

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

**FINAL DIRECT TESTIMONY
OF
DONALD J. O'HARA
ON BEHALF OF
THE UNITED STATES POSTAL SERVICE**

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LIST OF EXHIBITS

- Exhibit USPS-31A: Test Year Before Rates Financial Summary
- Exhibit USPS-31B: Test Year After Rates Financial Summary
- Exhibit USPS-31C: Summary of Revenues – Interim Years
- Exhibit USPS-31D: Summary of Percentage Changes in Rates
- Exhibit USPS-31E: Revenues and Incremental Costs

1 AUTOBIOGRAPHICAL SKETCH
2

3 My name is Donald J. O'Hara. I am currently Manager of Product Redesign in
4 the Pricing and Classification Department, where I previously served as Manager,
5 Classification and Product Development.

6 I have been employed by the Postal Service since 1981. My first position was
7 Principal Economist in the Planning Department, where I produced information and
8 analyses used in the strategic planning process. During this time, I also played a major
9 role in the development and implementation of the Postal Service's Total Factor
10 Productivity (TFP) measurement system. In the 1992 reorganization, I moved to the
11 reclassification project. I have made several appearances in proceedings before the
12 Postal Rate Commission. In Classification Reform I (Docket No. MC95-1), I provided
13 testimony on rates and classifications for First-Class Mail. In Classification Reform II
14 (Docket No. MC96-2), I provided testimony on rates and classifications for Nonprofit
15 Periodicals. In Docket No. R97-1, I provided testimony on the rate levels proposed by
16 the Postal Service. In Docket No. R2000-1, I provided rebuttal testimony on certain
17 issues related to First-Class Mail and Standard Mail, and in Docket No MC2002-1, I
18 testified in support of a proposed Experimental Delivery Confirmation Special Service
19 Category and Fee.

20 I received a Ph.D. in Economics from the University of California at Los Angeles
21 in 1971. From 1970 until 1980 I taught at the University of Rochester, first as an
22 Assistant Professor of Economics (through 1976), and then as an Associate Professor.
23 In 1980-81, I served on the staff of the President's Commission for a National Agenda
24 for the Eighties.

1 I. PURPOSE OF TESTIMONY

2 The fundamental purpose of my testimony is to present the Postal
3 Service's proposed cost coverages (or "rate-levels") for each subclass and
4 special service and explain why these proposals accord with the pricing criteria in
5 the Postal Reorganization Act. 39 USC § 3622(b). My testimony also includes
6 Financial Summary Exhibits demonstrating that the proposed rates will generate
7 a Test-Year net income that is very close to breakeven.

1 II. GUIDE TO TESTIMONY AND SUPPORTING DOCUMENTATION

2 The following tables illustrate the relationship between my testimony and
 3 other testimonies filed in this docket.

4
 5 Witnesses providing inputs to my testimony

| From Witness | Witness Number | Data/Information Provided |
|---------------------|-----------------------------|--|
| Loutsch | USPS-T-6 | <ul style="list-style-type: none"> ▪ Revenue Requirement, Other income and expenses |
| Thress | USPS-T-7 | <ul style="list-style-type: none"> ▪ Volume forecasts |
| Waterbury | USPS-T-10 | <ul style="list-style-type: none"> ▪ Rollforward costs by subclass |
| Pifer | USPS-T-18 | <ul style="list-style-type: none"> ▪ Incremental costs by subclass |
| McCrery | USPS-T-42 | <ul style="list-style-type: none"> ▪ Current and planned TY operating environment |
| Pricing witnesses | USPS-T-32 through USPS-T-41 | <ul style="list-style-type: none"> ▪ Revenues for interim years, TYBR, and TYAR ▪ TYAR volume shifts due to classification changes |

6
 7 Witnesses who use outputs from my testimony

| To Witness | Witness Number | Data/Information Provided |
|-------------------|-----------------------------|---|
| Pricing witnesses | USPS-T-32 through USPS-T-41 | <ul style="list-style-type: none"> ▪ Target cost coverages |
| Loutsch | USPS-T-6 | <ul style="list-style-type: none"> ▪ Revenue |

8
 9 The following Library Reference filed in this docket is associated with my
 10 testimony: USPS LR-L-131 -- Spreadsheets of Witness O'Hara (USPS-T-31).

11
 12

1 III. OVERVIEW

2 As it files this request, the Postal Service finds itself in an unusual
3 position: due to a series of unusual circumstances, postal products and services
4 have not been realigned since 2002. As a result, consideration of many issues
5 affecting pricing and classification has been deferred, perhaps longer than some
6 would like. Despite this, it is hard to characterize the last four years as anything
7 other than a postal success story.

- 8 • Effective operational management has driven more than \$5 billion in
9 costs out of the system, costs that our customers would otherwise have
10 had to pay in increased rates.
- 11 • New products and services, including the Priority Mail flat-rate box,
12 Parcel Return Services, Premium Forwarding Service, and negotiated
13 service agreements, have provided increased value to customers.
- 14 • Improved customer service options, including enhancements to
15 alternative access channels (e.g., Automated Postal Centers, Carrier
16 Pickup), have made it easier to do business with the Postal Service.

17 This case provides the Postal Service an opportunity for a broad-scale re-
18 examination of its products, including the relationship between its product
19 offerings, operational changes and the costs of providing service. For certain
20 customer segments, some of the specific proposals in this filing would result in
21 significant postage increases. However, in this case as in previous cases, the

1 Postal Service's overall objective has been to craft a price and classification
2 proposal that not only addresses concerns about the relationships between cost
3 drivers and prices but that also provides its customers with an increased number
4 of choices allowing them to elect the postal products and services that have the
5 most value in meeting their business needs.

6 Over time, the Postal Service has sought to increase the amount of mail
7 that it handles on automation equipment and has supported this effort through
8 rate design including the development of an extensive worksharing program
9 which encourages the entry of low-cost, automation-compatible mail. As a result,
10 customers who, for example, can prepare mail to automation standards less
11 expensively than the Postal Service could handle that mail receive rate
12 incentives to do so. In this case, we continue the process of developing
13 appropriate price signals by focusing on the effect of shape on postal costs. In
14 re-examining the relationship between costs and prices, it became clear that the
15 current rate structures did not adequately reflect the greater costs of handling a
16 flat or parcel as compared to a letter. Therefore, witness Taufique (USPS-T-32)
17 proposes a new shape-based First-Class Mail classification structure; and
18 witness Kiefer (USPS-T-36) proposes enhancements to the Standard Mail
19 classification structure that incorporate explicit pricing for parcels and pieces that
20 are not flat-machinable. Because the costs of handling a flat, for example, are
21 greater than the costs of handling a letter, customers sending light-weight First-
22 Class Mail flats could face larger than average price increases. I expect this may
23 cause some customers to re-evaluate their choices. In some instances, a

1 customer could pay lower prices by simply folding a mailpiece and reconfiguring
2 it as a letter; in other cases, a customer may determine that the aesthetics of a
3 flat-shaped piece better communicates their message to the recipient. In both
4 cases, the customer can make a choice as to the value of “shape” vs. “postage
5 expense” and, thereby the implicit costs of the Postal Service handling a mail
6 piece that is not letter-shaped.

7 In this case, we are also building on cost signals that have been
8 established in prior dockets. For example, the proposed Periodicals container
9 change encourages movement from high-cost sacks to pallets and further
10 encourages customers to co-mingle and co-palletize multiple Periodicals titles to
11 take advantage of lower postage rates. As a result, many smaller circulation
12 Periodicals including some with high editorial content who take advantage of
13 these opportunities may see only modest price increases. Similarly, the
14 proposed Priority Mail dim-weight price structure developed by witness Scherer,
15 expands on the price signals initially established through the balloon surcharge.
16 Cubic volume as well as weight is an important driver of transportation costs and
17 has not been fully reflected in Priority Mail rates. As a result, customers have not
18 necessarily considered their packaging choices when mailing Priority Mail
19 parcels. By instituting Priority Mail dim-weighting, we provide price signals to
20 customers that will encourage them to consider whether their needs can be met
21 with a smaller box having adequate but not excessive space for protective foam
22 peanuts and/or air pillows.

1 In another area, information from the recent Address Quality study
2 indicates that both mailers and the Postal Service would benefit from earlier and
3 more extensive use of the electronic Address Correction Service as a
4 supplement to NCOA-based move-update products. Mailers can benefit
5 because ACS will provide new addresses for many customers that NCOA does
6 not. (NCOA uses a computerized matching logic that only releases a new
7 address when the name in a mailer's address file is sufficiently close to the name
8 the customer put on his or her Change of Address form.) To encourage greater
9 use of electronic ACS, the Postal Service is proposing a new fee structure for the
10 service, as described by witness Mitchum (USPS-T-40).

11 At the same time, because the new study indicates that a large proportion
12 of mailers in all subclasses are already using move-update processes more
13 frequently than every six months, the Postal Service has determined not to
14 impose new or strengthened move-update requirements at this time.

15 Finally, in this docket, the Postal Service is proposing a "Forever Stamp"
16 that should reduce or eliminate the difficulties and/or inconvenience that some
17 customers encounter in acquiring new-rate postage or "make-up" stamps around
18 the date new postage rates are implemented – difficulties that persist despite the
19 Postal Service's best efforts to publicize each rate increase before its
20 implementation date and to make new-rate stamps available for purchase before
21 they are required. The Forever Stamp would be valid payment for first ounce
22 First-Class Mail postage, regardless of the current rate. Therefore, a customer
23 who purchased a forever stamp could use the stamp (without additional "makeup

1 postage”), on a one-ounce letter at any time following purchase – even if postage
2 rates have increased. Availability of the Forever Stamp will increase the
3 convenience and simplicity of single-piece First-Class Mail because customers
4 will no longer be required to make unscheduled trips to the post office to
5 purchase new rate postage. Additional information is contained in the testimony
6 of witness Taufique (USPS-T-48), filed on July 14, 2006.

1 IV. RATEMAKING CRITERIA

2 A. The Criteria of 39 U.S.C. §.3622(b)

3 The Postal Reorganization Act sets forth, in section 3622(b), the following
4 nine criteria that are to be considered in determining postal rate and fee levels:

- 5
6 1. the establishment and maintenance of a fair and equitable schedule;
7
8 2. the value of the mail service actually provided each class or type of mail
9 service to both the sender and the recipient including, but not limited to the
10 collection, mode of transportation, and priority of delivery;
11
12 3. the requirement that each class of mail bear the direct and indirect postal costs
13 attributed to that class plus that portion of all other costs of the Postal Service
14 reasonably assignable to such class or type;
15
16 4. the effect of rate increases upon the general public, business mail users, and
17 enterprises in the private sector of the economy engaged in the delivery of mail
18 matter other than letters;
19
20 5. the available alternative means of sending and receiving letters and other mail
21 matter at reasonable costs;
22
23 6. the degree of preparation of mail for delivery into the postal system and its
24 effect upon reducing costs to the Postal Service;
25
26 7. simplicity of structure for the entire schedule and simple, identifiable
27 relationships between the rates or fees charged the various classes of mail for
28 the postal services;
29
30 8. the educational, cultural, scientific and informational value to the recipient of
31 mail matter; and
32
33 9. such other factors as the Commission may deem appropriate.

34
35
36 To facilitate reference to these criteria in subsequent discussion, the
37 conventional abbreviated forms of the criteria are often utilized, as shown in the
38 following table:

1

2

PRICING CRITERIA

3

CRITERION NUMBER

ABBREVIATED FORM

4

5

1

FAIRNESS AND EQUITY

6

2

VALUE OF SERVICE

7

3

COST

8

4

EFFECT OF RATE INCREASES

9

5

AVAILABLE ALTERNATIVES

10

6

DEGREE OF PREPARATION

11

7

SIMPLICITY

12

8

ECSI

13

9

OTHER FACTORS

14

15

16

B. Discussion of Criteria

17

18

1. Fairness and Equity

19

Fairness and equity are fundamental objectives of the Postal Service's proposals in this case, and they have been considered throughout its preparation. They form the foundation on which the more specific factors addressed in the other criteria are considered and they provide a basis for arriving at a judgment as to the proper balance among the sometimes conflicting directions indicated by these other criteria.

25

26

2. Value of Service

27

Subsection 3622(b)(2) refers to the value of the mail service actually provided to both the sender and the recipient, specifically mentioning collection, mode of transportation, and priority of delivery. These and other specifically identifiable aspects of the service provided to different classes of mail are often

30

1 referred to as contributing to the intrinsic value of the service provided to a class
2 of mail.

3 Another aspect of value of service is the degree to which usage of the
4 service declines in response to price increases, often referred to as the economic
5 value of service. This is conventionally measured by the own-price elasticity of
6 demand, that is, the percentage decline in usage that results from a one percent
7 increase in price. The lower (in absolute value) the own-price elasticity, the
8 higher the value of service. The price elasticities mentioned in my discussion of
9 individual subclasses are the long-run elasticities provided by Witnesses Thress
10 (USPS-T-7). For convenience they are collected below in Table B-1.

Table B-1. Long-run Own-Price Demand Elasticities

| | | |
|--------------------------------------|--|-------|
| First-Class Letters, Flats & Parcels | | |
| Single-piece | | -0.18 |
| Work-shared | | -0.13 |
| First-Class Cards | | |
| Single-piece | | -0.26 |
| Work-shared | | -0.54 |
| Priority | | |
| Express Mail | | -1.02 |
| Express Mail | | |
| | | -1.65 |
| Periodicals | | |
| Within County | | -0.14 |
| Nonprofit and Classroom | | -0.21 |
| Regular Rate | | -0.29 |
| Standard Mail | | |
| Regular Rate | | |
| Regular | | -0.30 |
| ECR | | -1.08 |
| Nonprofit Rate | | |
| Nonprofit | | -0.31 |
| NECR | | -0.28 |
| Package Services | | |
| Parcel Post | | |
| Non-Destination Entry | | -0.37 |
| Destination Entry | | -1.40 |
| Bound Printed Matter | | -0.49 |
| Media & Library Rate Mail | | -1.20 |

Source: USPS-T-7, Table 1

3. Cost

This criterion requires that the revenues from each class of mail at least equal the costs attributable to that class. For the purpose of determining whether this requirement is satisfied for a given subclass, the Postal Service compares revenue from the subclass to the “incremental cost” of providing service for the entire volume of mail generating the revenue. Equivalently, incremental cost is

1 the cost savings that would result from completely eliminating the subclass
2 (holding volume in other subclasses constant).

3 In general, incremental cost for a given volume of mail will be greater than
4 the corresponding volume-variable cost, and thus this test is more stringent than
5 comparing revenue to volume-variable cost. If a subclass's revenue equals or
6 exceeds its incremental cost, that subclass imposes no burden on other
7 subclasses (i.e., it is not cross-subsided by other subclasses), and the more its
8 revenue exceeds incremental cost, the more it reduces the amount of institutional
9 cost that must be covered by other subclasses.

10

11 4. Effect of Rate Increases

12 This criterion provides for consideration of the effect of rate increases on
13 both mailers and private-sector competitors of the Postal Service. For mailers,
14 the percentage rate increase relative to the overall rate of inflation in the
15 economy and relative to the rate increases for other classes of mail are useful
16 indicators.

17 In developing its proposals in this case, the Postal Service has also
18 considered the effect of its proposed rate increases on competitors, examining
19 them to avoid unfair price competition.

20

21 5. Available Alternatives

22 This criterion considers the availability, at reasonable cost, of alternate
23 means of sending and receiving letters and other mail matter. This includes the

1 availability of similar services from other providers, such as private-sector
2 competition in the expedited and package delivery markets and alternate delivery
3 firms for periodicals and advertising matter. It may also include the availability of
4 other media, such as newspapers, radio, and television, for the delivery of
5 advertising messages, and the various electronic alternatives for First-Class Mail.

6

7 6. Degree of Preparation

8 This criterion addresses the degree to which the mailer has prepared the
9 mail before presenting it to the Postal Service and the effect of this preparation in
10 reducing postal costs. Beginning with Docket R90-1, the Postal Service has
11 introduced a significant number of additional worksharing discounts, so that the
12 degree of preparation by the mailer and its effect on Postal Service costs is now
13 much more directly reflected in the rates paid by mail with differing degrees of
14 preparation. As a consequence, this criterion now plays an important role at the
15 level of rate design within each subclass.

16 It is also worth noting that as the degree of preparation increases over
17 time, all else equal, the coverage required to obtain the same contribution also
18 increases. This is true for the system as a whole as well as for an individual
19 subclass.

20 For example, if total system volume is 100 billion pieces, each with a cost
21 of 10 cents for a total attributable cost of \$10 billion, and institutional costs are \$5
22 billion, a coverage of 150 percent will be required to breakeven. If half of these
23 pieces convert to worksharing, with a cost of six cents per piece, attributable cost

1 will drop by \$2 billion (50 billion pieces x \$0.04 per piece worksharing savings) to
2 \$8 billion, or a 20 percent decline. To obtain the \$5 billion contribution needed to
3 breakeven will then require a coverage of 163 percent ($= (8 + 5) / 8$).

4 Worksharing takes attributable costs out of the system but leaves institutional
5 costs unchanged. Thus, as the overall level of worksharing increases, the
6 percentage of total cost that is attributable can be expected to shrink and the
7 required system-average cost coverage will increase, all else equal.

8 Similarly, to maintain its contribution, the coverage of a subclass with a
9 greater-than-average increase in worksharing will need to increase relative to the
10 system-average coverage. For example, suppose that one subclass in the above
11 example is initially making a contribution of \$500 million above its attributable
12 cost of \$1 billion, or a 150 percent cost coverage (the initial system average).

13 Further suppose that worksharing reduces its attributable costs by a
14 greater-than-average 30 percent, to \$700 million. To maintain its previous \$500
15 million contribution, the cost coverage for the subclass must rise to 171 percent
16 ($= (700 + 500) / 700$), which is above the new system average of 163 percent.
17 Instead, if the subclass coverage was, as before, set equal to the system
18 average, its contribution would fall to \$438 million and other subclasses would be
19 unfairly burdened with additional contribution requirements.

20

21 7. Simplicity

22 This criterion points to the desirability both of simplicity in the rate
23 schedule as a whole and of simple, identifiable relationships between different

1 rates and fees. Over time, with the increased use of computers and software in
2 the preparation of bulk-entered mail, the acceptable degree of complexity in the
3 rate schedules for such mail has increased, and it has been possible to give
4 more detailed recognition to the degree of preparation by the mailer (criterion 6).
5 For these mailers, simplicity may be furthered by moving toward parallel rate
6 structures and preparation requirements across subclasses. For the individual
7 mailer, however, relatively simple rate schedules and understandable
8 relationships between rates remain as important as ever.

9

10 8. ECSI

11 This criterion directs that the educational, cultural, scientific, and
12 informational value to the recipient be considered in setting rates for each type of
13 mail. In the past, the Commission has applied this factor in setting rate levels for
14 First-Class Mail letters, Regular Periodicals, Media and Library Rate Mail, and, to
15 some degree, Bound Printed Matter. The Postal Service's rate-level proposals
16 conform to this practice.

17

18 9. Other Factors

19 Finally, in addition to the eight specific criteria discussed above, the Act
20 provides for the consideration of any other factors deemed appropriate by the
21 Commission in setting rate levels.

22

23

1 C. Preferred Rates

2 For those subclasses that have been determined to merit reduced rates
3 relative to those for similar mail in the same or a related subclass, § 3626
4 specifies the formulas that are to be applied.

5 In Periodicals, the Within County subclass receives preferential rate
6 treatment through a requirement that the markup for Within County Periodicals
7 be one-half the markup for the Outside County subclass.^{1*}

8 Within the Outside County subclass, postage for qualified Nonprofit and
9 Classroom mail pieces is discounted five percent. However, this discount does
10 not apply to postage for advertising pounds.

11 For Standard Mail, nonprofit rates are to be set so that the estimated
12 average revenue per piece for each nonprofit subclass is equal, as nearly as
13 practicable, to 60 percent of the estimated average revenue per piece of the
14 corresponding commercial subclass.

15 Within the Media and Library Rate subclass, Library rates are required to
16 be set, as nearly as practicable, five percent lower than the corresponding Media
17 Mail rates.

18

19

20

¹ For this purpose, the Outside County markup is calculated before applying the five percent rate reduction for Nonprofit Periodicals and Classroom Periodicals described in the next paragraph.

1 V. RATE LEVELS MAIL CLASSES AND SPECIAL SERVICES

2 In the following subsections, I discuss how I have applied the nine criteria
3 to develop rate level proposals for the subclasses governed by § 3622. For the
4 preferred-rate subclasses, the pricing witnesses have applied the § 3626 rules
5 summarized just above and the resulting cost coverages and average rate
6 increases are simply mentioned below in the appropriate subsection of my
7 testimony below.

8

9 A. First-Class Mail

10 1. Letters and Sealed Parcels Subclass

11 The Postal Service is proposing a cost coverage of 229 percent for the
12 First-Class Mail letters subclass. Consistent with that proposal, the rate for
13 single-piece, one-ounce, letter-shaped pieces would rise from 39 cents to 42
14 cents, an increase of 7.7 percent. For the subclass as a whole, the proposed
15 average increase is somewhat less at 7.1 percent, due to reductions in the
16 additional-ounce rate. This is well below the 8.5 percent system average
17 increase proposed for this case, and it is the smallest increase for any subclass.
18 The average increases for First-Class Mail are 8.2 percent for single-piece and
19 5.9 percent for workshare, reflecting the greater proportion of flats and parcels in
20 single-piece.

21 Value of service (criterion 2) for First-Class Mail letters is high in terms of
22 both intrinsic and economic measures. It benefits from the extensive collection
23 system, which is designed primarily for First-Class Mail, it travels by air when the

1 distance between sender and recipient warrants it, and it receives a high priority
2 of delivery. It is sealed against inspection and is forwarded (or returned to
3 sender) without additional charge.

4 First-Class Mail letters exhibit relatively low price elasticities of demand (-
5 0.18 for single-piece and -0.13 for workshare), indicating a high economic value
6 of service. However, it must be acknowledged that this elasticity may be due in
7 part to the Private Express Statutes.

8 The effect of the proposed rate increase (criterion 4) is certainly modest
9 for those whose mail-pieces are primarily letter-shaped and/or flats weighing
10 more than six ounces. For parcel mailers, the proposed rate structure entails
11 large increases, especially for lightweight parcels, but this is a necessary
12 consequence of recognizing that costs depend more on shape than on weight in
13 the current mail-processing environment. The new rate structure also provides a
14 20-cent reward for mailers of lightweight flats (say, up to 3 ounces) who convert
15 them to letter-shape. Under the current structure, a single-piece mailer can save
16 13 cents by converting a one-ounce flat to a letter, but above one ounce there is
17 no reward at all -- the rates for letters, flats and parcels are identical.

18 For many mailers, the available alternatives (criterion 5) to First-Class Mail
19 letters are quite limited. In addition to the restrictions imposed by the Private
20 Express Statutes, considerations of cost and accessibility mean that many
21 mailers have few practical hard-copy alternatives to the use of First-Class Mail
22 letters for transmitting correspondence, bills, and bill payments. Nevertheless,
23 the availability of alternatives to First-Class Mail letters is clearly expanding, with

1 growth in the number of businesses and households with access to the internet,
2 and with the increasing availability of electronic payment options.

3 The degree of preparation by the mailer and its effect on reducing Postal
4 Service costs (criterion 6) is reflected in the rate structure, which provides an
5 array of discounts for mail that is prebarcoded and presorted.

6 For some time, the Commission has recognized the informational value of
7 the business and personal correspondence that constitutes a large part of First-
8 Class Mail letters (criterion 8) and the Postal Service proposal maintains this
9 recognition.

10 At projected test-year after-rates volumes, First-Class Mail Letters
11 revenue is \$35,871 million and estimated incremental cost is \$16,907 million, so
12 that revenue clearly exceeds incremental cost (criterion 3).

13 The proposed rate level is fair and equitable (criterion 1); it reflects a
14 careful consideration of the § 3622(b) criteria.

15

16 2. Cards

17 The Postal Service is proposing a cost coverage of 176 percent for First-
18 Class Mail cards, lower than that for First-Class Mail letters. This corresponds to
19 an average rate increase of 10.6 percent for the subclass as a whole; the
20 increase is 12.0 percent for single piece cards and 9.3 percent for workshare
21 cards.

22 Both the intrinsic value of service and the economic value of service
23 (criterion 2) are somewhat lower for First-Class Mail cards than for letters.

1 Although many of the factors considered in evaluating intrinsic value of service
2 are identical for First-Class Mail letters and cards, the overall intrinsic value is
3 somewhat less for cards due to their limited message capacity and lesser degree
4 of privacy. The own-price elasticities for cards are -0.26 for single-piece and -
5 0.54 for workshare. These are higher (in absolute value) than the corresponding
6 elasticities for letters, implying that cards also display a lower economic value of
7 service than letters.

8 The availability of alternatives for First-Class Mail cards is somewhat
9 broader than for First-Class Mail letters (criterion 5). In addition to the electronic
10 alternatives mentioned in the discussion of letters, First-Class letters can be used
11 for personal messages and Standard Mail can be used for brief message, sale
12 announcements and other advertising, which are a more significant portion of
13 volume in cards than in letters.

14 The automation and non-automation presort rate structure for First-Class
15 Mail cards parallels that for First-Class Mail letters, so that considerations of
16 mailer preparation (criterion 6) and simplicity (criterion 7) are also parallel.

17 At projected test-year after-rates volumes, the projected revenue of
18 \$1,372 million for First-Class Mail cards exceeds its estimated incremental cost
19 of \$783 million (criterion 3).

20 The proposed rate level reflects a balanced consideration of all the
21 relevant criteria: it is fair and equitable (criterion 1).

22

23 B. Priority Mail

1 The Postal Service is proposing a cost coverage of 163 percent for Priority
2 Mail; this corresponds to an average rate increase of 13.6 percent. This is well
3 above the system average, but it reflects the above-average growth of Priority
4 Mail's unit cost.

5 Priority Mail clearly has a high intrinsic value of service (criterion 2). It
6 enjoys a higher priority in processing and dispatch than First-Class Mail letters,
7 and receives even greater use of air transportation, consistent with the two-day
8 Priority Mail service standard applicable to many metropolitan area origin-
9 destination pairs. Also contributing to Priority Mail's intrinsic value of service is
10 the availability of Delivery Confirmation Service on pieces of all shapes (in First-
11 Class Mail, Delivery Confirmation Service is only available for parcels).

12 On the other hand, Priority Mail enjoys the convenience of the collection
13 system only for pieces weighing no more than one pound if stamps are used for
14 postage payment. More important, the economic value of-service for Priority Mail
15 is much lower than that for First-Class Mail letters, as indicated by its much
16 greater response to price changes. It has a price elasticity of -1.02, much higher
17 (in absolute value) than the First-Class Mail letters elasticities for single-piece (-
18 0.18) and workshare (-0.13).

19 A 13.6 percent increase will necessarily have an adverse effect on Priority
20 Mail users (criterion 4), but (criterion 5) competitive alternatives are obviously
21 available to business users. And, for the general public, access to these
22 alternatives has become increasingly convenient in recent years (e.g., UPS
23 Stores and FedEx/Kinko's centers).

1 With respect to the effect on private sector enterprises engaged in the
2 delivery of mail matter other than letters (the other portion of criterion 4), the
3 significant rate increase, together with the significant difference between revenue
4 and incremental cost, means that the rate increase is not unfair to competitors.

5 The Priority Mail rate structure has long been relatively simple (criterion 7).
6 It currently has an unzoned rate for pieces weighing up to one pound, together
7 with a flat rate envelope and a flat-rate box; together these are expected to
8 account for almost half of its TYAR volume. Other pieces currently have an
9 understandable weight- and distance-based structure.

10 As discussed by witness Scherer (USPS-T-33), the Postal Service in this
11 case is proposing to introduce dim-weight pricing as a supplement to the current
12 weight-distance structure. This has become a standard industry practice for
13 packages traveling by air, where a weight-distance rate schedule does not
14 adequately reflect the costs of transporting bulky but lightweight packages.
15 Although this will make the rate structure somewhat more complicated for certain
16 users, without it the Postal Service will continue to attract a disproportionate
17 share of the bulky, lightweight packages, tending to push up rates for mailers of
18 packages that have a weight per cubic foot that is closer to average. The Postal
19 Service proposal applies only to Zones 5 through 8, where air transportation is
20 widely used, and is further restricted to packages exceeding one cubic foot, while
21 the industry generally applies dim-weight pricing to smaller packages as well.
22 With these restrictions, dim-weight factors will affect postage charges for only
23 about 2 percent of Priority Mail pieces.

1 At projected test-year after-rates volumes, Priority Mail revenue is \$5,189
2 million and estimated incremental cost is \$3,434 million, so that revenue is
3 comfortably above incremental cost (criterion 3).

4 The proposed rate level is appropriate in the light of all relevant criteria; it
5 is fair and equitable (criterion 1) to both mailers and competitors.

6

7 C. Express Mail

8 The Postal Service is proposing an Express Mail cost coverage of 191
9 percent, which corresponds to an average rate increase of 12.5 percent, well
10 above the system average.

11 Express Mail's value of service (criterion 2) is very high when intrinsic
12 factors are considered. It receives the highest delivery priority, extensive air
13 transportation, and a significant collection system, though not as extensive as the
14 general collection system used by First-Class Mail. It also benefits from a
15 tracking capability. On the other hand, Express Mail's price-elasticity, at -1.65,
16 the highest (in absolute value) of any subclass, which indicates an extremely low
17 economic value of service.

18 The 12.5 percent increase will clearly have an effect on its users (criterion
19 4) but is necessary to recognize the growth in its unit cost. Given Express Mail's
20 small market share, the proposed rate increase should not have an unfair effect
21 on competitors.

22 There are a number of private sector alternatives available to Express Mail
23 users (criterion 5). However, for the individuals and small-volume business users

1 that now appear to account for the bulk of Express Mail, these alternatives may
2 only be available at a higher price, though perhaps also with additional service
3 features.

4 For Express Mail, the deposit and/or pick-up of mail at the post office, as
5 provided for in a separate rate schedule, reduces postal costs and constitutes a
6 limited form of preparation by the mailer (criterion 6).

7 At projected test-year after-rates volumes, revenue is \$796 million and
8 estimated incremental cost is \$526 million, so that revenue exceeds incremental
9 cost by \$270 million (criterion 3).

10 The proposed rate level is fair and equitable (criterion 1), reflecting a
11 consideration of all the relevant criteria, including the effects on both competitors
12 and Express Mail users.

13

14 D. Periodicals

15 1. Outside-County

16 The Postal Service is proposing a cost coverage of 106 percent for
17 Outside County Periodicals, which corresponds to an average rate increase of
18 11.7 percent for the subclass. As noted in my Section IV.C, qualified Nonprofit
19 and Classroom mail pieces receive a discount of five percent from the rates paid
20 by Regular Periodicals (except for advertising pound rates). The above cost
21 coverage and rate increase figures have been calculated after applying this
22 discount.

1 The value of service (criterion 2) received by Periodicals is moderately
2 high in terms of intrinsic service characteristics, although not as high as First-
3 Class Mail, since they receive little or no air transportation, do not have a
4 collection system, and receive forwarding at no additional charge for only 60
5 days while First-Class is forwarded for a full year. Periodicals have a higher
6 priority of delivery than Standard Mail. The own-price elasticities for Outside-
7 County Periodicals are somewhat higher (-0.29 for Regular and -0.21 for
8 Nonprofit and Classroom) than for First-Class Mail letters (-0.18 & -0.13),
9 indicating a somewhat lower economic value of service.

10 The educational, cultural, scientific, and informational value (criterion 8) of
11 Periodicals has historically led to relatively low cost coverages for this mail. For
12 the past several cases, however, the proposed coverage has been lower than
13 the historical average to mitigate the effect of already-large rates increases
14 driven by large increases in cost (criterion 4).

15 Non-postal alternatives (criterion 5) include alternate delivery firms and
16 newsstand sales, but the degree to which different publications can utilize these
17 alternatives varies considerably.

18 The Periodicals rate structure is far from simple. It reflects the a variety of
19 goals including the recognition of the value of editorial content,, the de-emphasis
20 of the effect of distance on that portion of the rate structure, along with a whole
21 array of presort, automation and other distance based charges. However, the
22 Postal Service believes that its new container rate will simplify the existing rate

1 structure to some degree and eliminate the more complex requirements
2 associated with the ongoing co-palletization discounts

3 Outside County revenue at projected test-year after-rates volumes is
4 \$2,394 million, which exceeds the estimated incremental cost of \$2,290 million
5 by a margin of \$105 million (criterion 3).²

6 The proposed rate level is fair and equitable (criterion 1); it has been
7 developed after a careful consideration of all the criteria.

8

9 2. Within-County

10 The mark-up for Within County Periodicals is required to be set at one-half
11 of the Outside-County mark-up, calculated before the 5 percent Nonprofit and
12 Classroom discount is applied. That coverage is approximately 107 percent,
13 leading to a Within-County cost coverage of 103.5 percent, which corresponds to
14 an average rate increase of 24.4 percent. This is quite high, but the mark-up
15 formula leaves no room for mitigation. It might be noted, however, that in R2005-
16 1 the same mark-up formula result in a rate decrease of 2.3 percent for Within-
17 County Periodicals while rates for other mailers were increased 5.4 percent.
18 Within-County revenue is \$82.4 million, above its incremental cost of \$79.6
19 million.

20

21

2 As explained in the footnote to Exhibit USPS-T31E-Revised, the revised distribution of air transportation savings should reduce the Periodicals incremental cost shown above by about \$12 million.

1 E. Standard Mail

2 1. Regular and Nonprofit

3 The Postal Service is proposing a cost coverage of 176 percent for the
4 Regular subclass (including Nonprofit), which corresponds to an average rate
5 increase of 9.6 percent.

6 Standard Regular has a relatively low intrinsic value of service (criterion 2)
7 due to its lack of access to a collection system, reliance on ground transportation,
8 and its potential deferability for delivery. Mailers can request delivery within a
9 specific several-day window, and the Postal Service attempts satisfy such
10 requests if they can be achieved without adversely affecting mail with a higher
11 priority for delivery. To improve their odds, mailers making such requests
12 typically inform the Postal Service in advance about the mailing, and plan the day
13 and place(s) of entry to make it as easy as they can for the Postal Service to
14 deliver within their requested window. It is worth noting that some Standard
15 Regular (particularly, automation letters) is sorted simultaneously with First-Class
16 Mail at the destination plant and, at this point, loses its deferrable character.

17 The price elasticities for Standard Regular and Nonprofit are both about
18 -0.3. This is higher in absolute value than those of First-Class Mail letters (both
19 single-piece and presorted are below 0.2 in absolute value) but lower than all of
20 the subclasses in Package Services, suggesting an intermediate economic value
21 of service.

22 The 9.6 percent rate increase is slightly above the overall average of 8.5
23 percent, and its impact on the users of Regular mail should be acceptable

1 (criterion 4). The slightly above-average increase, together with the 176 percent
2 cost coverage, indicates that competitors are not unfairly targeted by this
3 increase.

4 The Standard Regular subclass is somewhat more suited to demographic
5 targeting of advertisements and solicitations while the Enhanced Carrier Route
6 subclass is somewhat more suited to geographic targeting. For this reason, the
7 availability of alternatives (criterion 5) is somewhat less for Regular, but a
8 number of alternatives for demographically targeted messages do exist – a given
9 target demographic can often be reached, though perhaps at higher cost, via
10 magazines, internet web sites, and cable television channels targeting the same
11 demographic group.

12 The mail within the Standard Regular subclass all has a substantial
13 degree of mailer preparation (criterion 6), with some of it being both prebarcoded
14 and sorted to 5-Digit areas. Overall, however, it does not have the same degree
15 of preparation as Enhanced Carrier Route.

16 At projected test-year after-rates volumes, the \$17,364 million revenue
17 from the subclass easily exceeds its estimated incremental cost of \$10,186
18 million (criterion 3).

19 The proposed rate level is fair and equitable (criterion 1); it appropriately
20 balances all the relevant criteria, including the effects on both users and
21 competitors.

22

23

1 2. Enhanced Carrier Route (ECR) and Nonprofit ECR

2 The Postal Service is proposing a cost coverage of 214 percent for the
3 Enhanced Carrier Route subclass, which results in a rate increase of 8.9 percent,
4 just above the overall average of 8.5 percent.

5 In common with Standard Regular, the intrinsic value of service for
6 Standard ECR is relatively low (criterion 2), since it lacks access to the collection
7 system, receives ground transportation, and its delivery may be deferred. Where
8 the Postal Service is able to accommodate mailer requests for delivery within
9 specific and sometimes relatively tight time frames, this again often requires
10 mailer preparation, coordination, and planning. For the high-density and
11 saturation rate categories, this may also be facilitated by the regularity with which
12 many of these mailings are deposited. The price-elasticity of commercial
13 Enhanced Carrier Route is about -1.1, much higher than those of Standard
14 Regular, First-Class Mail Letters and Cards, or Periodicals, indicating a rather
15 low economic value of service. The elasticity for Nonprofit ECR is about -0.3, but
16 since commercial ECR makes up about 83 percent of total ECR volume, the
17 commercial elasticity provides a good indicator of economic value of service for
18 the subclass as a whole.

19 At 8.9 percent, the rate increase for ECR is very close to the overall
20 average, and the impact on ECR mailers should be acceptable (criterion 4).
21 Given the near-average rate increase and a cost coverage that exceeds 200
22 percent, this rate increase does not result in unfair competition for private sector

1 enterprises engaged in the delivery of geographically targeted advertisements
2 and solicitations.

3 The availability of alternatives (criterion 5) for users of ECR mail is
4 relatively high. Due to its geographic concentration, both alternate delivery firms
5 and newspaper inserts may provide alternative ways of delivering the same
6 advertising messages.

7 ECR mail has a very high degree of preparation by the mailer (criterion 6);
8 even the basic rate category must be line-of-travel sequenced, and the high-
9 density and saturation categories are walk-sequenced.

10 At projected test-year after-rates volumes, ECR revenue is \$5,956 million
11 and estimated incremental cost is \$2,862 million, so that revenue exceeds
12 incremental cost by a wide margin (criterion 3).

13 While most of the criteria considered above might appear to indicate a
14 cost coverage lower than that actually proposed, recall the discussion in Section
15 I.C.6 of the relationship between degree of mailer preparation and cost coverage.
16 As mailer preparation increases, it reduces volume-variable costs but has no
17 effect on institutional costs. Rates for otherwise similar mail (shape, delivery
18 priority, type of transportation, etc.) can and should reflect to some degree the
19 cost differences due to different degrees of mailer preparation. At the same time,
20 it is important to retain a reasonable contribution per piece for ECR.

21 With that background, I would note that at proposed rates, contribution per
22 piece is about the same in ECR and Standard Regular (both round to 10.0 cents)
23 despite the different cost coverages (214% and 177%).

1 After considering all the criteria, I conclude that the rate level proposed for
2 ECR represents an appropriate balance among them and satisfies the fairness
3 and equity criterion.

4

5 F. Package Services

6 1. Parcel Post

7 The Postal Service is proposing a Parcel Post cost coverage of 115
8 percent, which corresponds to an average rate increase of 13.2 percent for the
9 subclass.

10 In general, Parcel Post exhibits a low intrinsic value of service (criterion 2);
11 it has a low delivery priority and uses primarily ground transportation. Due to
12 security concerns, it has only limited access to the collection system. Moreover,
13 the own-price elasticity is about -1.1 for the subclass as a whole, indicating a low
14 economic value of service. However, elasticities for the two components of the
15 subclass are not at all close to one another. For the Destination Entry portion of
16 the subclass the elasticity is -1.4; for the remainder of the subclass (primarily
17 Retail) the elasticity is only -0.4.

18 The proposed 13.2 percent average rate increase is well above average,
19 and will undoubtedly have some adverse effect on current mailers of Parcel Post
20 (criterion 4). However, an increase of this magnitude is necessary to reflect
21 increases in the cost of providing Parcel Post services. Private sector
22 enterprises engaged in package delivery have been able to compete successfully

1 at current Parcel Post rates, and increasing current rates by an average of 13.2
2 percent should not adversely affect their competitive position.

3 In one sense, alternatives to Parcel Post are plentiful, especially for large-
4 volume business shippers. For individuals, these alternatives are not uniformly
5 accessible, although in recent years the country's two largest package shippers,
6 UPS and FedEx, have greatly expanded access for individual shippers via UPS
7 Stores and FedEx/Kinko's centers. For individuals in small towns and rural
8 areas, however, practical alternatives to Parcel Post may be expensive and
9 rather inconvenient.

10 At projected test-year after-rates volumes, revenue is \$1,447 million and
11 estimated incremental cost is \$1,273 million, so that revenue is almost \$175
12 million above incremental cost (criterion 3).

13 The proposed rate level is fair and equitable (criterion 1); it reflects a
14 balanced consideration of the relevant criteria and takes into consideration the
15 interests of the diverse users of Parcel Post and its competitors.

16

17 2. Bound Printed Matter

18 The Postal Service is proposing a cost coverage of 125 percent for
19 Bound Printed Matter (BPM); this results in an average rate increase of 11.9
20 percent.

21 In common with Parcel Post, the intrinsic value of service for Bound
22 Printed Matter is relatively low (criterion 2). On the other hand, its own-price
23 elasticity is about -0.5, larger (in absolute value) than all the Standard Mail

1 elasticities other the commercial ECR, suggesting a low to moderate economic
2 value of service.

3 The 11.9 percent increase proposed for BPM is above the system-
4 average of 8.5 percent, and will unavoidably have some adverse effect on the
5 users of BPM (criterion 4). At the same time, this increase, together with the 125
6 percent cost coverage, indicates that actual and potential competitors are not
7 unfairly targeted.

8 The alternatives available to BPM mailers (criterion 5) depend on what is
9 being mailed. For mailers of books, the Media Mail subclass provides an
10 alternative. For mailers of heavy catalogs and telephone directories, alternate
11 delivery firms provide all least a potential alternative, although there do not
12 appear to be widespread efforts by such firms to develop service offerings
13 targeted at this portion of BPM.

14 Over a period of years, an increasing number of books have been mailed
15 as BPM. The Commission accordingly has given the subclass some ECSI
16 consideration in setting rate levels, and the Postal Service proposal maintains
17 that practice (criterion 8).

18 At projected test-year after-rates volumes, BPM revenue is \$790 million
19 and estimated incremental cost is \$637 million; revenue is well above
20 incremental cost (criterion 3).

21 The proposed rate level is fair and equitable (criterion 1); it reflects an
22 appropriate balance among all the criteria of Section 3622(b).

23

1 3. Media and Library Rate Mail

2 The Postal Service is proposing a cost coverage of 109 percent for the
3 subclass; this translates into average rate increases of 18 percent for Media Mail
4 and 18.4 percent for Library Rate. In common with other Package Services
5 subclasses, the intrinsic value of service for Media and Library Rate mail is
6 relatively low (criterion 2). Its price elasticity is -1.2, higher in absolute value than
7 commercial ECR's -1.1, suggesting that its economic value of service is also
8 rather low.

9 The 18 percent increases will clearly have some adverse effect on current
10 users of Media and Library Rate mail (criterion 4), but the rate increases reflect
11 cost increases and the revenue they generate provides only a small margin
12 above costs. For many business users of the Media Mail, Bound Printed Matter
13 provides an alternative (criterion 5). For many individual users, however,
14 alternatives are more limited and their prices are likely to exceed even those
15 proposed for Media and Library Rate Mail.

16 The books, films, sound recordings, and similar matter mailed in the Media
17 and Library Rate subclass have a significant ECSI value (criterion 8) which has
18 long been considered in determining its cost coverage. The Postal Service
19 proposal in this case maintains that consideration.

20 At projected test-year after-rates volumes, estimated incremental cost is
21 \$389 million and revenue is \$422 million, so that revenue exceeds incremental
22 cost by \$33 million (criterion 3).

1 The proposed rate level reflects a careful consideration of all the criteria; it
2 is fair and equitable (criterion 1).

3

4 G. Special Services

5 Exhibit USPS-31B summarizes the Postal Service's proposed fee levels for the
6 various Special Services. The detailed development of these fee levels is
7 described in USPS-T-39 (witness Berkeley), USPS-T-40 (witness Mitchum), and
8 USPS-T-41 (witness Kaneer). I have reviewed these testimonies and the
9 proposed fee levels, and I conclude that they are consistent with the Section
10 3622(b) criteria.

11

12