

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

JOINT INITIAL BRIEF
OF THE
SATURATION MAILERS COALITION
AND
ADVO, INC.

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TABLE OF CONTENTS

INTRODUCTION.....	1
STATEMENT OF POSITION	3
SUMMARY OF ARGUMENT	4
ARGUMENT	10
I. THE SATURATION MAILER INDUSTRY’S DAL INITIATIVE IS DRIVEN BY THE OVERRIDING IMPORTANCE OF POSTAL RATES TO THEIR BUSINESSES.	10
A. The Industry’s DAL Transformation Entails Substantial Uncertainty And Risk That Must Be Considered In Setting Postal Rates.....	10
B. For Rate Design Purposes, The Commission Must Use The Proper Costs For On-Piece Addressed Flats That Exclude DAL Costs.....	14
C. The DAL Surcharge Should Apply To All ECR Flats That Use DALs, Not Just To Saturation Mail.	18
II. THE HIGH ECR COST COVERAGE NEEDS TO BE MITIGATED BEFORE IMPLEMENTATION OF A NEW PRICE-CAP REGIME.....	19
A. The ECR Cost Coverage Is Too High, But Any Mitigation In This Proceeding Should Be Moderate To Limit Impact On Other Mailers.	19
B. ECR Rates Can Be Mitigated Without Changing The Postal Service’s Targeted ECR Contribution Or Adversely Affecting Other Mailers.	19
C. NAA’s Suggestion On Rebuttal That Institutional Costs Should Be Shifted From First Class To ECR Mail Is A Recipe For Disaster.	21
III. VALPAK’S ECR RATE DESIGN PROPOSALS IGNORE THE INTERRELATIONSHIP BETWEEN SHAPE AND WEIGHT AND THE POUND RATE, AND WOULD OVERCHARGE FLATS.	26
A. The Letter-Flat Unit Cost Differential Reflects Both Piece/Shape- and Weight-Related Cost Differences.....	28
B. The Letter-Flat Passthroughs Must Be Less Than 100 Percent To Avoid Double-Charging For Weight-Related Costs; Or Alternatively, The ECR Pound Rate Must Be Substantially Reduced.....	29

C.	The ECR Pound Rates Proposed By Ingraham And Mitchell Are Excessive And Ignore The Interrelationship Between Shape And Weight.....	30
D.	Mitchell’s “Product Pricing” Concept Is Incorrectly Implemented: He Has The Wrong Products, He Marks-Up The Wrong Costs, And His Results Are Economically Inefficient.....	34
E.	Mitchell’s Rebuttal Testimony And Cross-Examination Exposed The Illogic Of His Concept Of “Marking Up” The Letter-Flat Cost Differential, And His Failure To Consider The Pound Rate.....	36
F.	Crowder Proved The Absurdity Of Mitchell’s Markup Concept By Applying It To His Own Rate Model.	42
IV.	THE ECR HIGH DENSITY-SATURATION RATE DIFFERENTIAL PROPOSED BY THE POSTAL SERVICE IS COST-BASED AND SHOULD BE ADOPTED.....	45
V.	HALDI’S ASSERTIONS ON THE IMPACT OF CITY CARRIER CAPACITY CONSTRAINTS AND MITCHELL’S IMPLICATION THAT SATURATION LETTERS ARE SUBSIDIZING SATURATION FLATS ARE SPECIOUS, SELF-SERVING, AND WRONG	49

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INTRODUCTION

The Saturation Mailers Coalition (SMC) and ADVO, Inc. (Advo) hereby submit their joint initial brief to the Commission in this proceeding.

Advo and the other members of the SMC all make substantial use of Enhanced Carrier Route (ECR) mail, primarily at the saturation rate category, to distribute saturation advertising programs that serve the advertising needs of large and small retail and service businesses in local markets throughout the nation. Some members also use the ECR high-density rate category for portions of their mail programs, and in addition, a number of members use private delivery as an alternative to postal distribution. Their advertising programs utilize differing formats, including shared mail programs, shopper publications, and letter coupon envelope programs, but all of these companies operate in a highly competitive marketplace.

In this proceeding, SMC and Advo sponsored two witnesses. In the direct phase, SMC witness Pete Gorman (SMC-T-1), President of Harte-Hanks Shoppers, explained why the saturation mail industry urged the Postal Service to include in its rate filing a proposal to establish a separate lower rate for on-piece-addressed saturation flats and a surcharge on detached address labels (DALs). Although most SMC members have built their companies around the DAL addressing procedure, this revolutionary change

for the industry will substantially reduce Postal Service costs and thereby justify a low rate for on-piece addressed saturation flats, enabling this highly price-sensitive industry to remain competitive in the marketplace. In the rebuttal phase, SMC/Advo witness Antoinette Crowder (SMC-RT-1) addressed the costing, operations, and rate design issues raised in the direct testimony of the Newspaper Association of America (NAA) and Valpak.

The SMC also co-sponsored with Postcom and others the direct testimony of Godfred Otuteye (Postcom-T-8), the President and Chief Executive Officer of Money Mailer, LLC, a coupon envelope distributor and SMC member, in support of the proposal to increase the maximum weight of "heavyweight letters" from 3.5 to 4.0 ounces, or alternatively 3.7 ounces. That proposal, which the SMC and Advo support, is being briefed separately by Postcom.

STATEMENT OF POSITION

It is the position of the SMC and Advo that:

1. The Commission should adopt the Postal Service's proposal for an on-piece-addressed rate for ECR saturation flats, and a 1.5¢ surcharge for mailings that use DALs.
2. The Commission should recommend rates for on-piece-addressed saturation flats that are no higher than proposed by the Postal Service.
3. The cost coverage for ECR mail is too high. However, any reduction in ECR cost coverage should, at this time, be modest to mitigate impact on other classes and subclasses – with the understanding that the ECR coverage will need to be moderated prior to implementation of a new price-cap regime.
4. The net cost savings from elimination of DALs (which were not included in the Postal Service's cost or revenue requirement estimates) can be applied to mitigate ECR rates without diminishing the Postal Service's targeted ECR institutional cost contribution or revenue requirement, and without increasing rates for other classes or subclasses.
5. The Commission should reject NAA's suggestion on rebuttal that institutional costs should be shifted from First Class Mail to the ECR subclass.
6. The Commission should reject Valpak's proposal to increase the Postal Service's proposed ECR saturation letter-flat rate differential; if anything, it and the ECR pound rate are too high.
7. The Commission should reject NAA's proposal to narrow the Postal Service's proposed rate differential between the ECR high-density and saturation mail categories.
8. The Commission should again reject Valpak's unfounded "capacity constraint" argument, and its related argument that letters are being treated "unfairly" relative to flats.

SUMMARY OF ARGUMENT

Because ECR saturation flat mailers operate in a highly competitive and price-sensitive market, and because postage represents a substantial portion of their total costs and directly impacts their ability to compete, every postal rate case is critical to the industry. This rate case, however, is of even greater importance for two additional reasons.

First, as a result of the industry-initiated proposal to reduce Postal Service costs by offering a rate incentive for mailers to convert from the DAL addressing procedure to lower-cost on-piece-addressing of their flats, DAL mailers are currently undertaking the complex and costly steps to transform their business models and operations to the new world of on-piece addressing. That major transformation entails not only substantial conversion costs but significant risks. The one risk that the industry cannot afford at this critical juncture is an increase in postal rates above the level proposed by the Postal Service.

Second, with the enactment of the Postal Accountability And Enhancement Act (H.R. 2407), signed into law yesterday, this may be the last or next-to-last rate case decided under the Postal Reorganization Act of 1970 prior to implementation of a price-cap regime under the new law. Before that crossover which will permanently set rate structures and rate relationships, the high ECR cost coverage and pound rate will need to be mitigated.

The USPS-Proposed Rates. We support the Postal Service's proposed rates for ECR saturation flats in this proceeding because they are the maximum rates that the

industry can live with at this critical juncture, even though we believe they should be lower.

ECR Cost Coverage. We agree with MOAA and Valpak that the proposed ECR cost coverage is too high. However, in light of the magnitude of increases proposed for certain mail categories in other classes and subclasses, we recognize that a significant reduction of the ECR cost coverage at this time is impractical due to impact concerns. Any mitigation of the cost coverage in this rate case should therefore be moderate, with the understanding that there could be one other final rate case to rectify the ECR cost coverage before the new price cap regime becomes effective.

The Postal Service's cost, revenue requirement, and institutional cost contribution estimates for ECR were based on the assumption that no DAL mailers would convert to lower-cost on-piece-addressing in the face of the proposed surcharge for DALs. In fact, there will be very substantial conversion that will generate cost savings in excess of the DAL surcharge revenues estimated by the Postal Service, resulting in an ECR institutional cost contribution that will exceed the Postal Service's contribution target, as well as its revenue requirement estimate. To the extent the Commission decides to use these DAL cost savings for rate mitigation rather than just adding them to the Postal Service's revenue requirement surplus, these net cost savings (conservatively estimated) should be applied to moderate ECR rates, a result that would still meet the Postal Service's targeted ECR contribution and its overall revenue requirement, without affecting rates for other classes.

On the other hand, the Commission should reject out of hand the suggestion in the rebuttal testimony of NAA witness Sidak that institutional costs should be shifted

from First Class Mail to ECR. Sidak conceded that his “remedy” will have no meaningful effect on diversion from First Class Mail to electronic alternatives because those losses are due to non-price technological and service advantages of those alternatives. Just like the horse-and-buggy dealer of yore competing against inroads of the automobile, holding or cutting the price of First Class postage will not regain or stem volume losses. Even worse, by shifting First Class institutional costs to ECR – a highly price-sensitive subclass where postal rates *really do* have a major impact on volumes – Sidak’s remedy would make a difficult situation worse (except, of course, for his client’s member-newspapers who would benefit from the diminished ability of saturation mailers to compete). As with any business, in the Postal Service’s circumstances where one product is at risk for non-price reasons beyond the Postal Service’s control, the worst course would be to hold the price of that product artificially low by shifting the rate burden to a product that is far more price-sensitive. The only rational and economically-sound approach is to give greater emphasis to market factors and relative price elasticities in setting rates.

The ECR Letter-Flat Rate Differential.

Once again, Valpak’s proposal to increase the letter-flat rate differential through a 100-percent-or-greater passthrough of the letter-flat cost differential ignores the acknowledged fact that the cost differential reflects not just shape-related costs, but also weight-related cost differences that are separately recovered through the pound rate. The saturation letter-flat passthrough must be set below 100 percent to avoid double-charging flats for weight-related costs; or alternatively, the pound rate must be reduced.

Valpak witness Mitchell's concept of "marking up" the letter-flat cost differential by the ECR subclass cost coverage factor has been proven bogus in concept and application. Conceptually, cross-examination revealed that Valpak's blind focus on the letter-flat differential ignores the inextricable interrelationship between the piece rate and the pound rate; any increase in one of those rate elements necessarily requires a corresponding reduction in the other to avoid severely overcharging flats. SMC witness Crowder showed that application of Mitchell's markup concept to his own pricing model would result in flats being burdened with a much higher cost coverage and unit contribution than letters.

Crowder further explained why the saturation letter-flat cost differential must be based on the cost of on-piece-addressed flats excluding DALs, and results in a cost differential lower than the Postal Service's proposed rate differential. The USPS-proposed letter-flat rate differential should, if anything, be reduced, not increased as Valpak advocates.

The ECR Pound Rate.

The real problem with the ECR rate structure is not, as Valpak contends, that the letter-flat rate differential is too low, but that the ECR pound rate is too high and the piece-rates are too low. The Postal Service's very small proposed reduction in the pound rate is in the right direction, although certainly not far enough. Crowder's rebuttal to NAA (who opposed even the Postal Service's tiny improvement) showed that the pound rate far exceeds any plausible estimate of true weight-related costs. Even Valpak witness Mitchell touched lightly on this in defending his 100-percent passthrough of the letter-flat cost differential, claiming that because weight-related costs in ECR

appear to be small, a high letter-flat passthrough is appropriate. Valpak, however, can't have it both ways. If weight-related costs are too small to justify a less-than-100-percent passthrough of the letter-flat cost differential (which includes weight-related costs), then they are also too small to support the current high pound rate.

If the Postal Service's proposed letter-flat rate differential nevertheless were to be increased (particularly at the saturation level), then the pound rate would *have* to be reduced by a fully-offsetting amount.

The High Density-Saturation Rate Differential. In arguing for a smaller rate differential between high-density and saturation mail, NAA correctly noted that the Postal Service's estimate of high-density mail unit cost was overstated due to averaging with the costs of basic-presort mail. However, NAA failed to properly account for the fact that the Postal Service's estimate of saturation flat unit cost was also overstated because it included the costs of DALs that will be subject to a separate surcharge. SMC witness Crowder showed that those two errors offset one another, so that the corrected cost differential between high-density and flats saturation is virtually identical to the Postal Service's original estimate. The Postal Service's proposed rate differential is cost-justified and should therefore be adopted.

Valpak's "Capacity Constraint" and "Fairness" Arguments. In Docket R2005-1, the Commission rejected Valpak witness Haldi's contention that city delivery costs for saturation letters and flats were artificially skewed because letters are "bumped" from the low-cost "sequenced bundle" delivery in order to give flats priority in a capacity-constrained delivery mode. Undeterred, Haldi has reprised his argument in this proceeding. In addition, Valpak witness Mitchell has joined in by implying that, as a

result of Haldi's claim, saturation letters are subsidizing saturation flats. These claims have been thoroughly rebutted by witness Crowder.

Crowder has again shown that Haldi's claim is simply wrong. She explained that the Postal Service has considerable operational flexibility to handle saturation mailings and that postal witnesses have testified that they typically can handle most saturation flats as sequenced bundles. She also explained that the Postal Service's preference to DPS saturation letters rather than carry them directly to the street as third bundles is not due to a "sequenced bundle" constraint or to the presence of saturation flats, but is based on the operational reality that DPSing is a more efficient manner of processing letters. In fact, she demonstrated that the cost of saturation letters should decline as they are increasingly DPSed.

Crowder also showed that Mitchell's implication in VP-T-3 that saturation letters subsidize saturation flats is not only ridiculous but is contradicted by his own rate testimony in VP-T-1. She demonstrated conclusively that saturation flats could not possibly be subsidized but instead make a substantial institutional cost contribution that benefits all mail, including saturation letter mail.

In sum, Valpak's arguments and proposals on this matter should be rejected in their entirety.

ARGUMENT

I. THE SATURATION MAILER INDUSTRY'S DAL INITIATIVE IS DRIVEN BY THE OVERRIDING IMPORTANCE OF POSTAL RATES TO THEIR BUSINESSES.

A. The Industry's DAL Transformation Entails Substantial Uncertainty And Risk That Must Be Considered In Setting Postal Rates.

The saturation mailer industry-initiated proposal to deaverage the rates for saturation flats through a 1.5¢ surcharge on the use of detached address labels is unique in the annals of postal ratemaking. Never before has a mailer group voluntarily initiated such a surcharge for a longstanding industry procedure that will require a fundamental and costly transformation in the way the mailers produce and market their products. By creating a rate incentive for mailers to convert to on-piece addressing of their flats, this initiative will substantially reduce Postal Service costs, and thereby justify a lower postal rate.

Notwithstanding the substantial benefits that DALs offer to mailers, the industry has pursued this initiative for one overriding reason: the critical impact that postal rates have on their highly competitive and price-sensitive businesses. The industry's willingness to undertake this fundamental transformation is, in fact, the best evidence of its high price-sensitivity to postal rates.

SMC witness Pete Gorman, President of Harte-Hanks Shoppers, explained that shopper publications and shared mail programs "operate in the most highly competitive arena of any type of mail," competing among themselves and with newspapers and others for distribution of preprinted advertising circulars. SMC-T-1 at 4. Mail is not the only distribution alternative within the industry. More than half of all shopper publications are delivered privately, and a number of SMC members, including both

shoppers and shared mailers, also use private delivery for portions of their distribution.

Private delivery is a viable and widely used distribution alternative within the industry.

Id. As Gorman noted,

“While SMC’s members predominately use the mail, the bottom line on our distribution choice is our bottom lines. We must remain competitive to stay in business, and if postal delivery becomes unaffordable or unsuited to our needs, we will have no choice but to pursue alternatives.” *Id.*

Gorman explained the genesis of the DAL proposal, describing the 25-year history of the DAL procedure and its important benefits not only to mailers but the Postal Service in facilitating the handling and delivery of saturation flats. Over the last five years, however, the industry has become aware that changes in postal operations, particularly the letter automation program, have eroded the benefits to the Postal Service and increased the costs of handling DAL mailings. As Gorman stated:

“Our choice as an industry was either (1) to cling to the DAL procedure as long as possible and pay increasingly higher postal rates that reflected the underlying costs of DALs, with no assurance of its long-term continuance; or (2) to seek a proactive solution, in cooperation with the Postal Service, that would get the industry ahead of the curve and give mailers addressing alternatives to DALs and an incentive to convert to less costly procedures – reducing Postal Service costs and laying the foundation for lower rates over the long term that will ensure the viability of our mail programs – to the mutual benefit of our industry and the Postal Service.

* * *

“We have opted for the proactive solution, one that carries substantial risk for the industry but that we believe is an imperative.” SMC-T-1 at 6.

For saturation flat mailers, the transition from DALs to on-piece addressing will be extremely complex and costly.¹ For some mailers, however, conversion to on-piece addressing will not be feasible due to cost and/or operational constraints. It is for this reason that the industry, as a key element of its initiative, has urged the Postal Service to allow the use of simplified addressing on city-delivery routes for those mailers that want to avoid the DAL surcharge but cannot do on-piece addressing. To limit the impact of that simplified alternative, the industry has proposed a “simplified but certified” addressing alternative that would limit the option to mailers of regularly-distributed mail programs, as more fully described in witness Gorman’s testimony. SMC-T-1 at 14-15.

We recognize that because simplified addressing is an operational matter within the Postal Service’s discretion, it is not a matter for the Commission to decide. We remain hopeful and will continue to urge the Postal Service to allow a simplified addressing alternative to DALs on city-delivery routes, so that all saturation mailers that

¹ Witness Gorman explained how the DAL procedure, by separating the addressing function from the complex and time-sensitive preprint insert production function, greatly simplifies and speeds production of mailings to meet critical dispatch windows that advertisers demand. In order to convert to on-piece addressing, as witness Gorman described, (1) mailers will have to invest in printers to do addressing at the end of each of their inserter production lines; (2) because the addressing function will slow production speeds and risk meeting critical dispatch times, mailers may have to invest in additional inserter equipment; (3) mailers will have to reformat their products to allow space for addressing on the front of the mailpiece, and for promotion of causes such as the Missing Child Program that currently appear on the front of DALs, both of which will cut into prime advertising space; and (4) mailers will lose much or all of the advertising revenue that currently appears on the back of DALs. SMC-T-1 at 9-12. These are daunting issues for mailers, but for most are outweighed by the critical importance of achieving the lowest possible postal rates for their price-sensitive businesses.

wish to can avoid having to pay the DAL surcharge – thereby maximizing the Postal Service’s cost savings. As witness Gorman explained,

“[W]e have pressed the companion element of our proposal – the “simplified but certified” addressing option – in the good faith belief that it is essential to minimizing harm to some mailers in the industry and to maximizing postal cost savings. The benefits are not confined to the cost side of the equation. This option, by giving all mailers addressing alternatives that allow them to convert from DALs, will ensure a healthier, more vibrant saturation mail industry in the long run.” SMC-T-1 at 8.²

The 1.5-cent DAL surcharge is unopposed. The level of the surcharge has been carefully set to (1) create a strong incentive for mailers to undertake the costly conversion to on-piece addressing, yet (2) be manageable for those that cannot or choose not to convert.

As witness Gorman emphasized, the “true financial impact” of the Postal Service’s ECR rate proposal on mailers who convert from DALs to on-piece addressing “will be far greater than its rate schedule might suggest.”

“In order to qualify for the proposed (addressed) flat rate, we must incur additional investment and operating expenses coupled with revenue dilution that could be several times greater than the putative postal rate increase.” SMC-T-1 at 11-12.

² In a related regard, the SMC is pleased that the Postal Service has recently committed to implementing a “do not deliver” mechanism that will enable mailers to use simplified addresses for flats on rural routes. SMC-RT-1 at 12, Tr. 11730; see also Tr. 11799-801. For the Postal Service, simplified mail is the lowest cost flat mail on rural routes. Over the years, however, many saturation mailers that previously used simplified addressing on rural routes converted to higher-cost “city-style” addressing in order to comply with laws that require removal of an address from a mailing at the recipient’s request – a requirement that for a simplified mailing would necessitate deleting an entire carrier route from a mailing due to a single recipient’s request. A simple mechanism for identifying the very small number of “do not deliver” addresses will enable mailers to re-convert to simplified addressing on rural routes at substantial cost savings to the Postal Service.

The Postal Service, in designing its rates, was likewise aware that mailers would incur costs and risks in converting from DALs, and this was one of the factors that led to its lower proposed increase for on-piece-addressed saturation flats. Kiefer, Tr. 1181-82.

Gorman explained the dilemma this rate case presents to DAL mailers. Because of the long lead-time required for conversion to on-piece addressing, mailers are having to “spend the money to completely re-tool” their operations and products even before the Commission issues its recommended decision, “*not knowing until too late what the rates will be.*” *Id.* at 13 (emphasis in original). He noted that while every rate case creates uncertainty within the industry due to the price-sensitive nature of the business, in this proceeding the DAL surcharge and related issues “greatly magnify that uncertainty.”

“We are already facing seismic changes. I would therefore urge the Commission to exercise great caution in considering changes that others might propose to the rates proposed by the Postal Service for ECR saturation flat mail. Our extremely price-sensitive businesses cannot afford a meteor striking on top of the earthquake.” SMC-T-1 at 17.

For these reasons, we urge the Commission not to recommend rates for ECR saturation flats that are any higher than those proposed by the Postal Service.

B. For Rate Design Purposes, The Commission Must Use The Proper Costs For On-Piece Addressed Flats That Exclude DAL Costs.

In her rebuttal to the ECR rate design proposals of NAA and Valpak, Crowder estimated the unit cost of on-piece-addressed saturation flats, excluding DALs, based on Postal Service data and testimony. As Crowder explained, the appropriate unit cost for rate design is the cost of on-piece-addressed flats, not an averaged cost that includes DALs that are subject to a separate surcharge. The latter “averaged flat cost” was incorrectly used by the NAA and Valpak rate design witnesses and therefore

inefficiently skews the rate relationships among saturation/high-density flats and letters to the detriment of on-piece-addressed saturation flat mailers. SMC-RT-1 at 8-10, Tr. 11726-28.

The new DAL surcharge will cause a very substantial mailer conversion from DALs to on-piece addressing in the test year. SMC witness Gorman estimated that “certainly more than 70 percent of total DAL volume” will convert. Tr. 28/9542-43. That estimate is conservative. As witness Crowder testified, just Advo and Harte-Hanks alone – two mailers that have already committed to converting – account for 87 percent of total DAL volume. SMC-RT-1 at 13, Tr. 35/11731. This huge expected conversion is hardly surprising given that the DAL surcharge was proposed at the urging of the saturation mail industry as a means of reducing postal costs and rates.

In its rate filing, however, the Postal Service assumed zero DAL conversion, even though it was aware from discussions with the industry that there will be very substantial conversion. Thus, its test year ECR cost and contribution projections – including its estimate of the unit cost of saturation flats – retain the full historic cost of DALs that, in fact, will largely not be incurred in the test year. Kiefer Tr. 1073-80, 83-85; Kelley Tr. 3509-16. This results in an overstatement of the actual aggregate costs of saturation flats that will be incurred in the test year. Moreover, because the DAL conversion cost savings exceed the surcharge revenues assumed in the Postal Service’s filing, conversion will generate additional net institutional cost contribution that exceeds the Postal Service’s targeted ECR contribution and revenue requirement.

Crowder also separately estimated the aggregate net cost savings for ECR as a whole due to mailer conversion from DALs to on-piece addressing. Solely for purposes

of that estimate, Crowder employed the extremely conservative assumption that only 50 percent of existing DALs will convert. SMC-RT-1 at 8, 12-13.

In cross-examination, Valpak's counsel used Crowder's conservative assumed 50-percent conversion to construct a scenario whereby if half of current DALs (2.2 billion) remained in the system but paid a surcharge that covered only a third of the DAL cost, the result would be "\$67 million of unrecouped costs from DALs" (Tr. 11791). Valpak will obviously be taking the position that this \$67 million should be charged to saturation flats, including mailers that currently use on-piece addressing and those that convert away from DALs.

This is a fallacious comparison. The actual DAL conversion, as Crowder explained, will be far higher than the 50-percent figure that she used solely for conservatively estimating the net impact on total ECR institutional cost contribution and revenue requirement. Given that Advo and Harte-Hanks alone account for 87 percent of DALs, the true conversion will likely be in excess of 90 percent. Tr. 11842-43. Crowder's extremely low 50-percent assumption may be appropriate for purposes of conservatively estimating the aggregate impact on ECR institutional contribution and the revenue requirement, but it is certainly not appropriate for purposes of constructing an "averaged saturation flat" cost for rate design, nor for estimating any "unrecouped" costs of DALs remaining in the system (which will be only a small fraction of the \$67 million figure cited in Valpak's cross-examination).

As Crowder explained, the rate paid by a saturation flat mailer that uses on-piece addressing (whether that mailer currently uses on-piece addressing or converts from DAL addressing) should be based on the actual cost of on-piece addressed flats – not

on a hybrid cost that includes the cost of DALs and is dependent on an assumption about how many mailers will continue to use DALs. This is necessary in order to maintain proper cost-based relationships among rate categories. Saturation flat mailers, for example, compete fiercely with newspapers that use high-density mail. For the great majority of saturation flat mailers that either already use on-piece addressing or that will convert from DALs, charging them an artificially high rate that includes the cost of DALs they don't use would give their competitors an artificial cost advantage and distort the competitive playing field. SMC-RT-1 at 10, Tr. 11728.

Valpak's apparent concern about "unrecouped" DAL cost is not only exaggerated but misplaced. Some ECR parcels, for example, pay rates that do not fully cover their costs, in some cases because of concerns about rate shock and impact on those mailers. Such contribution shortfalls due to a less-than-100-percent passthrough of cost are not charged to other parcels but are borne by the entire ECR subclass. That approach is even more appropriate in the case of the radically-new DAL surcharge where a full passthrough of DAL costs would be extremely harmful to some mailers who cannot convert to on-piece addressing.

Moreover, unlike the parcel example where the rate paid is less than costs, the actual rate paid by DAL mailers will fully cover attributable costs and make a significant contribution to ECR institutional costs – just not as large a contribution as if the full DAL cost differential were passed through. Tr. 11791-93. Thus, there is no true cross-subsidy of below-cost rates. Even more importantly, both the DAL surcharge and the complex conversion process for mailers that will switch to on-piece addressing pose monumental challenges to the mailers in the industry. The mailers who undertake the

costly conversion (which will substantially reduce total ECR subclass costs) should not be penalized by imposition of a part of the cost of DALs they will no longer use.

C. The DAL Surcharge Should Apply To All ECR Flats That Use DALs, Not Just To Saturation Mail.

In its rate request, the Postal Service proposed DMCS language stating that the DAL surcharge would apply to “Saturation Rate Pieces.” USPS Request, Attachment A, page 21, note 7. Under the Postal Service’s Domestic Mail Manual, use of the DAL procedure is restricted to saturation flats and product samples. DMM §602.4.1. However, in response to a Valpak interrogatory, the Postal Service has provided data showing that nearly 8 percent of high-density mail that is drop-shipped to Destination Delivery Units (the rate category typically used by newspaper total market coverage program mailings) uses DALs. VP/USPS-2, Tr. 18D/6666. USPS witness Kiefer confirmed that these mailings involves flats, rather than small parcels, even though high-density flats are not permitted to use DALs. ADVO/USPS-T36-1, Tr. 5/903.

These data clearly suggest the possibility that some high-density flat mailers are using DALs despite the proscription in the DMM. Obviously, it would be extremely unfair to impose a DAL surcharge on saturation flat mailers (who are authorized to use DALs), while exempting high-density flat mailers that may (impermissibly) be using DALs, particularly if any of those mailers compete with saturation mailers.

The Postal Service agrees. Witness Kiefer has indicated that “there is no need for the DMCS language to specifically refer to ‘Saturation Rate Pieces’ and could easily refer to ‘flat-shaped pieces.’” NAA agrees, as well. Response of witness Sidak to ADVO/NAA-T1-6(a). Accordingly, the Commission should adopt this unopposed

modification so that the DAL surcharge will apply to “flat-shaped pieces” rather than the more narrow category of saturation mail.

II. THE HIGH ECR COST COVERAGE NEEDS TO BE MITIGATED BEFORE IMPLEMENTATION OF A NEW PRICE-CAP REGIME.

A. The ECR Cost Coverage Is Too High, But Any Mitigation In This Proceeding Should Be Moderate To Limit Impact On Other Mailers.

The SMC and Advo agree with MOAA and Valpak that the ECR cost coverage is too high. That excessive coverage will need to be mitigated prior to implementation of the new price cap regime pursuant to the Postal Accountability And Enhancement Act. Under that new law, the Postal Service will be allowed one year from the date of enactment (yesterday) to file a rate case that will be decided pursuant to the existing Postal Reorganization Act, which as a practical matter means that there will be only one more rate case after this one in which to rectify the ECR cost coverage.

However, we recognize that, in this proceeding, certain categories of mail in other classes and subclasses are facing significant rate increases due to restructuring of rates under the Postal Service’s proposal, and that a substantial reduction in ECR coverage such as proposed by Valpak could be disruptive to them at this time. Accordingly, we believe 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.

B. ECR Rates Can Be Mitigated Without Changing The Postal Service’s Targeted ECR Contribution Or Adversely Affecting Other Mailers.

The Postal Service’s Test Year ECR cost and revenue estimates assume that no DALs will convert to on-piece addressing as a result of the proposed DAL

surcharge, and therefore include no cost savings from elimination of DALs. The record shows, however, that there will be very substantial conversion away from DALs, eliminating well more than 80 percent of existing DALs from the system. Absent any mitigation of the proposed rates, the expected DAL conversions will cause the actual ECR institutional cost contribution and cost coverage at the Postal Service's proposed rates to exceed its targeted contribution and coverage – in effect imposing on ECR mailers a higher cost coverage than proposed. It will also generate additional net revenues in excess of the Postal Service's requested revenue requirement.

As explained in Section I.B. above, for purposes of estimating the net effect of conversion on institutional cost contribution and the revenue requirement, Crowder employed the very conservative assumption that only 50 percent of DALs will convert. The actual conversion will be much higher. Accordingly, her estimate of the net savings from conversion provides a substantial margin of error.

The Commission has three options in dealing with this excess revenue requirement generated by the cost savings from DAL conversion:

First, the Commission could just add this amount to the existing surplus under the Postal Service's revenue requirement by not applying the cost savings for rate abatement of any mail classes. That option would effectively increase the ECR institutional cost contribution and cost coverage above the levels targeted by the Postal Service. The benefit of the cost savings generated by the efforts of ECR saturation flat mailers who convert from DALs would thereby be spread among all mailers of all classes.

Second, the Commission could use all or a portion of the surplus generated by DAL conversions to reduce proposed rates for mailers in other classes, excluding ECR. As with the first option, that would effectively increase the ECR institutional cost contribution and cost coverage above the levels targeted by the Postal Service.

Third, the Commission could use all or a portion of the surplus to mitigate proposed rates within ECR. Under this option, the ECR subclass would still generate at least the level of total institutional cost contribution targeted by the Postal Service's rate filing, while still preserving the revenue requirement requested by the Postal Service. Because any such ECR rate mitigations would be based on conservatively-estimated cost savings not reflected in the Postal Service's filing, they could be achieved without any change to the rates proposed for other mail classes and subclasses.

If the Commission opts to use this surplus to mitigate rates, we submit that the mitigation should be applied most appropriately and fairly to the ECR subclass rather than other classes or subclasses. It is ECR mailers that initiated the proposal to transform their businesses in order to reduce postal costs, and it is they who, at substantial expense and risk, will be generating these postal cost savings.

C. NAA's Suggestion On Rebuttal That Institutional Costs Should Be Shifted From First Class To ECR Mail Is A Recipe For Disaster.

In its direct testimony, NAA narrowly addressed rate structure issues within ECR, focusing on the cost and rate differentials between the high-density and saturation tiers. Its testimony did not mention ECR cost coverage, much less suggest that the Postal Service's proposed ECR coverage was too low.

On rebuttal, however, in response to proposals by Valpak and the Mail Order Association of America (MOAA) to reduce the ECR cost coverage, NAA through the

rebuttal testimony of witness Sidak (NAA-RT-1) unleashed a broad argument suggesting that because of volume losses in First Class Mail due to diversion to electronic alternatives, First Class rates should be mitigated by shifting a greater portion of institutional costs to Standard Mail.

In a real sense, Sidak's testimony does not truly rebut the MOAA and Valpak cost coverage proposals. Although his ostensible purpose was to rebut their *ECR cost coverage* proposals, Sidak hardly mentioned the ECR subclass in his testimony, instead arguing more broadly (and nebulously) that the *Standard Mail class* should bear a greater institutional cost burden. In essence, he rebuts ECR cost coverage proposals by lumping the ECR subclass in with the Regular subclass. Yet as the Commission has repeatedly found, these two subclasses have markedly different cost and demand characteristics – and for ratemaking purposes, they must be assessed separately.

This is not merely a technical shortcoming; it goes to the heart of his “rebuttal.” For example, Sidak's volume history graph (based on USPS witness Thress's volume data), showing Standard Mail class volumes growing and intersecting with First Class volumes, masks the dramatically different volume histories of the Regular and ECR subclasses within Standard. He was unaware that the entirety of the Standard Mail volume growth from 1998 to 2005 came from the Regular subclass which grew by more than 50 percent, whereas ECR subclass volumes actually declined. Tr. 10850-53.

Sidak was likewise unfamiliar with the substantial differences between the Regular and ECR subclasses in terms of demand, price sensitivities, and marketplace factors – claiming that he was “focusing on the forest rather than the trees.” Tr. 10866-69. That might be acceptable if the trees in the forest are similar, and would be similarly

affected by the actions he is recommending. But ECR mail is unquestionably far more price sensitive than Regular mail, in large measure because of intense competition with the member-newspapers of Sidak's client.³ NAA's interest is not in watching out for the welfare of First Class bill payers, but in loading up the rate burden on competitive ECR mailers. Sidak's failure to address these real-world aspects of ECR mail, ignoring this distinctive subclass by discussing only the aggregated Standard class, is more than curious considering that the purported purpose of his testimony was to rebut MOAA and Valpak testimony concerning ECR cost coverage.

Sidak's conclusion -- that "it would seem wiser" to shift contribution from First Class to Regular "rather than risk further substitution away from First-class Mail and toward electronic communications" -- is disproved by his own testimony and that of USPS rebuttal witness Thress (USPS-RT-2). The Postal Service has not lost that First Class volume because of postal rates. That volume has converted because of the unmatched technological service and convenience advantages of electronic communications, and the "risk [of] further substitution," contrary to Sidak's claim, will be unaffected by changes in First Class rates. Thress, Tr. 38/13143-47.

Indeed, Sidak's own "bill-payer example" (Tr. 10834-35) undercuts his conclusion by demonstrating that postage is only a small part of the bill-payer's total opportunity cost compared to electronic alternatives, and that freezing or even reducing the First

³ Sidak did not undertake or present any analyses of absolute or relative price elasticities among mail classes and subclasses. Instead, he cited only generally to the testimony of GCA witness Clifton (GCA-T-1) whose analysis has been thoroughly discredited in the rebuttal testimony of USPS witness Thress (USPS-RT-2). Moreover, Clifton himself presented no analysis of ECR elasticity.

Class rate by a few pennies will have no meaningful effect on the huge non-postal-rate advantages of electronic alternatives.⁴

Finally, we address Sidak's claim that "it seems contrary to the intent of the postal monopoly for the Postal Service to keep raising the price charged to these inframarginal users of First-class Mail," on the theory that "the purpose of having a postal monopoly in the first place is to keep the delivery of letters affordable...." NAA-RT-1 at 15, Tr. 10835. This contention fundamentally misconstrues the purpose of the monopoly. The monopoly is indeed intended to keep letters affordable, but by preventing diversion to hard-copy delivery alternatives that might otherwise be available. Sidak conceded that the monopoly has nothing to do with the diversion to electronic alternatives. Tr. 10864-65. Moreover, he conceded that those very same electronic alternatives, for the same reasons, have similarly lessened the potential demand for *private hard-copy delivery* of First Class single-piece mail even if the monopoly were abolished.

Q: I'm saying if they were allowed to do that, if you're allowed to pay bills, through hard-copy means outside the Postal Service.

A: Yes. I think it's quite possible that there would not be sufficient demand for private delivery of first-class, single-piece letter mail.

⁴ In his example, the bill payer's total opportunity cost of using the mail rather than electronic bill payment, assuming 144 bills per year, is \$164.16 annually – of which postage represents only \$56.16. NAA-RT-1 at 14-15, Tr. 32/10834-35. A one-penny reduction in the First Class rate would reduce the opportunity cost by only \$1.44 annually. That less-than-one-percent reduction in the opportunity cost of mail payments would be highly unlikely to affect the bill payer's decision to either stay in the mail or convert from electronic payment back to the mail. In other words, marginal changes in First Class rates will have no meaningful impact on bill payment volumes or on decisions to switch, which are driven by the non-postal-price advantages of electronic alternatives that the Postal Service cannot match.

Q: So that really means that if you looked at the monopoly, it might not have that much impact anyway.

A: I think that's quite possible. (Tr. 10865-66)

Under Sidak's novel theory, the postal monopoly would be transmogrified from its intended purpose of preventing the loss of mail volumes to private delivery (a purpose he concedes is becoming moot), into a non-economic excuse to cross-subsidize First Class single-piece mail users by raising rates for Standard mail users. Using the monopoly as an excuse to shift contribution to ECR mail not only contravenes the intent of the statutory monopoly provision, but would undermine the Postal Service's long-term financial viability by driving away the most price-sensitive volumes in the postal system.

When one product is under siege due to technological advantages of alternatives that are beyond the Postal Service's ability to match or control, either through pricing or service changes, the worst course of action would be to regress to non-economic pricing by shifting rate burdens to other products that are more price sensitive. Such an approach would not recapture volumes already lost to superior electronic alternatives, nor would it prevent further diversion which, by its nature, is due to factors other than postal rates. What it would do is artificially further reduce First Class contribution at the risk of volume and contribution losses in other price-sensitive subclasses, most particularly the ECR subclass.

The only rational pricing approach under the Postal Service's current circumstances is to place even greater emphasis on market-based pricing. Otherwise, the approach advocated by Sidak would make a difficult situation untenable.⁵

III. VALPAK'S ECR RATE DESIGN PROPOSALS IGNORE THE INTER-RELATIONSHIP BETWEEN SHAPE AND WEIGHT AND THE POUND RATE, AND WOULD OVERCHARGE FLATS.

The ECR subclass serves three shapes of mail at each of three different mailing density levels: basic, high-density, and saturation. Further, at each density level, there are three rate elements: (1) minimum-per-piece rates for pieces weighing up to the 3.3-ounce breakpoint; (2) a per-piece rate for pieces over the breakpoint; plus (3) a per pound rate for pieces over the breakpoint. Changing any one of these rate elements affects the others – thus, they must all be set with reference to each other. No one rate element can be set in isolation from the others.

⁵ NAA witness Ingraham's rebuttal testimony (NAA-RT-2) merits only brief comment. His hypertechnical "confidence interval" arguments about the price elasticity of ECR mail are particularly unhelpful for ratemaking. In particular, his contention that, "loosely speaking," all elasticity figures within the confidence interval range are "statistically equivalent" (Tr. 11852-53) obfuscates the obvious statistical fact that USPS witness Thress's estimate of a -1.079 elasticity for ECR is the best estimate of the true elasticity. Only after three rounds of cross-examination -- during which Ingraham artfully dodged the point with clever statistical jargon about "null hypotheses" and "zero probability" of any one estimate being correct – did he finally concede the point (Tr. 11872), which as MOAA counsel so aptly stated, "It's not very obscure, is it?" Tr. 11867.

Equally ridiculous was Ingraham's claim that any doubts about whether ECR is price elastic are tipped by GCA witness Clifton's "belief" that ECR is inelastic. Counsel for USPS exposed the absurdity of this position. Ingraham based his conclusion on his "presumption" that Clifton, "as an econometrician," must have done an analysis to support his belief, "rather than just picking a number out of the air." Tr. 11896. He conceded, however, that Clifton had presented no such analysis. Tr. 11896-97. It is Ingraham who is picking arguments out of thin air.

Moreover, the rate relationships between and among the various types of ECR mail are extremely important because ECR mailers compete with each other. If each rate element is not properly developed, competitive relationships among ECR mailers can be biased. Accordingly, the design of ECR rates must be carefully balanced. SMC-RT-1 at 6-8.

In its proposed rate design, however, Valpak once again focuses simplistically on only the piece rates, arguing that the piece-rate differential between letter and flat mail should reflect 100% or more of the unit cost differences between letters and flats. It ignores the interrelated pound rate and the fact the letter and flat unit costs it uses to develop the rate differential include the costs not only of piece-rated mail but also pound-rated mail. Technically, and as a matter of sound, unbiased pricing, the letter-flat piece-rate differential should be designed to recover only those piece-related cost differences between letters and flats that are due to *piece/shape*. It should not recover cost differences that are due to *weight over the breakpoint*, because that is recovered separately through the pound rate. SMC-RT-1 at 15-16.

Because of its too-narrow focus, Valpak's rate design is ill-conceived and biased. The correct approach to rate design, discussed below, leads to the following conclusions:

- Because the letter-flat unit cost differential reflects both piece/shape- and weight-related costs, it cannot be set without consideration of the level of pound rate;
- The ECR pound rate is already too high and should be reduced even more than proposed by the Postal Service;
- Valpak's "product pricing" proposal, designed to support a greater letter-flat passthrough, is wrongly conceived and implemented.

A. The Letter-Flat Unit Cost Differential Reflects Both Piece/Shape- and Weight-Related Cost Differences.

In Docket R2005-1, just as he has in this case, Valpak witness Mitchell advocated as a “default solution” that the letter-flat cost differential should be “marked up” by an amount equal to the ECR cost coverage (R2005-1 Tr. 9/5414-15), ostensibly as a means to equalize the cost coverages of letters and flats, as though they were separate products or subclasses. At a minimum, he contended that in no event should the passthrough be less than 100 percent. However, he did not address the interrelationship between piece/shape- and weight-related costs. Instead, he simply assumed (without discussion) that the letter-flat cost differences reflect solely piece/shape-related differences.

The problem that Mitchell overlooked then, and continues to overlook, is that the letter and flat unit costs, from which the cost differential is derived, reflect both piece/shape-related *and* weight-related cost differences. Almost 43 percent of ECR flats are pound-rated, averaging over 5 ounces per piece; while only 2.2 percent of ECR letters are pound-rated, averaging only 3.9 ounces.⁶ To the extent that the weight of pound-rated flats causes costs in mail processing and delivery operations, those weight-related costs (including piggybacks) are fully “baked into” the letter-flat unit cost differential. SMC-RT-1 at 14, Tr. 35/11732.

Cross-examination in Docket R2005-1 revealed that Mitchell was unaware that the letter-flat cost differential reflects not just piece/shape-related but also weight-related cost differences. Tr. 9/5417-19, R2005-1. He was also unaware that the Commission

⁶ USPS LR L-36, WP-STD-ECR-6021.xls, TYAR Commercial Pieces & Pounds.

had addressed this issue in Docket R2000-1 and agreed with Crowder's analysis on this same point. *Id.* at 5419-20. As the Commission said:

"However, because the weight of letters and flats varies, the letter/flat cost differential by density level likely reflects differences in both weight and shape. As the pound rate is supposed to reflect the effect of weight on cost, passing through a substantial portion of the ECR letter/flat differential amounts to a double counting of the effect of weight." PRC RD, Docket 2000-1, at 365.

In his testimony in this current proceeding, Mitchell now acknowledges that the letter-flat cost differential reflects the cost effects of both piece/shape and weight. VP-T-1 at 178-80. That, however, has not deterred him from continuing to advocate a 100-percent passthrough of the cost differential. Nor has it deterred him from continuing to argue that the optimum passthrough should be far greater than 100 percent, equal to the ECR cost coverage factor. *Id.*

B. The Letter-Flat Passthroughs Must Be Less Than 100 Percent To Avoid Double-Charging For Weight-Related Costs; Or Alternatively, The ECR Pound Rate Must Be Substantially Reduced.

Because the letter-flat cost differential includes weight-related costs that are separately recovered through the pound rate, the passthrough must be less than 100 percent to avoid double-charging for those weight-related costs. Indeed, the passthrough and the pound rate are, inherently, directly but inversely related to one another. For example, under the extreme assumption that 100 percent of the cost differential were due solely to shape/piece-related cost effects rather than weight (as Mitchell apparently assumed), then there would be no cost justification for a pound rate. Conversely, if 100 percent of the cost differential were weight-related, then the letter-flat rate differential should be zero.

Mitchell attempted to finesse this dilemma by suggesting that weight-related costs within ECR appear to be small, citing the Postal Service's response to NAA/USPS-1 (Tr. 9/6295) which shows that ECR unit costs by ounce increment increase quite modestly throughout almost the entire 0- to 16-ounce ECR weight range. VP-T-1 at 179, fn. 65. He used this – the “presumption that the effects of weight on costs is not large” -- as justification for a 100-percent or higher passthrough of the letter-flat cost difference. Yet he steadfastly ignored the necessary corollary: if weight-related costs in ECR are low, then the ECR pound rate is too high. Instead, as Valpak has persistently done in the past, Mitchell incorrectly treats the pound rate as an issue that is entirely separate from the letter-flat rate differential.

C. The ECR Pound Rates Proposed By Ingraham And Mitchell Are Excessive And Ignore The Interrelationship Between Shape And Weight

The Postal Service has proposed that the ECR pound rate be reduced from its current level of 64.3 cents to 64.1 cents, a reduction of only 0.2-cents per pound. We support the Postal Service's proposal, although even with this slight reduction, the proposed pound rate is still far excessive in relation to weight-related costs.

As Crowder explained, the ECR pound rate is critical to high-density/saturation mailers in the saturation advertising market – affecting their viability and growth. She also explained that the delivery of heavier-weight saturation pieces is more susceptible to migrating to non-postal alternatives: newspaper delivery, private delivery, and even electronic delivery. SMC-RT-1 at 7-8 and 14; see also Tr. 35/11812-15, 11823-24. Therefore, the ECR pound rate warrants serious consideration. Crowder also testified,

based on cost information presented by the Postal Service in this proceeding, that the pound rate is far greater than the relevant underlying weight-related costs. SMC-RT-1 at 14-16, Tr. 35/11825-27.

NAA and Valpak, however, continue to ignore the problems with the high pound rate. In his direct testimony, NAA witness Ingraham was unwilling to accept even the tiny 0.2-cent proposed reduction, and advocated that the pound rate remain unchanged. Valpak witness Mitchell took a slightly different tact, accepting the proposed pound rate but then proposing dramatically lower piece rates – in effect sharply increasing the proportion of ECR revenues derived from pound-rate mailers. Neither witness attempted to present any quantitative or qualitative support for his proposed pound rate or to assess its impact on the market.

As discussed by Crowder, in ECR, the unit costs by shape and density level are based on total mail processing plus delivery cost, adjusted to reflect origin-entry level. Those unit costs by rate category, therefore, are an average of the costs for pieces below and above the 3.3-ounce breakpoint. This means that rate category unit costs include the effect of weight over 3.3 ounces for pound-rated pieces; but that cost effect should be recovered only in the pound rate. Consequently, the ECR pound rate should be based on the cost of weight over the breakpoint and the ECR piece rate differentials should be based on the unit cost differences among piece-rated pieces. SMC-RT-1 at 14-16.

In practice, however, the pound rate has not been set on the basis of weight-related costs, but instead has been arbitrarily selected, and the piece-rate differentials have been developed using unit cost differentials that include the cost impact of weight

over the 3.3-ounce breakpoint. If the unit cost differentials are then passed-through 100 percent, as Mitchell and Ingraham have done, the resulting piece-rate differentials are overstated. This is particularly relevant to the letter-flat piece rate differentials because, relative to letters, a significant amount of flat volume exceeds the breakpoint and pays the pound rate. When the pound revenue from flats is then added to the piece revenue to develop average flat revenue, the average revenue difference between letters and flats substantially exceeds the average cost difference.⁷ SMC-RT-1 at 15.

Part of this rate design problem is caused by the 100-percent passthrough of unit cost differences to piece rate differences. But the major cause of the problem is that the ECR pound rate is too high.⁸ Because of the breakeven constraint, if the pound rate is set too high, then the piece rates, in combination, are too low. Mitchell attempted to argue that this is strictly a flat problem, and that letter rates should not be affected by any adjustment in the pound rate. VP-T-1 at 182-183. He is wrong. Clearly, the reason why his “Product Pricing” concept generates such a huge disparity between letter and flat coverages and unit contributions is specifically because the pound rate is too high relative to the piece rates. SMC-RT-1 at 31, fn. 61; see *also*, Section III. F., *infra*.

⁷ This defect is hidden in Mitchell’s conventional “presort tree” analysis because his “presort tree” compares minimum-per-piece rates by shape and density level to unit costs that include weight-related cost for pound-rated pieces. Thus, his “presort tree” analysis can falsely imply that a rate design is efficient when clearly it is not.

⁸ Mitchell recognized this problem but still proposed 100% passthrough of the letter-flat unit cost differentials as well as a high pound rate. He implied that the 100% passthroughs are acceptable because weight-related costs are not large. (VP-T-1 at 178-179, see especially footnote 65) Yet if that is the case (and we agree with him on this point), then he should have reduced the pound rate by at least the same proportion as he reduced the piece rates.

On cross-examination of Crowder, Valpak attempted to pursue Mitchell's claim that letter rates should not be affected by the fact that the pound rate is excessive. But Mitchell's contention is absurd, given how ECR rates are developed. Crowder clearly explained that if the pound rate is too high, then the piece rates for *both* letters and flats are too low – a conclusion that has cost support in this record. Tr. 35/11824-27.

Additionally, Crowder provided an “extreme estimate” of the maximum ECR marginal weight-related cost under the hypothetical assumption that *all* saturation flat cost is weight-related, an assumption which yields an origin-entry pound cost of 45.7 cents. This estimate, she emphasized, is “well above an upper bound” on the origin-entry pound cost because the unit cost used includes piece-related casing and delivery costs. SMC-RT-1 at 16. At the prompting of Valpak cross-examination, Crowder explained that one could come up with another rough estimate by combining the Parcel Post non-transportation weight-related piece cost of 2 cents with the weight-related origin-entry cost of roughly 24.1 cents to obtain a total weight-related cost estimate of 26.1 cents. Even this, she explained, was probably too high. Tr. 35/11839-41.

By comparison, the current origin-entry pound rate of 64.3 cents selected by NAA witness Ingraham, as well as the Postal Service's proposed pound rate of 64.1 cents, are excessive. Similarly, witness Mitchell's rate proposal to retain the high USPS-proposed pound rate of 64.1 cents while reducing all other ECR piece rates, shifting an even greater proportion of ECR costs to pound-rate mailers, is completely unfounded and self-serving.

D. Mitchell's "Product Pricing" Concept Is Incorrectly Implemented: He Has The Wrong Products, He Marks-Up The Wrong Costs, And His Results Are Economically Inefficient

Essentially expanding upon his testimony on ECR rate design in Docket R2005-1, Valpak witness Mitchell proposed the use of what may be termed "Product Pricing." This involves applying separate institutional cost markups for separate products within the same subclass. Mitchell claimed that ECR letters and ECR flats are separate products in terms of their cost and demand characteristics and, for efficiency reasons, he proposed to mark up each by the same percentage in order to cover ECR institutional costs. VP-T-1 at 118, 178. He claimed that this is an intermediate step in the direction of separate subclasses. Response to ADVO/VP-T1-6(a). Instead, it is simply a contrivance to incorrectly lower the letter rates relative to flat rates.

On rebuttal, Crowder explained that Mitchell has not correctly identified "products" within ECR. In reality, the market and demand characteristics of ECR mail are far more complicated than he leads the Commission to believe. SMC-RT-1 at 25-29, Tr. 35/11743-47. Information on record in this case, some of which is provided by Mitchell himself, sheds light on the relative market and demand characteristics of mail within the ECR subclass:

- Mitchell presented information that shows that ECR flats -- and saturation flats, in particular -- have greater price elasticity than other mail in the ECR subclass. He observed that private delivery is an available alternative for many saturation flat mailers, and that much of the mail that is a candidate for being handled by alternative carriers weighs more than 3.3 ounces or has more than 24 pages (e.g., catalogs). SMC witness Pete Gorman described the extensive use that saturation shopper publications and shared mailers (all flat shaped) make of private delivery.⁹ Conversely,

⁹ SMC-T-1 at 4 and responses to NAA/SMC-T1-3(d) and 4.

Mitchell was unaware of any saturation letter mailers that used private delivery.¹⁰

- There is a strong rivalry between ECR saturation and high-density flat mailers for advertising customers, and such customers can easily shift between a saturation mail program and a newspaper TMC program. NAA witness Ingraham emphasized the competition between the saturation and high-density flat rate categories in the Total Market Coverage market.¹¹ This also supports the notion of greater price elasticity for flats than for letters.
- ECR letter-shaped mail sometimes becomes a rated “flat” by exceeding the 3.3-ounce breakpoint and sometimes also exceeding the 3.5-ounce “heavy letter” automation breakpoint. Even Valpak mails letter shapes that exceed these breakpoints.¹² In Docket R2005-1, SMC witness Godfred Otuteye explained that Money Mailer, the second largest saturation letter mailer in the system (after Valpak) often exceeds those breakpoints and its competitive positioning is very much affected by saturation flat rates.¹³
- SMC witness Gorman explained that saturation letters are part of the saturation mail industry that also includes saturation and high-density flats.¹⁴ Within this industry, these mailers compete with each other for many of the same advertisers (e.g., local retailers and service companies).¹⁵ And, conversely, local retail and service companies may

¹⁰ VP-T-1 at 57, 59-60, 82, 84-85, and response to ADVO/VP-T1-16. Despite this information, Mitchell claimed that he has no information on “comparative price sensitivities” of ECR letters and flats. Response to ADVO/VP-T1-11 (a-b).

¹¹ NAA-T-2 at 2-3; response to NAA/SMC-T1-3. Mitchell also recognized this strong rivalry. Tr. 25/8954-55, 8992-93, and responses to ADVO/VP-T1-17 and 18.

¹² Response to ADVO/VP-1; 7.2% of Valpak’s letter coupon program mail were over the 3.3-ounce breakpoint, 4.6% were over 3.5 ounces.

¹³ See ADVO-RT-2 in R2005. Mr. Otuteye also offers similar testimony in this case in PostCom-T-8.

¹⁴ He describes this industry as mailers involved in “the assimilation and distribution of advertising matter from numerous retailers, service companies, and entrepreneurs for mailings to consumer households, typically targeted by zip code in a manner that allows each advertiser to select and reach potential customers within their unique service areas, often within a few-miles’ radius of their business locations.” SMC-T-1 at 3, and response to NAA/SMC-T1-3.

¹⁵ Response to NAA-T-3(i).

consider both letter and flat mail programs as potential means to deliver their advertising.

Accordingly, Mitchell's division of ECR mail into letter "products" and flat "products" is extremely simplistic and likely would not fit the criteria for separate subclass treatment.¹⁶ By contrast, the high degree of competition between high-density and saturation flats, as well as between high-density/saturation flat postal service and alternative delivery services, is strong evidence that the own-price elasticities of high-density/saturation flats are far higher than those of any ECR letter category.¹⁷ Thus, high-density/saturation flats should not only be treated as a separate "product" -- or, indeed, as a separate subclass -- but should also receive a lower markup than the rest of ECR. SMC-RT-1 at 30.

E. Mitchell's Rebuttal Testimony And Cross-Examination Exposed The Illogic Of His Concept Of "Marking Up" The Letter-Flat Cost Differential, And His Failure To Consider The Pound Rate.

In Docket R2005-1, Mitchell first presented his novel concept that the ECR letter-flat rate differential should ideally be set by "marking up" the cost differential by the ECR subclass cost coverage factor. In rebuttal in that docket, witness Crowder

¹⁶ When asked whether all ECR letters are one product and, separately, whether all ECR flats are one product, Mitchell answered both: "Basically, yes." However, he then admitted that "a case could be made for giving separate recognition in rates" to saturation letters and saturation flats "for competitive reasons." Responses to ADVO/VP-T1-7 and 8, Tr. 25/8950.

¹⁷ Mitchell also agreed that there are crossovers between saturation and high-density flat mail programs, such as saturation mailers that convert into newspaper TMC programs, that are influenced by postal rate differences. Tr. 25/8992-93, 9030-33. He also appears to recognize that there are few, if any, saturation letter mailers that use alternate delivery services. Tr. 25/8973.

explained how Mitchell's approach incorrectly mixed and confused two different pricing concepts: (1) the traditional rate-category approach to pricing within a subclass; and (2) the proper approach for pricing of separate products that are treated as separate subclasses. Mitchell's approach of "marking up" the letter-flat cost differential, she explained, is not only patently incorrect but would greatly exacerbate the double-charging for weight-related costs that are embedded in the letter-flat cost differential. ADV0-RT-1 at 8-9, 13-14; Tr. 10/5734-35, 5739-40, Docket R2005-1.

Crowder then presented the correct approach to the pricing of separate products as distinct subclasses, explaining that the correct measure of a product's cost coverage is its *total* revenues (including, for example, pound-rate revenues) divided by its *total* costs. Mitchell's approach of "marking up" a single rate element while ignoring the excessive revenue contribution that flats make from the pound rate, as Crowder aptly said, is nonsensical.

In the current proceeding, Mitchell has again put forth his illogical concept that "marking up" the letter-flat cost differential by the ECR cost coverage factor is economically-appropriate. On rebuttal, he attempted to bolster his markup concept by trying to demonstrate through hypothetical examples that marking up the letter-flat cost differential by the subclass cost coverage produced the same results as if letters and flats were separate subclasses with the same cost coverages. Tr. 11907-09 (VP-RT-1); 11913-14 (cross-examination). His attempt backfired.

During cross-examination, Mitchell was led through a series of variations on his hypothetical, using a set of five cross-examination exhibits, ADV0-XE-1 through 5. For

ease of reference, the five scenarios in these cross-examination exhibits are summarized in a table below.

Scenario 1 is Mitchell's initial scenario which assumed hypothetically that flats and letters were separate subclasses, with flats costing twice as much as letters but being less price sensitive, thus warranting a higher subclass cost coverage. His resulting rate difference for the two subclasses was 250% of the cost difference, which he claimed "can be viewed reasonably as a passthrough." He claimed this same result could be achieved with flats and letters in the same subclass by applying a 250% passthrough of the average letter-flat cost difference. VP-RT-1 at 3-4; Tr. 11907-08.

Scenario 2 merely reversed Mitchell's hypothetical price sensitivity and cost coverage assumptions by assuming that flats are more price sensitive than letters (the far more realistic assumption). That single change reduces the resulting passthrough from 250% down to 100% of the cost difference. Mitchell conceded that this demonstrates that price elasticity can have a major impact on the appropriate passthrough. Tr. 11918.

Scenario 3 simply asked Mitchell to further assume that flats, on average, cost only 40% more than letters, not the 100% difference assumed in his original hypothetical. Mitchell agreed that this was more in line with the actual letter-flat cost difference, adding that "[i]t might even be closer than that." Tr. 11919-20. This more realistic assumption further reduces the passthrough down to *only* 25% of the cost difference. Mitchell agreed that this demonstrates the results of his example are sensitive not only to price-elasticity assumptions but to the level of the cost difference,

and that it can produce passthroughs of less than 100 percent – far less than the subclass cost coverage. Tr. 11919-21.

Scenario 4 changed the previous one only by assuming equal cost coverages for letters and flats (assuming, as he had in his own examples, equal volumes of letters and flats). This change, under his conception, would result in a 6.8-cent letter-flat rate difference representing a passthrough of 170%, equal to the subclass cost coverage. The resulting rate for flats would be 23.8 cents. Mitchell stated that in this example, the 6.8-cent figure is the appropriate letter-flat rate differential. Tr. 11922-24.

He was then asked:

Q: Have we forgotten anything here? What about the pound rate?
Does this assume a zero pound rate?

Following a non-responsive answer, he was asked again:

Q: You didn't answer my question. Does that assume a zero pound rate?

A: It does not make any assumptions about pound rate; it only discusses the piece rates in the example.

That, of course, is the core defect with Mitchell's entire rebuttal analysis, as well as his direct testimony on his novel "markup" concept: in his myopic focus on the piece rate, he completely ignored the implications of the pound rate, and the inherent interrelationship between the piece and pound rate elements in designing rates.

In ensuing cross-examination (Tr. 35/11925-28), Mitchell conceded that:

- Charging flats *any* pound rate on top of the piece rate generated by his markup concept would cause flats revenues to exceed his targeted "equal cost coverage" for letters and flats;
- If a pound rate is added to his concept, the only way to maintain the targeted flats cost coverage is to *reduce* the piece rate, so that the

passthrough of the letter-flat cost differential is *less than the subclass cost coverage*.

- The higher the pound rate, the lower the piece rate has to be dropped in order to maintain the targeted cost coverage.

Scenario 5, the final scenario, modified the previous scenario by assuming that mail in the flats subclass also pays a pound rate in addition to the piece rate, and that the pound rate constitutes 4-cents of the total 23.8-cents flats revenue-per-piece. In that circumstance, Mitchell agreed that in order to preserve an equal cost coverage for letters and flats, the letter-flat rate differential would have to be reduced by 4 cents. As a result, the letter-flat rate differential would decline to only 2.8-cents, representing only a *70% passthrough* of the letter-flat cost differential – a passthrough that is not only far less than the 170% subclass cost coverage, *but even less than the 100% passthrough that Mitchell claimed in his testimony is the minimum justifiable passthrough*. Tr. 35/11932-11933.

That cross-examination and the accompanying cross-examination exhibits, summarized below, expose the fallacy of Mitchell's markup concept: his failure to consider the implications of the pound rate in setting the piece rate.

SUMMARY OF ADVO-XE-1 THROUGH 5

ADVO-XE Exhibit:	1	2	3	4	5
Scenario:	Mitchell Ltrs. More Elastic	Flats More Elastic	Smaller Cost Diff.	Equal Cost Coverage	With Pound Rate
ECR Letters					
Ave. Cost per Piece	10	10	10	10	10
Cost Coverage	150%	200%	200%	170%	170%
Ave. Rev. per Piece	15	20	20	17	17
ECR Flats					
Ave. Cost per Piece	20	20	14	14	14
Cost Coverage	200%	150%	150%	170%	170%
Ave. Rev. per Piece	40	30	21	23.8	23.8
Pound Rate per Piece	0	0	0	0	4
Piece Rate per Piece	40	30	21	23.8	19.8
Letter/Flat Cost Diff.	10	10	4	4	4
Piece-Rate Diff.	25	10	1	6.8	2.8
Piece-Rate Passthrough	250%	100%	25%	170%	70%

Moreover, they also prove Crowder's points that (1) the ECR piece rate and pound rate are inextricably interrelated; (2) the letter-flat passthrough and piece-rate differential cannot be set a vacuum, without regard to the pound rate; and (3) a high passthrough of the letter-flat cost differential without an offsetting reduction in the pound rate results in overcharging of flats relative to letters, and particularly relative to weight-related costs.

We would note that on follow-up cross, counsel for AAPS attempted to resuscitate Mitchell's debunked theory by suggesting that perhaps the cost and rate comparisons laid out in Mitchell's testimony and cross-examination were for letters and flats that paid only the piece rate, not the pound rate. Tr. 11939-41. That is malarkey.

Mitchell's testimony clearly purported to assess costs and rates *at the subclass level*, as though letters and flats were separate subclasses. Tr. 11907-09. The costs and rates he developed were necessarily intended to represent the average subclass costs and rates, and he nowhere suggested that his "flats subclass" excluded flats over the 3.3-ounce breakpoint that pay the pound rate. Otherwise, his comparison would be meaningless to his contention that his concept of marking up the letter-flat cost differential produces the same result as if letters and flats were separate subclasses. The problem is that in making his comparisons, Mitchell completely forgot about the pound rate and its interrelationship with the piece rate. That is a defect that no amount of *post hoc* rationalization can remedy.

In any event, it is irrelevant what Mitchell or Valpak might now try to say Mitchell's comparisons represented (such as a claim that the flats in his subclass comparison were intended to be a hybrid subclass of "light-weight flats that only pay the piece rate, not the pound rate"). His cross-examination and the cross-examination exhibits stand on their own as full refutation of his markup theory.

F. Crowder Proved The Absurdity Of Mitchell's Markup Concept By Applying It To His Own Rate Model.

Mitchell's rebuttal testimony and cross-examination disproves his own theory on a conceptual level. Crowder further disproved it by applying Mitchell's markup concept to his own ECR rate model. As she showed (SMC-RT-1 at 31), his approach of marking up the letter-flat cost differential by his proposed ECR subclass cost coverage factor would produce a total cost coverage for flats (including pound rate revenues) far in excess of that for letters:

**Impact of Mitchell Letter-Flat Markup Concept
177% Passthroughs Using His Rate Model**

	Cost Coverage	Contribution
ECR Letters	162.4%	4.3 cents
ECR Flats	192.9%	8.5 cents
High-Density/Saturation Letters	206.9%	4.7 cents
High-Density/Saturation Flats	246.1%	8.9 cents

This shows that Mitchell's full-blown markup concept yields a tremendously-excessive coverage and unit contribution from the so-called "flat products" relative to the "letter products." Clearly, his proposal would not accomplish what he had implied: equal coverages for letters and flats. His concept produces distorted results primarily because (1) he has marked up the wrong costs – the cost differential between Basic Rate piece-rate letters and flats; and (2) he has ignored pound rate revenues.¹⁸ As Crowder explained, if one wants to compare cost coverages (markups) or unit contributions for individual "products," the comparisons should be based on total product revenue and total product variable cost, not on the cost and revenue from one rate element/category. SMC-RT-1 at 30.

Moreover, Crowder explained that, by requiring the most price-sensitive mail within ECR – high-density/saturation flats – to provide the greatest coverage and unit

¹⁸ Most tellingly, Crowder re-ran Mitchell's concept and implementation again but assumed a substantially lower pound rate (55 cents). The resulting disparity in letter-flat cost coverages and unit contributions was reduced, although not eliminated. SMC-RT-1 at 31, fn. 61.

contribution, his proposal would generate enormous bias and economic inefficiency. It would:

- Provide incorrect price signals to mailers, advertisers and private delivery carriers,
- Bias rates for some mailers/competitors in favor of others,
- Increase rates for those portions of the subclass that are lowest cost and at most risk for diversion to private delivery alternatives, and
- Encourage inefficient entry of competitors to the Postal Service.

SMC-RT-1 at 31-32.

Clearly, Mitchell's letter-flat "product" contrivance should be rejected. However, if the Commission were to institute "Product Pricing" within the ECR subclass, it must treat high-density/saturation flats as a separate product within ECR, with a lower-than-subclass-average markup. Alternatively, if the Commission prefers to pass through 100% of unit cost differences to piece-rate differences, then it must reduce the pound rate correspondingly.

Valpak's debunked markup theory has now been thoroughly and exhaustively litigated in two consecutive rate cases. Moreover, certain aspects of Valpak's arguments, such as its insistence on viewing the setting of the letter-flat rate differential and the pound rate as unrelated issues, has persisted since before the start of this century. We urge the Commission to clearly reject Valpak's approach so that the parties, in the next and likely final rate case, can focus their and the Commission's energies on more important issues.

IV. THE ECR HIGH DENSITY-SATURATION RATE DIFFERENTIAL PROPOSED BY THE POSTAL SERVICE IS COST-BASED AND SHOULD BE ADOPTED.

A principal purpose of NAA witness Sidak's direct testimony in this proceeding was to explain why rate differences among ECR density levels should reflect cost differences. He called this approach Efficient Component Pricing (ECP). NAA-T-1 at 6-11. We agree and note that ECP treatment is particularly important in developing rates applying to the saturation advertising market where there is competition (1) between private delivery alternatives and the Postal Service, and (2) among some categories of ECR mail: saturation flats, saturation letters, and high-density flats.¹⁹

NAA witness Ingraham noted the "potentially significant competitive rate advantage [saturation mailers could have] over newspaper Total Market Coverage programs that rely on High-Density mail" if the incorrect USPS-proposed high-density rate is implemented. NAA-T-2 at 2-3. He, however, ignored the significant negative impact on saturation flat mailers if an excessively high saturation on-piece-addressed flat rate (relative to other ECR rates) is implemented. Indeed, the reason why the saturation flat mailers initiated and accepted the DAL surcharge was to thereby eliminate the DAL cost from the flat rate, thus ensuring that the competitive position of on-piece-addressed flat mailers is not hampered because other flat mailers use DALs. SMC-RT-1 at 6-7.

¹⁹ See, e.g., SMC witness Gorman's responses to NAA/SMC-T1-2 –5. He noted that saturation flat mailers, saturation letter mailers, and newspapers/private delivery firms that also use mail for TMC programs are all a part of the saturation advertising market. Response to NAA/SMC-T1-3.

The Postal Service proposed a 2.2-cent piece-rate differential between the ECR high-density and saturation tiers. In its direct testimony, NAA challenged that differential on the grounds that the Postal Service's supporting estimate of high-density unit costs incorrectly "averaged" the delivery costs of high-density and basic-presort mail, thereby overstating high-density costs. Based on deaveraged delivery costs supplied by the Postal Service, Ingraham estimated a cost differential of only 0.8 cents between the high-density and saturation tiers. NAA-T-2 at 21.

By contrast, Ingraham recognized that the saturation unit delivery cost included all DAL costs – Crowder calls this the "averaged" saturation flat cost – even though the flat rate he developed was for flats without DALs. He then passed through 100% of the cost difference between that "averaged" saturation flat cost and the on-piece-addressed high-density flat cost. SMC-RT-1 at 9. As Crowder explained, this approach is inconsistent with the ECP concept espoused by both Sidak and Ingraham:

"The correct approach, consistent with ECP principles, is to base the rate for on-piece-addressed Saturation flats on their costs, excluding the costs for DALs they do not use. This ensures that (1) mailers and their customers make the correct decisions concerning postal usage, (2) mailers that switch from DALs to on-piece addressing are properly rewarded, and (3) competitive relationships are not harmed." SMC-RT-1 at 10.

Crowder in her rebuttal identified the correct on-piece-addressed flat delivery cost (i.e., the flat cost exclusive of the DAL cost) based on (1) the unit delivery cost model in USPS LR L-67, (2) the testimony of both USPS witnesses Kelley and Coombs that they believe all city carrier costs caused by DALs can be saved if all DALs are eliminated and the flats are addressed on piece [USPS-T-44 at 13 (Coombs); and Tr. 12/3515-3516, 3536-37 (Kelley)], and (3) the recent Postal Service statement that it is

committed to implementing a Do Not Deliver procedure so that saturation flat mailers can utilize simplified addressing on rural routes. SMC-RT-1 at 10-12.

Crowder then developed a set of rates to demonstrate the effect of using the correct unit cost for saturation on-piece-addressed flats, recognizing the DAL cost savings, and lowering the pound rate slightly. The piece rate differentials were set at 100% of unit cost differentials, not because she believed that was appropriate but because she wanted to focus on the pound rate which “is exceedingly high and . . . likely causes far more inefficiencies than the imprecision in the piece-rate differences.” SMC-RT-1 at 17, fn. 27. Her rates were designed to meet the ECR/NECR institutional cost contribution requested by the Postal Service, for which purpose she estimated DAL cost savings on the conservative assumption that only 50% of DALs would convert to on-piece-addressing in the test year.²⁰

The resulting rates that Crowder developed, reproduced in the table below, clearly show that:

- (1) The on-piece-addressed saturation flat rate is considerably lower than proposed by the Postal Service;
- (2) At the origin-entry level, the high density-saturation flat cost difference, based on the correct high-density and saturation on-piece-addressed flat unit costs, is 2.2 cents – precisely the rate differential proposed by the Postal Service, and

²⁰ Her rate design also incorporated (1) de-averaged High-Density and Basic-Rate delivery costs; (2) de-averaged High-Density and Saturation mail processing costs; (3) the on-piece-addressed Saturation flat cost; (4) the proposed DAL surcharge, applied to all ECR flats that use DALs; (5) the USPS proposals on automation letters and elimination of letter DDU dropship discounts; (6) retention of the equal Basic-Rate letter and flat piece rates for USPS automation policy reasons; and (7) development of parcel piece rates on the basis of the new information in POIR No. 16, Item 1. SMC-RT-1 at 17-19.

- (3) The saturation letter-flat cost difference declines to 0.7 cents – considerably lower than the Postal Service’s proposed rate differential of 1.0 cents.²¹

Accordingly, NAA’s proposal to reduce the Postal Service’s proposed piece-rate differential between high-density and saturation flats is not cost-based, would bias postal rates against saturation flat mailers and cause inefficient market decisions, and should, therefore, be rejected.

**ECR Rates Using Corrected Saturation Flat On-Piece-Address Cost
And Recognizing DAL Cost Savings**

	Origin Minimum Per Piece	DBMC Minimum Per Piece	DSCF Minimum Per Piece	DDU Minimum Per Piece	Piece Rate for Pound- Rated	Origin Pound Rate	DBMC Pound Rate	DSCF Pound Rate	DDU Pound Rate
LETTERS									
Basic	23.9	21.1	20.5		11.5	60.3	46.7	43.5	
High-Den	17.6	14.8	14.2		5.2	60.3	46.7	43.5	
Saturation	16.7	13.9	13.3		4.3	60.3	46.7	43.5	
						60.3	46.7	43.5	
FLATS						60.3	46.7	43.5	
Basic	23.9	21.1	20.5	19.7	11.5	60.3	46.7	43.5	39.8
High-Den	19.6	16.8	16.2	15.4	7.2	60.3	46.7	43.5	39.8
Saturation	17.4	14.6	14.0	13.2	5.0	60.3	46.7	43.5	39.8
						60.3	46.7	43.5	39.8
PARCELS						60.3	46.7	43.5	39.8
Basic	52.4	49.6	49.0	48.2	40.0	60.3	46.7	43.5	39.8
High-Den	47.8	45.0	44.4	43.6	35.4	60.3	46.7	43.5	39.8
Saturation	26.5	23.7	23.1	22.3	14.1	60.3	46.7	43.5	39.8

SMC-T-1 at 19, Tr. 11737.

²¹ See SMC- LR-1, AC-WP-STDECR.xls, Inputs.

V. HALDI'S ASSERTIONS ON THE IMPACT OF CITY CARRIER CAPACITY CONSTRAINTS AND MITCHELL'S IMPLICATION THAT SATURATION LETTERS ARE SUBSIDIZING SATURATION FLATS ARE SPECIOUS, SELF-SERVING, AND WRONG

In R2005-1, Valpak witness Haldi tried to claim that city carrier capacity to carry out low-cost "sequenced-bundle" mail was constrained and therefore (1) saturation flat delivery cost was too low and (2) saturation letters were deprived of the benefit of the low-cost "sequenced-bundle" treatment. The Commission, in that proceeding disagreed:

"The Commission agrees with witness Bradley that the current cost system is designed to reflect current operating procedures. In addition, evidence suggesting the limited nature of a capacity constraint for handling third bundles has been presented. Therefore, the Commission rejects witness Haldi's proposed alternative for calculating the marginal city carrier costs for saturation ECR in this docket." PRC RD 2005-1 at 140.

In this R2006-1 rate case, Haldi again tried the same argument, claiming that new information concerning low-cost "sequenced bundle" capacity has been uncovered in this case. VP-T-2 at 63. He then reprised his old claim that the city delivery cost of saturation flat mail is too low, implying that carriers are reaching or have reached their capacity to handle "sequenced bundles." And, he complains that saturation letters are being permanently "bumped" up to the plant for DPS processing because the Postal Service wants to reserve its "sequenced bundle" capacity for saturation flats. He implies that saturation letter costs will increase as a result. *Id.* at 56-73.

Based on Haldi's analysis, Mitchell in VP-T-3 then expressed the concern that it is not fair that city carriers principally handle saturation flats as low-cost "sequenced bundle" mail while saturation letters are handled either as DPS or cased mail. He

raised the specter of saturation letters subsidizing saturation flats and asked for redress from the Commission.

Haldi's and Mitchell's testimony on this issue is self-serving, specious, and just plain wrong. Haldi has not uncovered any new information in this case that would suggest a capacity constraint problem. In fact, he has not uncovered any new information at all. Further, he misconstrued the reason for DPSing saturation letters. As explained in detail by Crowder, the Postal Service has sufficient "sequenced bundle" capacity to handle all saturation mail suitable for such handling and, thus, saturation flats will continue to be carried out as "sequenced bundles" as they always have. SMC-RT-1 at 35-38. Crowder also explained that many saturation letters are not suitable for "sequenced bundle" treatment because of their physical characteristics, so the Postal Service has appropriately decided to DPS as many of them as possible. Although there may be some saturation letters that could be handled as "sequenced bundles," it would be extremely inefficient for the Postal Service, at the plant, to try to determine which saturation letters were suitable and which were not; so the most efficient decision is to DPS all of them. The Postal Service decision to DPS saturation letters has nothing to do with city carrier "sequenced bundle" capacity or the presence of saturation flats. *Id.* at 38-39. Most importantly, Crowder demonstrated that, as more saturation letters are DPSed, their average delivery cost should decline from its current level. *Id.* at 40.

Although it is clear that Haldi's arguments on this issue are incorrect, Mitchell's related "fairness" argument is so outlandish that it warrants comment. Indeed, his argument in VP-T-3 contradicts his own test of "fairness" in VP-T-1. In the latter, he explained that if rates for a category of mail exceed their stand-alone costs, then that

mail is being treated unfairly. For saturation flats in particular, he explained his belief that their rates exceed stand-alone costs and, and that saturation flats are, themselves, being treated unfairly (burdened with costs from other mail categories). VP-T-1 at 57-60. Thus, Mitchell's argument in VP-T-1 that saturation (flat) rates may exceed stand-alone saturation (flat) average cost contracts his specious argument in VP-T-3 that saturation letters may subsidize saturation flats.

Separately, Crowder demonstrated that, even assuming the extreme case that absent saturation flats, saturation letters would be shifted from DPS processing so that some may be delivered as "sequenced bundles," saturation flats still cover *all the incremental costs not only of the flats themselves but also all the mail processing and delivery costs of saturation letters*. And even then, they still make a large contribution to institutional cost. SMC-RT-1 at 43. Thus, saturation letters cannot possibly be subsidizing saturation flat rates, nor can saturation letter mailers claim unfair treatment. Indeed, Crowder explained that the large contribution made by saturation flats benefits other mail in the system, including saturation letters. *Id.* at 44.

The Commission should again reject Haldi's "capacity" argument, as well as Mitchell's related "fairness" argument.