stated in the Postal Service's initial brief, the impact of END on the test

would be that the DDU cost avoidance would increase. See Postal Service Initial Brief at 337 n.1.

⁴³ PSA Initial Brief at 18-19.

⁴⁴ See LR-L-59, Attachment 4E, at 12, n. 1.

⁴⁵ PSA Initial Brief at 16.

year is not known with any specificity.⁴⁶ There is no record evidence in either this docket or in Docket No. N2006-1 to suggest otherwise. Therefore, PSA witness Finley is simply asking the Commission to do the impossible.

2. Bound Printed Matter

- a. Amazon.com fails to support its proposal to allow non-bound non-printed electronic media to be mailed as Bound Printed Matter.

Amazon.com, having noted that “postal offerings have not been frozen in place,”⁴⁷ skates all over the ice with regard to its creative, but flawed, proposal that matter that is neither bound nor printed be allowed to be mailed as Bound Printed Matter. Amazon.com’s brief, like witness Haldi’s testimony, at first blush appears to be proposing that “books published in electronic format” be allowed to be mailed as Bound Printed Matter.⁴⁸ Yet further examination revealed that his proposal would allow *all* electronic media to be mailed as Bound Printed Matter regardless of the physical characteristics of the media or of whether the media contain books, movies, music, or hockey games.⁴⁹

Misinterpreting criticism that his initial logic asserting the similarity in content between books and certain electronic media failed to hold when extended to all electronic media, witness Haldi put forth an alternative under which only electronic media that the Postal Service determined contained book content or otherwise substituted for printed material would be eligible.⁵⁰ This proposal completely ignored

⁴⁶ See Tr. 18D/6616-23; Postal Service Initial Brief at 330.

⁴⁷ Amazon.com Initial Brief at 12.

⁴⁸ *Id.* at 14.

⁴⁹ Tr. 27/9377-80, 9402.

⁵⁰ Tr. 27/9402.

the fact that such a restriction would be unenforceable. There is no way for postal acceptance employees fairly and consistently to determine the ultimate source of, or inspiration for, the material contained on electronic media.⁵¹ So, the logic that *some* DVDs have similar content to some books would have to suffice as a justification for allowing *all* electronic media to be mailed as Bound Printed Matter. The logic for this broader eligibility is non-existent; the reality for the less broad eligibility results in an unworkable situation. This is reason alone to reject the proposal.

Yet even more important is the lack of analysis of the effects of the proposal on postal costs. Addressing Postal Service objections regarding differences in density between books and catalogs on the one hand and electronic media on the other,⁵² Amazon's brief criticizes witness Kiefer for not having weighed books and DVDs of similar cube.⁵³ This is a shocking misunderstanding of the relevant issue. It is not the density of the items that matter; it is the density of the parcels that contain them.

Amazon also ignores the difference in size between the average DVD/CD and the average book, as well as differences in size between CDs and DVDs. The record is devoid of data on these issues. Instead of providing the data and doing the analysis needed to justify its proposal, Amazon argues that "the record in this docket contains no evidence that CDs and DVDs have density or cost characteristics that are any less

⁵¹ Witness Haldi concedes that "refined procedures" would be necessary to enforce situations in which it was not obvious if a DVD were based on a book. *Id.* One shudders at the need for a continuously updatable DMM table showing, in one column, all electronic media ever produced and, in the next, a determination, presumably by some panel of experts retained by the Postal Service, of whether the electronic content is related to a book, thus allowing its acceptance as "BPM."

⁵² USPS-RT-11 at 27-32.

⁵³ *Id.* at 25.

favorable than those of books”⁵⁴ The burden, however, is on the proponent of a classification change to show its effects. Amazon has failed to meet this burden and its proposal should be rejected.

As MOAA demonstrates in its brief,⁵⁵ the favorable cost characteristics of Bound Printed Matter are due to the nature of the material as the subclass has evolved: first large catalogs, and later books with and then without advertising. These favorable characteristics have been diluted somewhat in recent years, perhaps due to the way some mailers package their books in boxes that have little relation to the size of the book (or the CD or DVD for that matter). These changes and the evolving needs of mailers, is certainly worthy of attention. The instant record, however, does not justify the radical change proposed by Amazon.

In its brief, Amazon claims that its proposal will benefit the Postal Service.⁵⁶ Amazon, however, fails to demonstrate how changing the indicia on an otherwise identical mailpiece (*i.e.*, from Media Mail to BPM) will improve Postal Service finances. The costs of the piece would not change, but revenue would clearly be reduced.⁵⁷ Amazon’s attempt to dress up a bid for lower prices as a bonus for the Postal Service fails and provides another reason to reject Amazon’s proposal.

⁵⁴ *Id.* at 26. Witness Haldi admitted that he did no analysis of the effects of his proposal on postal costs. Tr. 27/9401.

⁵⁵ MOAA Initial Brief at 28-33.

⁵⁶ Amazon.com Initial Brief at 16.

⁵⁷ USPS-RT-11 at 28-29.

- b. PostCom describes Angelides's proposed prices for Bound Printed Matter as merely reflecting a different cost coverage, but this is false.

In its initial brief, PostCom says that its proposed rates for BPM reflect Commission recommended cost coverages.⁵⁸ So while invoking precedent as a reason to adopt its entire proposal, it effectively rejects precedent rather than honors it in the Bound Printed Matter rate design. Witness Angelides demonstrates the refutation of precedent by proposing per-piece rates that vary by zone,⁵⁹ a radical departure from established Bound Printed Matter rate design. Moreover, he does this without a word of explanation. The entire proposal should be rejected since it is unsupported on the record.

- c. Carlson's proposal to include PVI in DMCS section 3040 is unnecessary and unwise.

Mr. Carlson's proposal to amend DMCS section 3040 to include a PVI label⁶⁰ as a valid form of postage payment is unnecessary. The section already provides that other payment methods may be specified by the Postal Service, so specification of PVI labels is not needed. Moreover, the section addresses how customers may prepay postage. It is not directed at postal operations, such as the particular technologies that postal clerks use. Given that such technologies may change over time, specifying a particular one in the DMCS is unwise, as well as unnecessary.

⁵⁸ PostCom Initial Brief at 39.

⁵⁹ PostCom-T5 at 13-14.

⁶⁰ Carlson Initial Brief at 9.

- d. Carlson's and Popkin's concerns about the availability of Bound Printed Matter are overstated.

The concerns expressed by Messrs. Carlson and Popkin in their briefs concerning alleged discrimination against certain customers in the provision of Nonpresort Bound Printed Matter⁶¹ are unfounded. No action that the Postal Service plans to take will treat different classes of customers differently. No customers will be denied access to services. The Postal Service certainly does not plan to instruct its employees to deny the existence of Bound Printed Matter (or any other service). These fears do not provide a basis for rejecting the Postal Service's proposal to more accurately rename Single-Piece Bound Printed Matter as Nonpresort Bound Printed Matter, since it is also used by bulk mailers. Nothing in that name change precludes its use by non-bulk mailers.

3. Media Mail

- a. PostCom mischaracterizes Kiefer's criticism of witness Angelides's proposal and fails to address its core deficiency.

In its initial brief, PostCom attempts to support witness Angelides's proposal for a new Media Mail rate design, but ultimately falls on its own sword. Witness Kiefer had criticized Angelides's exempting the first pound from his half-pound-incremental rate design.⁶² In response, Postcom suggests that the Commission explore such increments. Rather than remedying the minor fault pointed out by witness Kiefer, this additional proposal actually highlights the core deficiency of witness Angelides's proposal, which is the lack of any record evidence showing cost causation by weight.⁶³

⁶¹ Carlson Initial Brief at 7-12; Popkin Initial Brief at 11-14.

⁶² PostCom Initial Brief at 41; see USPS-RT-11, at 34.

⁶³ See USPS-RT-11, at 33-4.

Witness Kiefer's criticisms overall stand unrebutted. The Commission should recommend prices consistent with the rate design proposed by witness Yeh and not adopt witness Angelides's unsupported proposal.

VII. CRITICISMS OF THE POSTAL SERVICE'S SPECIAL SERVICE PROPOSALS ARE UNFOUNDED, AND ALTERNATIVE PROPOSALS SHOULD BE REJECTED.

The Postal Service presented the basis for its special service proposals in its initial brief. Postal Service Brief, Section VII. The Postal Service responds to arguments raised on brief by the intervenors and the OCA below.

A. MMA Misunderstands, Mischaracterizes, and Muddies the Record Relating to High Volume QBRM Fees.

It is clear from MMA's Initial Brief that MMA is unwilling to accept the Postal Service's estimate of the proportion of manually counted high volume Qualified Business Reply Mail (QBRM) presented in USPS-LR-L-34. Yet, it is telling that there is nothing in MMA's brief that indicates that USPS-LR-L-34 was anything other than an unbiased study of BRM accounting and billing practices, based on sound statistical principles. Rather than pointing to any specific flaws in the study design or sampling method, MMA offers several irrelevant observations and consistently misinterprets or mischaracterizes basic aspects of the BRM rate category and USPS-LR-L-34, reflecting a fundamental misunderstanding of the issues. A careful reading of the record evidence reveals that there is nothing to support MMA's position that the BRM Practices Study is "fatally flawed;" rather, the manual counting estimates in USPS-LR-L-34 are unbiased estimates and are based on a sound statistical study.

1. MMA misunderstands basic statistical principles and key aspects of the QBRM universe.

As discussed in the Postal Service's Initial Brief, MMA witness Bentley has demonstrated a lack of understanding about the High Volume QBRM category and the difference between expected and actual volume. USPS Brief at 375. In addition,

MMA's Initial Brief exhibits a basic misunderstanding of the concept of seasonality. Seasonality is different from day-to-day fluctuations in volume. There may be large day-to-day fluctuations in volume when seasonal volume is relatively constant, and there may be small day-to-day fluctuations when seasonal volume varies greatly.

Moreover, MMA fails to understand how a cross section of BRM mail can account for seasonal fluctuations in an individual mailer's volumes. The population of High Volume BRM is comprised of the volume of hundreds of unique customers. Within the universe of BRM customers, some have relatively stable daily volumes throughout the year while others, such as survey firms and proxy processing firms, will have large fluctuations within the year. However, as illustrated in the table below, the aggregate volume of High Volume QBRM is relatively constant throughout the year.

FY 2005 High Volume QBRM Pieces by Quarter

High Volume QBRM	Quarter 1 ¹	Quarter 2 ²	Quarter 3 ³	Quarter 4 ⁴
	37,277,345	43,506,462	37,329,430	45,425,386

For this to be possible, at any point in time there must be customers experiencing peak volume levels and others that are in the volume troughs. A random sample, which was collected in USPS-LR-L-34, will capture both peaks and troughs.

In such cases, a random sample will observe relatively large volumes being counted manually, as is the case in the observations reported by MMA in the table on page 16 of its brief. A random sample will also record observations at the trough of a

¹ Source: USPS-LR-L-87, workbook Shape Q1 2005rv.xls, sheet "First," cell E52.

² Source: USPS-LR-L-87, workbook Shape Q2 2005rv.xls, sheet "First," cell E52.

³ Source: USPS-LR-L-87, workbook Shape Q3 2005rv.xls, sheet "First," cell E52.

⁴ Source: USPS-LR-L-87, workbook Shape Q4 2005rv.xls, sheet "First," cell E52.

customer's volume, as is the case in the observations reported by MMA in the table on page 18 of its brief. MMA mischaracterizes these observations as being anomalous, when given the characteristics of some High Volume QBRM customers, these observations are accurate and expected. Similarly, MMA erroneously states that the study "cannot and does not account for changes to more efficient counting methods when volume increases occur." MMA Brief at 19. A cross-sectional random sample, such as the sample in USPS-LR-L-34, will observe non-manual methods when offices have adjusted to increased volumes. These mistaken assertions by MMA demonstrate a lack of understanding about basic statistical principles, the concept of seasonality, and the BRM Practices Study itself.

Additionally, MMA continues to misunderstand and mischaracterize the duplicate records in the "alldata2" file that were removed in the Postal Service's errata filing on December 13, 2006. During cross examination of witness Loetscher's rebuttal testimony, MMA identified certain duplicate records in "alldata2." Witness Loetscher investigated these instances and found a total of six duplicate observations in the "alldata2" file. In the December 13 errata, those observations were removed from the original filing, which originally included a total of 1,789 observations. As the Postal Service has made clear, each observation may correspond to multiple lines of data in the file. Those six duplicate observations correspond to 118 duplicate lines of data,⁵ and the original version of the "alldata2" file contained a total of 19,803 lines of data. Thus, less than one percent of the original data, in terms of either observations (6 out of

⁵ These 118 duplicates include the 64 "duplicated data errors" referred to by MMA. MMA Brief at 14.

1,789) or lines of data (118 out of 19,803), were found to be duplicates and were removed in the Postal Service's December 13 errata.

MMA's mischaracterizations of the Postal Service's errata and the "alldata2" file, seems to be based on MMA's continued misunderstanding of the terms "site," "observation," "record," or "lines of data." MMA's extensive discussion of the errata and its assertions that these duplicates represent a "fatal flaw" in USPS-LR-L-34, serve only to clutter the record and obscure the key issues. Moreover, as the Postal Service's errata makes perfectly clear, the removal of these six duplicate observations had minimal impact on the estimate of High Volume QBRM that is manually counted. Prior to the removal of the duplicate records, 26.6 percent of High Volume QBRM was estimated as being counted manually, and after the removal of the duplicate records, the estimated proportion of manual counting increased by half a percentage point to 27.1 percent. *Compare* USPS-LR-L-34, Table 1, page 13 (as revised on December 13, 2006) *with* USPS-LR-L-34, Table 1, page 13 (original version filed May 3, 2006).

Finally, despite MMA's apparent misunderstandings about multiple issues related to USPS-LR-L-34, MMA asserts that witness Oronzio's testimony "does not hold up under even the most cursory scrutiny." MMA Brief at 20. Witness Oronzio provides rebuttal testimony in this docket about manual counting of High Volume QBRM from an operational perspective. He explains that in certain situations, it is more efficient to manually count High Volume QBRM that is received in smaller volumes.⁶ Tr. 36/12272-

⁶ Witness Loetscher also testifies that High Volume QBRM rates may be an attractive option to customers at low volume levels. Tr. 38/13271. Further, he demonstrates that the Postal Service uses non-manual counting methods when High Volume QBRM is received in large volumes, and uses manual counting methods when it is received in small volumes. Tr. 38/13278.

3. Yet MMA criticizes witness Oronzio even though MMA chose not to cross examine him during the hearing on his rebuttal testimony. It is difficult to understand how MMA can allege that the testimony of a Postal Service operations expert “does not hold up under even the most cursory scrutiny” when MMA chose not to put the expert’s testimony under any scrutiny at the hearing.⁷ This is yet another example of how MMA is either unable or unwilling to face the facts regarding BRM practices, either from an operational perspective or based on the results from a statistically sound study. The Commission should not accept MMA’s mistaken assertions about BRM practices over the testimony of Postal Service witnesses Loetscher and Oronzio.

2. MMA clutters the record with irrelevant observations and exaggerations in order to obscure the fact that witness Loetscher’s BRM Practices Study is the most statistically sound BRM study on the record.

MMA’s Initial Brief is filled with several irrelevant observations and exaggerations that serve only to cloud the record. At best, many of these observations only further reflect MMA’s misunderstanding of statistical principles and the BRM Practices Study in USPS-LR-L-34. First, MMA devotes considerable effort in describing when and how witness Loetscher became aware of previous estimates of High Volume QBRM accounting in Docket Nos. R2000-1 and R2001-1. MMA Brief at 11-12. This point is irrelevant, and misses the point about statistically sound study design. It is clear from witness Loetscher’s rebuttal testimony that the results of previous studies, and the methodology employed in the previous studies, had absolutely no bearing on how witness Loetscher designed, conducted or evaluated the BRM Practices Study. Nor

⁷ It appears as if MMA urges the Commission to rely on an outdated video of the operational practices of inexperienced KeySpan clerks rather than the testimony of witnesses Oronzio and Loetscher. See MMA Brief at 16, fn. 6; Tr. 21/7915-7.

should it have had an effect: as witness Loetscher testifies, the Docket Nos. R2000-1 and R2001-1 studies and their estimates were flawed in both statistical design and the measurement of accounting practices. Tr. 38/13271-6. These studies produced biased estimates that underestimated the proportion of High Volume QBRM that was counted manually. *Id.* It makes no sense to design a statistically sound study based on flawed methodology from prior dockets.

In addition, MMA claims that the USPS-LR-L-34 sample was not representative of High Volume QBRM because the sample was drawn to be representative of all BRM, not just High Volume BRM. MMA Brief at 15. For supporting evidence, MMA points to the fact that eight of the twenty sites in the certainty strata received less than 1 million pieces of High Volume QBRM. *Id.* The sites in the certainty strata were selected with certainty, and as such, are only meant to be representative of themselves. See USPS-LR-L-34 at 7-8. Suggesting that the characteristics of the sites in the certainty strata have any bearing on the representativeness of the sample is patently irrelevant and, at best, reveals a lack of understanding of statistics. MMA provides no evidence to suggest that the statistically drawn stratum is not representative, because the sample for the BRM Practices Study was drawn based on sound statistical principles.

MMA also comments on the fact that volumes for individual accounts were not collected. MMA Brief at 15-16. This fact, although true, is irrelevant. The purpose of the BRM Practices Study was to estimate the accounting and billing practices employed for the entire population of BRM pieces. Information on individual account volume is not necessary to produce the required estimate. It is both necessary and sufficient to measure the actual BRM rate, accounting method, and billing method used for each

sample piece. This is what was collected in the study. Knowledge of individual account volumes, if collected, would have had absolutely no bearing on the estimates, and MMA's discussion of individual account volumes only clutters the record.

MMA also seeks to sow confusion regarding the way the sample was weighted.

MMA Brief at 21. The weighting method used is consistent with the sample design and is clearly described on pages 9 and 10 of USPS-LR-L-34, which states:

The responses to the Volume Data section of the survey were consolidated across all responding stations to a 3-digit ZIP Code total. These offices were then controlled to the ODIS volumes that were used for sample selection. A Horowitz-Thompson estimator was also used in order to weight correctly the randomly sampled sites in Strata 2.

MMA's comparisons of the final result to the unweighted sample, or to any ad hoc analysis used to detect data entry errors, is inappropriate and irrelevant.

Finally, MMA attempts to characterize the BRM Practices Study as being hastily designed and conducted. MMA Brief at 11. MMA cites a portion of the transcript from the hearings on witness Loetscher's rebuttal testimony in support of this allegation, yet ignores the following exchange from the transcript (Tr. 38/13289):

Q: Okay. So, you generated everything necessary for the study over the holiday period in December of 2004?

A: I can't remember the exact date that we were contacted. It may have been late November. But, yes, about a month it took us to develop the training materials and survey instruments and we worked hard and we have a lot of experience doing that. It's a tight bind, but we were – I think we came up with a good product.

Clearly, this is a last-minute effort by MMA to obscure the key issues related to the BRM Practices Study, rather than accept the fact that the BRM Practices Study was a statistically sound study performed by an experienced firm and experienced, qualified

individuals. MMA's attempts to cloud the record with this sort of allegation, as well as several other irrelevant observations, should be ignored.

B. Growing Family and OCA's Arguments for Lower COD Fees Are Unsupported on the Record, and Should Be Rejected.

Growing Family asks the Commission to either apply the cost coverage for COD service to a so-called "corrected" forecast of indemnities to be paid by the Postal Service in the Test Year, or recommend fees that cover only 101 percent of the Postal Service's Test Year forecasted costs for COD. Growing Family Brief at 17. It also asks the Commission to recommend that COD fees be based on reproduction cost for the COD item, instead of the amount to be collected. *Id.*

Growing Family relies on the testimony of its Vice President, Operations, Robert Paul (GF-T-1), and chides the Postal Service for not offering rebuttal testimony. Growing Family Brief at 1. Mr. Paul complains about how the Postal Service pays claims by Growing Family when it sends a package by COD, but then receives neither the money the addressee would pay (if purchasing the package), nor a return of the package (if the addressee refuses it). He testifies that until May 2005, the Postal Service would reimburse Growing Family in an amount equal to what was to be collected from the addressee (which could result in Growing Family receiving a double payment, one from the Postal Service and one from the customer in the event that it mailed the article to the customer a second time and the customer paid for it). But he claims that, since May 2005, the amount reimbursed has generally been limited to only the reproduction cost of Growing Family's items (along with postage and COD fees).

See GF-T-1 at 2-3. The Postal Service has presented good reasons for not paying the amount to be collected in every case:

A decision to pay indemnity in the amount of the retail value in all instances would contradict the principles underlying the indemnity standards by making the sender better off, in some instances, than it would have been. For instance, if the addressee refuses the parcel and it is lost upon return to the sender, compensation in the amount of the retail value would provide the sender a profit it is not entitled to since the addressee refused the package. Where the package is lost enroute to the addressee, providing the compensation for reproducing the package allows the sender to resend the package to the addressee to see if a sale can still be made.⁸

On brief, Growing Family argues that because this change in reimbursements to Growing Family took place in the middle of the Base Year, the COD revenue requirement and fees in the Test Year are overstated "by an amount that Growing Family has been unable to determine," and should be reduced to reflect the impact of the Postal Service's alleged new claims payment practice in relation to Growing Family.⁹

Growing Family had a full opportunity to assemble the data necessary to support its argument through discovery, but failed to do so. It failed to submit any evidence that could be used to quantify the impact of the Postal Service's payment practice in relation to Growing Family on the Postal Service's projected total COD claims payments in TY 2008. It further failed to present evidence of any alternative projected costs for the Test Year.

⁸ March 10, 2006 letter from Postal Service Consumer Advocate Delores Killeto to David Straus, attorney for Growing Family, at 2. Tr. 15/4483. Also see Tr. 15/4652.

⁹ Growing Family Brief at 8-10; GF-T-1 at 8-9, 15-16. Witness Berkeley explains that any change in May 2005 was "due to a clarification of the Postal Service's policy," as explained in the March 10, 2006, letter from Postal Service Consumer Advocate Delores Killeto to David Straus, attorney for Growing Family. Tr. 15/4482-86.

Specifically, there is no evidence in the record concerning the percentage of the Postal Service's total COD claims payments going to Growing Family, or what percentage of the dollars in claim payments go to Growing Family. In the absence of any such evidence, there is no basis to alter the Postal Service's projected Test Year COD claims payments, nor was there any need for the Postal Service to produce rebuttal testimony.

The indemnity costs associated with Growing Family and similar photo mailers is a small part of just one cost segment that is part of the total volume variable costs for COD service. The payouts to Growing Family, the largest of the COD photo mailers, represent a very small percentage of total COD costs. Therefore, even if all of the payouts to Growing Family ceased and the total volume variable costs were adjusted downward appropriately, there would be a negligible effect on the proposed Test Year cost coverage for COD. Given the low proposed cost coverage for COD service (113 percent, a reduction from the Docket No. R2005-1 coverage of 129 percent), a small cost coverage increase would certainly be consistent with the statutory pricing criteria.

Specifically, the overall volume variable cost for COD for the base year (05) was \$8,736,000. See USPS-LR-L-5, B_Workpapers, ExA_BY05.Crpt, tab CSSummary, cell U38. The indemnity costs paid to mailers in BY05 was \$1,952,000. See USPS-LR-L-5, B_Workpapers, CS20.xls, Tab 20.5.1, cell E11. Thus only 22 percent (1,952,000 divided by 8,736,000) of the overall volume variable costs for COD in BY05 consisted of indemnities. Growing Family states that it represents 10 percent of COD volume. Growing Family Brief at 9. Even if Growing Family represented 10 percent of indemnity costs paid to mailers for BY05 (and the Postal Service believes that would be an

overstatement) eliminating all those costs would remove only about 2 percent of COD total volume variable costs.¹⁰

Thus, there is no basis for the cost reductions proposed by Growing Family, or for adjusting the cost coverage down to 101 percent. Reducing the cost coverage by 12 percent, as suggested by Growing Family, would be grossly inconsistent with a cost reduction that would be less than 2 percent of costs.

As to the calculation of the fee for COD service, Growing Family's suggestion that it should be calculated based on the reproduction cost of the item mailed, GF-T-1 at 6, 16, would unduly complicate the application of the fee schedule, as each mailer would have to calculate, in advance, how much it would cost to replace each item mailed by COD. More importantly, COD indemnities to mailers are not always limited to reproduction costs. There are situations in which the Postal Service will be required to reimburse the mailer for the full amount that was to have been collected from the recipient. Postal Service Brief at 379. In addition, Postal Service Headquarters (Accounting) plans, to the extent possible, an extended effort before the test year to further support application of the policies in the Killette letter for adjudication of COD claims, which, in some cases could allow for GF to receive the full retail value of the photographs. Accordingly, it is appropriate to maintain the current formula for fee calculation. The Postal Service therefore submits that the Commission should recommend the fees proposed by witness Berkeley, and that Growing Family's claims dispute should have no effect on the pricing of COD service.

¹⁰ There is moreover no basis for eliminating all of Growing Family's indemnity costs, since Growing Family witness Paul testifies that Growing Family is typically reimbursed for reproduction cost plus postage and fees, and the base year costs already reflect this payment approach for the last 4-5 months of that year.

On brief, OCA cites Growing Family's evidence, and makes conclusory arguments that there has been a change in payment policies for COD packages, resulting in random payments for packages that are delivered but not paid for, and the Commission should recommend a markup for COD "close to zero." OCA Brief at 163. For the same reasons listed above in relation to growing Family's arguments, the Commission should not pay heed to this argument.

C. The Postal Regulatory Commission Should Recommend the Fee Design, Fees, and Classification Changes for Confirm That Are Proposed by the Postal Service, With One Exception.

In its initial brief, the Postal Service specifically addresses how the Postal Service proposal for Confirm improves the fairness and equity of pricing for Confirm. Postal Service Brief, Section VII, Part D. Since the OCA's proposal for Confirm service retains the existing pricing structure, part D also shows that the Postal Service proposal is far superior to the OCA's proposal. Finally, the Initial Brief explains why MMA's limited proposal for Confirm service cannot be recommended by the Commission based upon the existing evidentiary record. This Reply Brief addresses arguments raised by intervenors and the OCA in their initial briefs, first by providing additional background on the history of Confirm service.

The Postal Service proposal for Confirm turns away from subscription pricing, with its unlimited scan option for the top tier, because despite several years of trying the service has never covered attributable costs; moreover, the OCA's attempt to retain subscription pricing also shows little likelihood of covering costs. As such, the Postal Service proposal recognizes the fact that the marginal cost for Confirm scans of mailpieces approaches zero dollars with prices that do the same. The Postal Service

Initial Brief also explains how the new pricing for Confirm facilitates expansion of the Confirm infrastructure to embrace new services without compromising any of Confirm's capabilities for evaluating service performance assessment. Postal Service Initial Brief at 386.

The Postal Service Initial Brief explains why only its proposed fee design can realistically be expected to generate sufficient revenue for Confirm service to cover costs in the test year. In short, the existing fee structure has not generated revenue sufficient to cover costs for the several years that Confirm service has been in existence, so a new approach must be taken.¹¹ The only full blown alternative, a proposal made by witness Callow for the OCA, mistakenly retains the existing pricing design. That retention, plus a range of exceptionally risky financial and behavioral assumptions incorporated into the proposal, make it very unlikely that, if implemented, attributable Confirm costs would be covered.¹²

Major Mailers Association (MMA) witness Bentley proposes an alternative price structure that appears to assume that some unspecified costs for Confirm service would be rolled into the cost base for First-Class Mail. Thus, each First-Class Mail Confirm subscriber would pay just \$2000 annually for a subscription. The absence of details, including any proposal for mailers of other classes, is problematic.

The main point of contention for Confirm service is an aspect of the present pricing design that provides unlimited scans to subscribers at the highest of three subscription tiers, Platinum. This structure was implemented via Docket No. MC2002-1,

¹¹ Postal Service Initial Brief at 379-87.

¹² Somewhat curiously, the OCA also argues that Confirm service need not cover its costs, because that failure could somehow be addressed in a future case. Tr. 33/11383-84, 11402.

based on the rationale that it would encourage use of Confirm service, thus generating more Confirm mailpiece scans for analysis of mail flowing through the processing system.

Confirm scans of customer mail, however, have been less useful for service performance assessment than originally hoped.¹³ The Postal Service accordingly set up an alternative method of using the Confirm infrastructure for service performance assessment.¹⁴ Costs for this method, totaling approximately two million dollars, have been excluded from the cost base for Confirm service, a decision that has gone unchallenged in this docket.¹⁵

The existing fee design for Confirm service has proven that it does not work. Indeed, consideration of how to fix Confirm prices led to exclusion of Confirm from the preceding omnibus rate case, Docket No. R2005-1, since it was then clear that an across-the-board increase in Confirm fees would generate insufficient revenue to cover costs.¹⁶

¹³ Tr. 14/3942-43, 3947-48, and 3965-66.

¹⁴ See, e.g., Tr. 14/3942-43.

¹⁵ Tr. 14/3956. The Postal Service generally does not recognize revenues from its own use of postal products and services. See also, Response of Postal Service Witness Mitchum (USPS-RT-13) to Question Posed at the November 30, 2006 Hearing (December 7, 2006).

¹⁶ See *Notice of the United States Postal Service Regarding Exclusion of Confirm Service from General Rate Proceeding* (April 8, 2005) which concluded as follows:

In a context that involves comparatively rapid evolution of the Confirm infrastructure, and steep learning curves for both customers and the Postal Service regarding how Confirm can best be used, the Postal Service has concluded that an in-depth review of Confirm operations and performance, as well as evaluation of its price structure, is warranted. Consequently, it has concluded that it would be premature to propose increased fees at this time. The Postal Service is now evaluating its options, *including the potential for changing the structure of the fee schedule*, and expects that it will address both fees and service aspects

The Postal Service put together a very comprehensive, and ultimately persuasive, direct case when introducing the unusual subscription approach to pricing Confirm in Docket No. MC2002-1, relying upon testimony from five witnesses. Product manager Paul Bakshi (USPS-T-1) described the service, its operation, and the various stages of implementation. Industry witness (and then MTAC industry chairman) Joe Lubenow (USPS-T-2) described the evolution of Confirm service both retrospectively and prospectively. Costing expert Norma Nieto (USPS-T-3) estimated test year costs for Confirm service. Survey researcher Beth Rothschild (USPS-T-4) projected demand for Confirm service at two different price points for both resellers and non-resellers; the Postal Service recognized that it was creating a new market that would be filled by mailing service providers, so the pricing for Confirm needed to balance the needs of that aftermarket with its own revenue requirements. Economist Dr. James Kiefer (USPS-T-5) proposed pricing for Confirm service that differed from the usual transaction based paradigm, ultimately settling on the Silver, Gold and Platinum subscriptions that were later implemented.

Seven briefs were filed by intervenors in this docket,¹⁷ plus one from the OCA, all weighing in on Confirm fees and largely on behalf of Platinum subscribers or resellers.

of Confirm in a separate proceeding to be filed in the future. [Emphasis added.]

¹⁷ The briefs include: *Initial Brief of the American Bankers Association* (ABA herein); *Brief of Alliance of Nonprofit Mailers, National Association of Presort Mailers, National Postal Policy Council, and Office of Consumer Advocate on Pricing of Confirm Service* (ANM herein); *Initial Brief of GrayHair Software on Pricing for Confirm Service* (GrayHair); *Initial Brief of Major Mailers Association On Issues Regarding First-Class Presort Rates* (MMA); *Initial Brief of the Mail Order Association of America* (MOAA); *Initial Brief of the Association for Postal Commerce and the Mailing and Fulfillment Service Association* (Postcom); *Initial Brief of Major Mailers Association on Selected Special Service Issues* (MMA); *Initial Brief of Discover Financial Services LLC* (Discover); and *Initial Brief Janyce Pritchard for the Flute Network* (Flute).

So no surprise should attach to the fact that they all argue for retention of a subscription tier that provides unlimited scans, since in the short and long run Confirm fees for users of more than 254 million scans would be less under the OCA proposal than under the Postal Service proposal. Tr. 21/7803. In large measure, these briefs rely upon arguments made by the Postal Service in support of subscription pricing in Docket No. MC2002-1, or in subsequent restatements of the vision and justification for the subscription pricing approach.¹⁸ The Postal Service does not understand that repetition of the arguments made in that docket is productive at this time because howsoever well that approach was supported at the time, it did not lead to the fiscal success that was necessary and intended. The fact that the OCA attempt to resuscitate the subscription approach contains myriad weaknesses further demonstrates the impropriety of that approach.¹⁹

So, as the Postal Service prepared for the instant docket, it had to face the failure of Confirm service to recover its costs in any year of service. Also noteworthy is the success of value-added resellers, a market sector the Postal Service deliberately created and continues to support. Yet much of the recent volume growth of Confirm

¹⁸ More recent materials include a speech by a Postal Service officer that was prepared shortly before the Request was filed. See, e.g., ANM Brief, *passim*. That speech was prepared prior to the preparation of the current proposal, and completed prior to the filing of witness Mitchum's testimony, so the speech needed to stick with the prior, now superseded, public position of the Postal Service. However, not even the 36 mentions of this speech in the ANM brief can change the fact that the current and official Postal Service position on Confirm service appears in the Request and supporting materials such as USPS-T-40 and USPS-RT-13. The Postal Service was justifiably proud of the novel pricing approach taken with Confirm service at its launch, but the inescapable conclusion is that the pricing approach was unsuccessful since it never recovered the service's cost in any of its years of operation, and no workable means of salvaging that approach is now available.

¹⁹ See USPS-RT-13 at 5-17, Postal Service Initial Brief at 383-86.

has not generated concomitant revenue for the Postal Service since customers are making use of the resellers.

Taking all that into consideration together with the legal necessity of recovering attributable costs while making some contribution to institutional costs, witness Drew Mitchum (USPS-T-40) in this docket explains the Postal Service's return to a more traditional transaction based pricing paradigm²⁰ and why that is necessary if Confirm is to survive. Given that the marginal cost of scans approaches zero, witness Mitchum details a proposal wherein the price of scans follows their cost curve, with both approaching zero at volumes in the hundreds of millions.²¹ Witness Mitchum also points out the unrealistic assumptions on which the OCA proposal rests in its strained effort to retain the failed pricing approach; he also responds to the support the OCA proposal garners among Platinum subscribers and resellers.²²

Much as the OCA proposal would require the largest Confirm customers to pay less, and smaller users to pay more, the Postal Service proposal does just the opposite:

²⁰ While the transaction basis for pricing is traditional, the Postal Service pricing approach also reflects decidedly novel elements such as declining block pricing and a very low "per transaction" price. Previous references to transaction-based pricing for Confirm did not discuss specific prices per transaction.

²¹ Witness Mitchum provides the means to calculate the average cost of a Confirm scan to a customer who pays for one billion scans as \$0.000056 (approximately six thousandths of a cent). USPS-RT-13 at 18, Table 2: ($\$56.03/1,000,000=\0.000056). While one billion scans is a number far in excess of any single customer's consumption to date, GrayHair claims to require that many scans in 2006. GHS-T-1 at 16. (GrayHair Software witness Bellamy refused to elaborate on the one billion scan expectation in response to USPS-GHS-T1-11, a response that was accordingly not designated as record evidence.) Under the proposed declining block fee schedule for scans, the least expensive block of one million scans costs \$17.50. Proposed Fee Schedule 991. If all those units were used to purchase First-Class Mail scans, the marginal price would be only \$0.0000175 ($=\$17.50/1,000,000$), or a little less than two thousandths of a cent per scan. Plainly, such a price approaches, without reaching, zero.

²² USPS-RT-13 at 5-17.

the largest customers would pay somewhat more, while smaller customers would pay less.²³

The OCA has been very active via discovery, testimony and otherwise in its attempt to retain the unlimited scan Platinum tier for users of Confirm service. While it may seem odd that the OCA aligns itself with the largest of mailers by arguing that high volume Confirm prices should be lower while those of smaller customers should be higher, the likely explanation lies with the potential for Confirm scans to assess service performance. So relatively early in this docket, the OCA persuaded the Postal Service to back away from its proposal to change DMCS §991.31.²⁴

As noted above, this use of Confirm scans has been less successful than originally hoped. Mailers have sometimes failed to provide advance electronic notice of what will be mailed where, or, for whatever reason, the notice and actual mailing are not consistent with one another.²⁵

The Postal Accountability and Enhancement Act (Public Law 109-435) imposes new requirements for assessing service performance. As such, it focuses new light on use of Confirm service because, for example, Confirm provides information about Standard Mail letters that is not available from any other source.²⁶ The Postal Regulatory Commission should accordingly recognize that all aspects of Confirm

²³ *Id.*

²⁴ See Postal Service Initial Brief at 380, n. 8.

²⁵ Resellers face this problem, as well, in the reports provided to customers. A variety of other problems with scans has been found, although these are not well explored in the evidentiary record; record evidence does establish that the Postal Service needed to create its own means of using Confirm for service performance assessment rather than relying upon aggregate customer scans. Tr. 14/3942-43, 3947-48, 3951-54.

²⁶ See Flute at 29.

service will be subjected to scrutiny by postal management that has not heretofore been applied.

In any event, the Postal Service's agreement with OCA not to pursue its proposed changes to DMCS §991.31 has certainly been validated. All of the capability of Confirm service to provide information about mail as it is variously collected, transported, processed and delivered, will be retained under the Postal Service proposal; hence in the short term transparency will not be harmed,²⁷ while in the long run it needs to be improved.

The Postal Service recognizes that little support for its proposed pricing approach and fees for Confirm service is found among those intervenors who have been active via discovery, testimony or briefs on Confirm issues.²⁸ Intervenor activity has largely focused upon retention of a subscription tier with unlimited scans. Initial briefs from various participants express support for the subscription approach to pricing and opposition based on various grounds to the Postal Service proposal. However, as the fee increases for the Platinum tier, an unlimited tier makes economic sense for fewer and fewer customers. USPS-RT-13 at 9 (Table 1). Most subscribers would use the Silver or Gold tiers, which would charge for scans at much higher fees than the scan fees under the Postal Service proposal.²⁹

²⁷ Postal Service Initial Brief at 386.

²⁸ While large Confirm customers are well represented in this proceeding, smaller ones, including those who would benefit from the Postal Service proposal, generally are not. See Tr. 33/11378.

²⁹ Similarly TrackMyMail.com has developed pricing that is transaction based, as shown by OCA-XE-Mitchum-#1 (Tr. 14/4147). Apparently GrayHair Software has comparable pricing. OCA Brief at 130, n 150.

The involved intervenors are, of course, arguing in favor of a position consonant with their financial interests. The Postal Service submits, however, that prognostications of untoward consequences for Confirm if the Postal Service proposal is recommended are vastly overblown; the plain economic facts speak by themselves to the contrary. The intervenors like what Confirm provides them and they want it to continue. Giving up Confirm service should the Postal Service proposal be implemented would be counter-intuitive given the small amount of money necessary to obtain scans for a mailpiece compared to the cost of mailing.

The central disputed issue for Confirm is how the price is set for high volume scans. The Postal Service proposes declining block fees, such that the cost of a single scan for a customer who obtains one billion annual scans is approximately six thousandths of a cent. The costs to prepare a mailpiece, and to pay postage, are several orders of magnitude larger. Accordingly, any claim that the cost of scans for a mailpiece amounting to less than a hundredth of a cent are of sufficient magnitude to drive customer decisions about usage of Confirm service should properly be understood as reflecting large Confirm mailers' self interest in lowering their costs – albeit not by very much. As such, any claims that mailer behavior will be transformed if the Postal Service proposal is implemented lack credibility.

Several intervenors focus on the fact that the Postal Service proposal for Confirm includes a projection that scan volume will decrease by ten percent.³⁰ Witness Mitchum includes this projection because he recognizes that, in general, when prices increase

³⁰ MOAA, for example, characterizes the ten percent reduction in scan volume as “huge”. MOAA at 26.

volumes decrease. As such, the projection constitutes a reasonable assumption in his calculation of costs and revenues for the test year.

The OCA proposal, on the other hand, makes no comparable assumption. Intervenors such as ANM who address this issue evidently believe that witness Mitchum's use of the assumption means that some structural element of the Postal Service proposal somehow dictates the decrease in scan volume.³¹ Both the Postal Service and the OCA proposals include a substantial fee increase, necessary to cover costs and make an appropriate contribution. But only the Postal Service proposal makes any adjustment to recognize that price increases can affect volume. While GrayHair Software recognizes that the OCA proposal could cause a decrease in volume,³² the OCA itself projects no volume decrease in response to its larger, 95 percent price increase. This exemplifies how unrealistic the revenue and volume projections embodied in the OCA proposal are. Postal Service Initial Brief at 383-85.

The Postal Service in fact hopes and expects that Confirm volume will continue to increase.³³ The tools and information available today, however, indicate that conservative assumptions should be used since the projections made upon the launch of Confirm service overestimated the number of subscribers and consequent revenue.

An own price elasticity for Confirm is difficult to quantify, given that there has been no previous change in the price of Confirm service. Several participants address this or a related issue, the price sensitivity of customers.³⁴ The high price sensitivity of Confirm customers was reported by witness Rothschild in the seminal Confirm docket,

³¹ See, e.g., ANM at 23-24; GrayHair at 3.

³² GrayHair at 7.

³³ MOAA agrees. MOAA at 26.

³⁴ See, e.g., GrayHair at 2.

where she found that demand for subscriptions varied substantially depending upon price. Given, however, that the costs for creating a mailpiece and paying for its postage are so much larger than the per-scan or per-mailpiece cost of Confirm service, it is unlikely that the price of Confirm will itself have much impact upon mailer decisions to obtain additional scans.³⁵ Moreover, the limited information available in the record on resellers indicates that they charge (value added) per scan prices that are large multiples of Confirm's scan prices, as high as 2.1 cents per scan,³⁶ adding support to the conclusion that Confirm's price has little impact on customers' use of it, and that transaction pricing is a viable model for Confirm.³⁷

Resellers are part of the customer base for Confirm; GrayHair Software is itself a reseller, one that criticizes the Postal Service for trying to earn contribution from scans.³⁸ From some intervenor briefs, one might infer they think the Postal Service is not supportive of resellers.³⁹ The Postal Service, however, has a long and successful track record with mailing service providers. While it is true that the Postal Service proposal in some sense impacts resellers by eliminating the subscription tier with unlimited scans, the proposal simply reflects the realities presented by the more mature

³⁵ The 95 percent increase in price for a Platinum subscription proposed by the OCA, on the other hand, might well have an impact on mailer decisions, although the OCA's proposal does not recognize this possibility. That increase amounts to a large, one-time increase of \$9500, rather than the block charges ranging from \$70 down to \$17.50 under the Postal Service proposal.

³⁶ Based on the TrackMyMail.com product where the fee is \$50 for up to 1,000 Planet coded pieces, each of which will average 2.3638 scans.

³⁷ Tr. 14/4145-47, 4167. \$50 for 1,000 Planet-coded pieces amounts to \$50 for 2364 scans (2.3638 scans per piece) or \$21,152/million scans. For \$21,152, under the Postal Service proposal, a customer could obtain information for 288 million scans (assuming 55 percent First-Class Mail and 45 percent other classes).

³⁸ GrayHair at 12.

³⁹ See, e.g., ANM at 27.

market for Confirm than was projected in the survey market research used to help launch Confirm. In any event, the scan prices are very small, approaching zero. There is no standard that requires the Postal Service to lose money on Confirm so that resellers can profit more. The Postal Service proposal would effectively accommodate a very wide range of possible prices for all users, including a marginal rate of zero for very high volume users if it is later determined that such a price structure is best suited to the changing objectives of the Postal Service. The minute marginal prices for scans, metered by units, accordingly constitute an appropriate proposal for Confirm service that the Commission should recommend.

One mystery that is not explained by the evidentiary record is why some Confirm customers have subscribed at levels that outstrip their actual usage of the product. In written and oral cross-examination, and on brief, various counselors have suggested possible answers, including: insurance, simplicity, avoidance of transaction costs, foolishness, etc. ANM Brief at 35. The OCA proposal simply assumes that customers who over-subscribe will continue to do so⁴⁰ – a fiscally risky assumption that the Postal Service does not make.⁴¹ Indeed, the OCA argues that there is no reason why a Confirm customer would stop over-buying.⁴² While the record may not provide answers to why customers over purchase, any economist would readily assume that customers faced with price increases (especially increases of the size the OCA proposes) would

⁴⁰ OCA Initial Brief at 117.

⁴¹ Witness Bentley on behalf of MMA also does not make this assumption. MMA-T-1 at 31 and Tr. 25/7893-95.

⁴² OCA Initial Brief at 117.

respond rationally and decrease what they purchase, especially when they can do so without giving up any service.⁴³

The evidentiary record provides participants the opportunity to make various arguments about what is called “value pricing”.⁴⁴ That term does not have a single, well understood definition, which helps explain the wide range of points argued about whether the Postal Service proposal is, or is not, an example of value pricing. Witness Mitchum’s denial that the Postal Service proposal exemplifies value pricing draws upon the history of Repositionable Notes, as reflected in Docket Nos. MC2004-5 and MC2006-2; there the discussion of “value pricing” centered on the rather narrow concept of value perceived by mailers in the absence of any underlying costs.

In the first Repositionable Notes docket, the Commission identified two rational bases for “value pricing”:

The Mailers' Coalition points out that the purpose of grouping mail into distinct classifications is to charge a price — one that is rational and fair. It argues that if costs do not vary according to the presence or absence of a particular mail characteristic, there is no rational basis for applying what amounts to a surcharge for it. In other words, there is no rational basis for deciding how far above zero to go. Mailers' Coalition Reply to Postal Service Response at 2, 5.

There is, potentially, a rational basis for deciding how far above zero to go if the objective can be identified. If the objective were to maximize the Postal Service’s net revenue from RPNs, one level is implied. If the objective is to maximize consumer welfare, another level is implied. Both require knowledge of an RPN demand function; knowledge that cannot begin to be gained unless the RPN proposal is implemented.

PRC Op., Docket No. MC2004-5 (Repositionable Notes) at 12. The analogy of “value pricing,” as the term was used in that docket, to units or scans in this docket does not

⁴³ USPS-RT-13 at 14.

⁴⁴ Tr. 14/3963.

work because scans do have a small cost at the margin.⁴⁵ On the other hand, that cost is quite small.⁴⁶

Be that as it may, witness Mitchum was justifiably concerned about being boxed in by the RPN definition of “value pricing,” given its foundation of a costless product. But the Postal Service proposal does delve into the relative values of First-Class Mail and Standard Mail to customers in the form of its proposed prices of one unit per scan for First-Class Mail and five units per scan for other classes, including Standard Mail.

First-Class Mail provides greater value for various reasons ranging from its content (correspondence and statements of account) to embedded features such as forwarding and return service, and higher contribution. Several of the negotiated service agreement dockets (NSAs) place higher value on First-Class Mail solicitations because of their greater success in generating responses. The Postal Service proposal for Confirm service builds upon these pre-existing distinctions by proposing a lower fee for First-Class Mail scans than for those in other mail classes. Contribution under the Postal Service proposal from Confirm scans remains consistent with such class value concerns, since the combined contribution from a scan (priced at one unit) and a First-Class Mail piece exceeds the combined contribution from a scan (priced at five units)

⁴⁵ Witness Page estimates the average cost of a scan as \$0.00011. Tr. 15/4733-34.

⁴⁶ Indeed, witness Page’s estimate of a scan’s average cost (\$0.00011) exceeds the average price of a scan for a customer who buys one billion scans (\$0.000056 *supra*, at note 12) and exceeds the marginal fee for a scan purchased at the lowest price (\$0.0000175, *id.*).

and a Standard Mail piece.⁴⁷ MMA agrees that the greater unit contribution First-Class Mail pieces justifies the pricing distinction for Confirm.⁴⁸

Intervenor briefs make claims about Confirm service that do not withstand scrutiny. MOAA, for example, claims to face a 585 percent increase in fees.⁴⁹ Witness Callow corrected this figure to a lower amount using two of his three errata.⁵⁰ This shows that even active participants were misled by witness Callow's many errors in quantifying changes; repetition of such claims by counsel and in the press further energized opposition to the Postal Service proposal.⁵¹

⁴⁷ Also worth noting is that this five-to-one ratio does not actually carry through to the price paid by Confirm customers. Interrogatory USPS/GHS-T1-16, for example, illustrates how the relative costs of Standard Mail scans and First-Class Mail scans vary over a range of scan purchases by a Confirm customer from 100,000 scans (where the costs are the same) to one billion costs (where the cost of Standard Mail scans is 3.85 times as expensive as First-Class Mail scans). Tr. 21/7496.

⁴⁸ MMA-T-1 at 31-34. In addition, witness Bentley strongly criticizes the Postal Service for a 49 percent increase for Confirm, when the OCA proposes a 95 percent increase in the annual fee for a Platinum subscription. *Id.* at 31.

⁴⁹ MOAA at 23.

⁵⁰ See OCA-T-5 at 8; Notice of Office of the Consumer Advocate Concerning Errata to the Testimony of OCA Witness: James F. Callow OCA-T-5 (September 22, 2006)(change from 585 to 587); Second Notice of Office of the Consumer Advocate Concerning Errata to the Testimony of OCA Witness: James F. Callow OCA-T-5 (October 10, 2006) (change from 587 to 460).

⁵¹ Tr. 14/4144, 4157-58. During cross-examination of witness Mitchum, OCA Counsel noted that she had had discussions with Platinum subscribers that were concerned that their Confirm costs could be as high as 50 times their current expenditures (a 4990 percent fee increase). If we assume her conversation took place with an existing subscriber that purchased no additional IDs that would be a fee of \$500,000. The Postal Service notes that Attachment 1 of witness Callow's original testimony (OCA-T-5), on the "USPS Comps Platinum" tab, showed a fee increase of 4,995 percent for customers receiving 10 billion scans (an amount that no customer has come close to reaching). This percentage was then revised upward on September 22, 2006, before being revised downward to 4,870 percent on October 10, 2006.

Similarly, witness Bellamy of GrayHair Software repeats again and again that GrayHair faces a 460 percent increase.⁵² The only support that can be found for this claim appears in the response to USPS/GHS-T1-15,⁵³ where he compares his current Confirm fees of \$40,000 with projected fees of \$220,000. While the latter figure is 450 percent more than the former, the missing ten percent is unexplained. Under the Postal Service proposal, \$220,000 could purchase 5.1 billion scans with a 55 percent First-Class Mail, 45 percent Standard Mail mix; or a Confirm subscriber who uses First-Class Mail exclusively could purchase enough scans to track roughly 12 percent of all presort FCM -- seemingly a bargain for \$220,000. More critically, witness Bellamy never bothers to mention that the increase he projects arises not as a consequence of proposed fees but almost entirely *from the expectation that his reseller business will see substantially expanded volume, thus requiring him to purchase additional scans for his clients*. As such, witness Bellamy's claim that he projects spending \$80,000 or more if the OCA proposal were implemented versus \$220,000 or more if the Postal Service proposal is implemented must be understood as having little basis in reality.⁵⁴

In this docket, the Presiding Officer initiated an information request seeking to learn more about the role arbitrage plays, or could play, in customer use of Confirm.⁵⁵ Witness Mitchum responded by indicating that the potential for arbitrage was recognized, that the existing fee schedule for Confirm presented a greater opportunity for arbitrageurs than the Postal Service proposal, and that this potential helped guide

⁵² The 460 percent claim appears throughout his testimony and the GrayHair Initial Brief.

⁵³ Tr. 21/7494-95.

⁵⁴ Tr. 21/7484. No explanation of how these numbers were derived is ever presented.

⁵⁵ Presiding Officer's Information Request No. 12, Question 5 (August 24, 2006).

the Postal Service proposal for new Confirm prices and structure.⁵⁶ In his rebuttal testimony, witness Mitchum indicated that the likelihood of significant arbitrage actually taking place was low, owing to the fact that the price for scans was relatively low and that resellers could increase profits by adding value to scans; he also indicated that the potential for arbitrage was greater under the OCA's proposal than under existing fees.⁵⁷

ANM devotes several pages to arbitrage, arguing both that it does not occur and that, even if it does occur, this is a good thing.⁵⁸ GrayHair claims that arbitrage does not occur,⁵⁹ although witness Bellamy's knowledge of other resellers is hardly complete.⁶⁰ Since the Postal Service proposal for Confirm specifies the same price for scans, regardless of whether they are used for arbitrage or not, whether arbitrage is or is not appropriate does not really matter. If the evidence showed that the Postal Service was losing money on a service thanks to extensive arbitrage, that situation might require closer analysis. Meanwhile, the Postal Service continues to be supportive of the aftermarkets that it has created, including resellers of Confirm scans.

Witness Mitchum has explained how the Postal Service proposal for Confirm improves fairness and equity,⁶¹ points that are summarized in the Postal Service Initial Brief.⁶² The Postal Service proposal narrows the range of effective per-scan costs such that small customers would pay a smaller multiple of larger customers' prices than

⁵⁶ Tr. 19/6784-89.

⁵⁷ USPS-RT-13 at 14-17.

⁵⁸ ANM at 26-34.

⁵⁹ GrayHair at 8.

⁶⁰ See, e.g., Tr. 25/7485

⁶¹ USPS-RT-13 at 17-19.

⁶² Postal Service Initial Brief at 381-82.

under the existing fees or those proposed by the OCA.⁶³ Also, the relative burden of paying for Confirm is shifted by the Postal Service proposal (as compared with existing rates or under the OCA proposal) to larger customers. The Postal Service proposal has an ancillary benefit as well: currently, most of the Platinum subscribers' volume has been low enough that, in retrospect, those customers could have utilized a Gold subscription and thereby spent less on Confirm. That potential for confusion or guesswork is eliminated by the Postal Service proposal. Finally, the Postal Service proposal improves fairness and equity through its use of declining block rates for scans. While Confirm was unable to cover costs when an unlimited subscription tier was available, under the Postal Service proposal the largest Confirm customers can still acquire scans at prices that approach, without actually reaching, zero dollars – and at a price that is below cost!

The Postal Regulatory Commission should accordingly recommend the Postal Service proposal for Confirm service.

D. The Office of the Consumer Advocate's Proposal to Lower Insurance Fees Even More Than the Postal Service's Proposal Should Be Rejected.

The Postal Service proposes to lower almost all the insurance fees. USPS-T-40 at 25-26. This would result in a cost coverage of 131 percent, and the OCA admits that “[a]t first glance, this relatively low coverage would appear to be appropriate.” OCA Brief at 157. But, based on its perception of how the Postal Service handles insurance claims, the OCA advocates “a strong pricing signal by the Commission - a cost coverage . . . set close to zero so that postal management will take seriously the need

⁶³ USPS-RT-13 at 18 (Table 2)

[to improve the claims process].” *Id.* at 161-162. The OCA cites none of the pricing criteria in support of its proposal. The Postal Service does not believe that the pricing criteria can lawfully be applied to send messages to postal management, rather than to determine an appropriate amount of contribution to be recovered from each subclass or service.

Beyond the wish to send a message to postal management, the OCA does not justify a minimal cost coverage for insurance. The OCA notes that approximately one-fifth of claims were denied in the first 2 quarters of FY 2006; however, the data presented to the OCA in response to discovery show that in FY2005 only 15.7 percent of claims were denied.⁶⁴ This means that nearly 85 percent of claims were paid during the base year, the most recent full fiscal year of data on the record. Moreover, witness Mitchum showed that nearly 80 percent of denied claims are denied for reasons that clearly justify denial:

- 26.0 percent of claims were denied because there was a signature of receipt on file, even though the claims were for total loss.
- 26.5 percent of denied claims were filed more than 180 days after mailing, the deadline for filing claims. DMM 609.1.4.
- 23.0 percent were denied because the claimant did not respond to requests for additional information.
- 3.7 percent were denied because submitted receipts of proof of purchase were dated after the mailing date.

Tr. 14/4187-88, 4195. These percentages total 79.2 percent, so only 20.8 percent of claims denied are even open to question, and those account for only 3.3 percent of all claims, or 0.013 percent of all insured items in the Base Year.⁶⁵

⁶⁴ Tr. 14/4106 (29,886/198,933).

⁶⁵ Insurance volume in the Base Year was 50,814,498. LR-L-124, WP-6 at 2. There were 198,933 claims filed in FY 2005, of which 31,169 were denied. Tr. 14/4106. Thus only 6,483 of denied claims (20.8 percent of 31,169) are open to questioning, which is

The OCA claims that indemnity payments are decreasing because the Postal Service makes it difficult to file and receive a claim payment. OCA Brief at 158-59. The Postal Service agrees that there has been a decrease in indemnity payments, but it results from the reduction in the number of claims filed in the last two years. Tr. 14/4114. In fact, while insurance volume increased from FY 2004 to FY 2005, claims decreased by 18 percent. Thus, the Postal Service believes that it has done a better job at reducing damage and loss. The OCA position that customers have recently stopped filing claims in cases of damage or loss out of frustration is without record support, and ignores information witness Mitchum provided to the OCA during discovery. The OCA should not pessimistically conclude that a reduction in claims can only be explained by an increased difficulty in submitting claims.

A 101 percent cost coverage would not reflect the fact that the Postal Service is already improving the claims process with the imminent introduction of online claims filing, and that the Postal Service proposes to reduce fees for nearly all categories of service. Tr. 14/4197-98; USPS-T-40 at 24. Moreover, the OCA is mistaken when it alleges that “customer indemnification . . . is the essence of what the customer hopes to obtain.” OCA Brief at 158. Insurance customers are purchasing peace of mind, with a hope to obtain safe delivery of the insured mail item. 50.8 million items were mailed with insurance in FY 2005, and 198,933 claims were filed. Tr. 14/4106. Thus, 99.6 percent of insurance customers received their primary goal for the insured mailing: having it delivered safely without any need to file a claim.

3.3 percent of claims ($0.033 = 6483 / 198,933$) and 0.013 percent of items for which insurance is purchased ($0.00013 = 6,483 / 50,814,498$).

One area in which the OCA and the Postal Service agree is the need to improve the average time it takes a claim to be resolved. OCA Brief at 11, 160, and 162; Tr. 14/4197-98 (witness Mitchum). The imminent implementation of online claims filing should speed up claims processing substantially. Currently, time is needed for the claim to be physically created, transported, mailed, delivered, and routed internally. Online claim filing will reduce this time to virtually zero days for loss claims, as the claim will be electronically submitted directly to St. Louis. Additionally, the system will prompt the user for all needed claims information, thus reducing delays caused by Postal Service requests for additional information. Tr. 14/4198.

The OCA states that the clock on the 10 day target for the resolution of properly completed claims starts once the claims reach St. Louis. OCA Brief at 161. While this is true, the 48 day figure that the OCA relies on is the full time for resolution of all claims, included incomplete claims. Tr. 14/3992-93.

Once a claim reaches St. Louis the average time for resolution is 15 days. Part of the reason the average time exceeds the 10-day target (for handling of a properly completed claim) is the average time that the OCA requested includes the processing of incomplete claims. 23 percent of all denied claims in FY 2004 were denied because the customer failed to provide requested additional information. Tr. 14/4187. Given that these claims remain open until the grace period for the additional information expires, it is likely that the nearly 5 percent of all claims that fall into this category are responsible for a large part of the difference between 15 days and the 10 day target for the St. Louis resolution time. Additionally, for those claims that are paid after a customer provides additional information, the average time would reasonably be well above 10 days. The

Postal Service expects that the introduction of online claims will reduce the number of incomplete claims forms submitted, and in turn reduce the average claims processing time in St. Louis.

Another area in which the Postal Service and the OCA appear to agree is the need for better monitoring of claims. OCA Brief at 162. The online claims system will provide a digital trail for all claims submitted via the online process.

The OCA notes that indemnification payouts account for only 15.5 percent of insurance revenue. OCA Brief at 10, 158. But this simply reflects the need to recover window clerk and carrier costs for providing insurance service. USPS-T-40 at 23. It is completely unreasonable to try to compare Insurance on a package through the Postal Service with insurance on a car or home. If you had to go to your insurance agent's office each time you were going to drive your car or turn on an appliance in your home, and to have your agent certify that you returned without incident each time you drive your car, the share of costs that were indemnity would decrease substantially in those segments of the insurance industry. Additionally, unlike its package delivery competitors, the Postal Service does not automatically include insurance; insurance is optional so that the basic postage rates can be kept low.

The Postal Service notes that the OCA did not file direct testimony on insurance. As a result, the Postal Service was not able to probe the OCA's concerns through discovery. Furthermore, while declining to add to the record, the OCA brief uses information that is not on the record. OCA Brief at 159, 161.

The record shows that the Postal Service has improved service such that the number of claims filed has decreased from 2004 to 2005, while the number of items

insured increased. Additionally, the Postal Service is in the process of implementing an online claims process that will speed up the claims process by allowing the claim to be submitted directly to St. Louis for adjudication, and ensure that claims forms are filled out completely. The Postal Service's proposed fees and classification changes therefore should be recommended.

E. Douglas Carlson's Electronic Return Receipt Proposals Should Be Rejected.

Douglas Carlson continues to try to impose his personal views of how the Postal Service should integrate the relatively new electronic return receipt option into the mix of return receipt options. But the Postal Service has a fuller understanding of all its customers, and the financial and marketing concerns that must be addressed.

1. Carlson does not justify lowering the electronic return receipt fee by even more than the Postal Service's proposal.

Douglas Carlson defends his proposal to lower the electronic return receipt fee by 52 percent, from \$1.35 to \$0.65, rather than the more moderate, but still large reduction to \$0.85 proposed by the Postal Service. Carlson Brief at 16-24. However, the Postal Service explained in its initial brief why the \$0.85 fee is far superior to Carlson's alternative, because it produces a more appropriate per-piece contribution. Postal Service Brief at 391-93. Moreover, the Postal Service's proposed fee is justified by a general policy of conservatively spreading out large changes in price over time. Tr. 15/4380, 4412. While a new product, such as electronic return receipts, is developing, the Postal Service wants to keep the price as stable as possible, limiting the risk that a subsequent price increase would be necessary to correct for underpricing. Tr. 15/4413. It makes no sense to push the electronic return receipt fee below \$0.85 when future

analysis of window service costs might force a fee increase in the future.

See Postal Service Brief at 391-92.

Carlson alleges that “[t]he Postal Service twice has deceived the Commission and participants in proposing fees for electronic return receipt.” He refers to the Docket No. R2001-1 testimony, filed on September 24, 2001, which stated that customers would provide an email address at the window when purchasing electronic return receipt, and that an electronic image of the signature would be provided by a secure email. USPS-T-26 at 14-16; USPS-T-36 at 57. The electronic return receipt option was not implemented until September 5, 2004, nearly three years later, so that the new technology for the option could be fully developed. While the implemented technology changed to collecting the email address over the Internet, and sending the signature by regular email, the Postal Service did not deceive the Commission during earlier proceedings. Instead, the testimony reflected the best knowledge of the witnesses at the time the testimony was filed and entered into evidence.⁶⁶

Witness Berkeley’s rebuttal testimony presents the Postal Service’s plan to deploy new scanners that will allow signatures to be scanned at the time of delivery, or shortly thereafter, so that “electronic return receipt should generally provide customers with access to the signature on the day of delivery.” The scanners are being tested now, and “are expected to be fully in use by the test year. USPS-RT-17 at 5. Carlson

⁶⁶ In Docket No. R2005-1, Postal Service witness Wesner learned that the email was not sent via secure email after his testimony was filed. He corrected his testimony before it was entered into evidence, and used his best knowledge at that time to support continued reliance on the same cost estimate. See Notice Of United States Postal Service of Filing of Revised Testimony of Witness Wesner (USPS-T-24), filed June 24, 2005, and the responses of witness Wesner to DFC/USPS-T24-2-4, also filed June 24, 2005 (Tr. 8-B/3897-99).

rejects this testimony as relying only on witness Berkeley's "belief." Carlson Brief at 21. But Carlson failed to cross examine witness Berkeley on this matter, and her testimony is record evidence presenting the Postal Service's official plan. This plan presents further support for maintaining an implicit cost coverage for the electronic return receipt option that is higher than that for the basic return receipt option.

Carlson argues that the implicit cost coverages for the basic return receipt and electronic return receipt options should be equal. Carlson Brief at 16. But he ignores the Commission's recommendations in Docket Nos. R2001-1 and R2005-1, which both established a higher implicit cost coverage for electronic return receipt than basic return receipt.⁶⁷ These recommendations are consistent with the facts that electronic return receipt can provide more value than basic return receipt, by providing signatures more quickly, and in an electronic format that makes storage and retrieval easier. Tr. 15/4374, 4396, 4410.

2. The Postal Service has substantial concerns about including an electronic return receipt as a basic feature of Certified Mail.

Carlson also urges the Commission to recommend that the Postal Service propose in the next rate case that an electronic copy of the signature be included as a basic feature of Certified Mail. Carlson Brief at 25-26. He does not propose this combination of services in this proceeding, and recognizes that it would result in an additional fee increase for Certified Mail.⁶⁸

⁶⁷ See Docket No. R2001-1, LR-J-109, WP-11, page 6 (143 percent for electronic vs. 125 percent for basic); Docket No. R2005-1, Exhibit USPS-27F, page 6 (152 percent for electronic vs. 129 percent for basic).

⁶⁸ *Id.* at 26. Carlson suggests a fee increase of 20 cents, but that may not be adequate to reflect the increase in Certified Mail's value of service.

In deciding whether such a proposal makes sense, the Postal Service would need to consider if customers want such an enhancement, especially at a higher Certified Mail price. Certified Mail already provides delivery information, which should be adequate for many customers, just as Delivery Confirmation is adequate for parcel mail, rather than Signature Confirmation. Certified Mail provides the lowest cost means to get delivery information on letter and flat mail. See Tr. 15/4376. Moreover, many customers, especially those with legal requirements for a return receipt, may need the original signature on a green card (rather than an electronic return receipt email), and thus would get little value from Carlson's enhancement. Tr. 15/4392, 4407-08. In FY 2005, 91 percent of Certified Mail customers opted for return receipt service, but less than 0.1 percent chose the electronic return receipt service.⁶⁹

The Postal Service also must consider how it could offset a possible loss of contribution from basic return receipt service, which currently is expected to provide \$139 million in contribution in the test year. (\$442,599,000 - \$303,498,000, from USPS-LR-L-123, WP-27, page 5). Basic return receipt service has already begun a decline as a portion of Certified Mail volume. Tr. 15/4389. Including an electronic return receipt with Certified Mail service might accelerate that decline.

F. The Internet/Phone Change of Address Charge is the Result of Third-Party Requirements and Therefore Should Not Be in the DMCS.

In his initial brief, Mr. Popkin argues that the one-dollar identity validation charge for change of address orders submitted over the Internet or the telephone is a fee "and as such must be authorized and provided for in the DMCS." Popkin Initial Brief at 15. It

⁶⁹ Tr. 15/4453; USPS-LR-L-123, WP-5, 20 (215,285 eRR transactions / 261,144,424 Certified Mail transactions).

seems that Mr. Popkin misunderstands the DMCS, and the one-dollar identity validation charge. The DMCS contains fees for postal services, and the one-dollar identity validation charge is not such a fee. This is amply illustrated by the fact that one does not have to pay this charge in order to have a Change of Address request processed. If one fills out a PS Form 3575 and mails that form to the post office, or hands it to a postal clerk, there is no charge at all. As is explained in the record, identity validation is performed to enhance security and prevent fraudulent changes of address in situations where signatures are not present (such as in orders submitted over the Internet or over the telephone). Tr. 18B/5473; Tr. 19/6936. Credit card companies do not perform this validation for free. Tr. 18B/5473. They require a minimum charge on the credit card, imposed by the credit card company on the card holder. *Id.* The dollar charge is a result of this third-party requirement, rather than a charge to be included in the DMCS.

CONCLUSION

For the reasons stated above, the rates for postal services, fees for special services, and the modifications of the domestic mail classification schedule proposed or endorsed by the United States Postal Service are supported by the evidentiary record and are in accord with the applicable provisions of the Postal Reorganization Act.

WHEREFORE, the Postal Service requests that the Postal Rate Commission recommend under 39 U.S.C. § 3624(d) the rates and fees and changes in the Domestic Mail Classification Schedule requested by the Postal Service in this Docket.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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

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