

**BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON, DC 20268-0001**

---

**POSTAL RATE AND FEE CHANGES, 2006**

---

:  
: Docket No. R2006-1  
:

**REBUTTAL TESTIMONY  
OF  
ANTOINETTE CROWDER  
ON BEHALF OF  
THE SATURATION MAILERS COALITION AND ADVO, INC.**

**Communications with respect to this document should be sent to:**

**John M. Burzio  
Thomas W. McLaughlin  
Burzio & McLaughlin  
1054 31<sup>st</sup> Street, N.W., Suite 540  
(202) 965-4555; Fax (202) 965-4432  
burziomclaughlin @covad.net**

**Counsel for the Saturation  
Mailers Coalition and ADVO, Inc.**

**November 20, 2006**

**TABLE OF CONTENTS**

**PURPOSE AND SUMMARY OF TESTIMONY ..... 1**

**I. THE NAA AND VALPAK RATE DESIGNS ARE FLAWED .....5**

A. ECP Principles Should Be Used To Develop The On-Piece-Addressed Flat Rate And The Pound Rate..... 6

B. The Correct Cost for Saturation On-Piece-Addressed Flats And The DAL Cost Savings Should Be Used To Set Rates ..... 8

(1) The “Averaged” Saturation Flat Unit Cost Used By Ingraham And Mitchell Is The Wrong Basis For The On-Piece-Addressed Saturation Flat Rate..... 9

(2) The Correct Unit Cost For Saturation On-Piece-Addressed Flats And Cost Savings From DAL Elimination..... 10

C. All ECR Flats Using DALs Should Also Pay The DAL Surcharge..... 13

D. The ECR Pound Rates Proposed By Dr. Ingraham And Mr. Mitchell Are Excessive ..... 14

E. ECR Rates Based On The Correct Saturation On-Piece Addressed Flat Cost And ECP Principles ..... 17

**II. VP WITNESS MITCHELL’S PRODUCT PRICING CONCEPT IS NOT EFFICIENT RATEMAKING .....20**

A. Correct Measures of Efficient Pricing Refute Mr. Mitchell’s Claim Of Discriminatory Rates..... 22

(1) Correct Efficiency Measures ..... 22

(2) Mr. Mitchell’s Rate Discrimination Claim Is Wrong ..... 23

B. Mr. Mitchell’s Letter And Flat “Products” Are Not Based On Real-World Market And Demand Conditions..... 25

(1) Mr. Mitchell’s Letter and Flat “Products” Are Constructed To Fit His Purpose ..... 25

(2) Mr. Mitchell Ignores Real-World ECR Letter And Flat Market And Demand Information ..... 26

(3) High-Density/Saturation Flats Warrant Separate Product (Subclass) Treatment ..... 28

C. Mr. Mitchell’s “Product Pricing” Concept Will Not Improve Rate Efficiency ..... 29

## TABLE OF CONTENTS

(1) Correct “Product” Cost And Revenue Comparison .....	30
(2) Comparison To The Correct Efficiency Benchmark .....	30
<b>III. VP WITNESS HALDI’S ASSERTIONS ON THE IMPACT OF CITY CARRIER CAPACITY CONSTRAINTS ARE UNREALISTIC .....</b>	<b>33</b>
A. The “Sequenced Bundle” Capacity Limitations .....	34
B. Dr. Haldi’s Marginal Flat Delivery Cost Concern Is Exaggerated.....	35
(1) USPS Techniques To Expand “Sequenced Bundle” Capacity....	36
(2) Evidence Of Capacity To Handle Extra Bundles.....	37
C. DPSing Of Saturation Letters Is Not Caused By Saturation Flats.....	38
(1) Saturation Letters Are Not Suitable For “Sequenced Bundle” Treatment On Many Delivery Sections .....	38
(2) Saturation Letters Will Benefit From Increased DPSing .....	39
<b>IV. VP WITNESS MITCHELL’S IMPLICATION THAT SATURATION LETTERS ARE SUBSIDIZING SATURATION FLATS IS SPECIOUS, SELF-SERVING, AND WRONG.....</b>	<b>41</b>
A. Saturation Letters Are Not Subsidizing Saturation Flats .....	43
B. Mr. Mitchell’s Own Stand-Alone Cost Arguments Imply That Saturation Flats Are Burdened by Mail From Other Rate Categories .	44
<b>AUTOBIOGRAPHICAL SKETCH .....</b>	<b>46</b>

1 **PURPOSE AND SUMMARY OF TESTIMONY**

2 The purpose of my testimony is to address the serious deficiencies and  
3 inaccuracies in:

- 4 ▪ The ECR rate design proposals of Valpak (VP) witness Robert Mitchell  
5 (VP-T-1) and Newspaper Association of America (NAA) witness Allan  
6 Ingraham (NAA-T-2), and  
7
- 8 ▪ The ECR costing comments and proposals of VP witnesses John Haldi  
9 (VP-T-2) and Robert Mitchell (VP-T-3).

10  
11 With respect to ECR rate design, I also show corrections that would yield a more  
12 efficient and competitively unbiased set of ECR rates.

13 Mr. Mitchell and Dr. Ingraham propose ECR rate designs that include the  
14 USPS proposed DAL surcharge. However, they both incorrectly develop the piece  
15 rate for on-piece-addressed Saturation flats that do not use DALs, resulting in a rate  
16 that is too high relative to all other ECR piece rates. They also propose an ECR  
17 pound rate that is excessive relative to their proposed piece rates. Both of their rate  
18 designs have a severe bias against Saturation flat mailers.

19 Mr. Mitchell also advocates a "Product Pricing" concept with contrived,  
20 unrealistic assumptions that, if implemented, would substantially increase the ECR  
21 High-Density/Saturation letter-flat piece rate differential. His proposal would  
22 artificially reduce letter rates by shifting a greater portion of the subclass revenue  
23 burden to flats and pound-rated mail that are already greatly overcharged in relation  
24 to weight-related costs.

25 Finally, Dr. Haldi and Mr. Mitchell absurdly imply that Saturation letters are  
26 subsidizing delivery costs for Saturation flats. They are wrong.

1 All three witnesses advocate cost and rate treatments that increase rates for  
2 Saturation flat mailers. Unsurprisingly, they represent rival mailers that compete in  
3 the saturation delivery market against Saturation flat mailers. By contrast, the  
4 Postal Service has offered ECR rates that are reasonably balanced among the  
5 competing mailer claimants. The Commission should recognize the extent of  
6 competition that the entire saturation market of letters and flats faces and adopt ECR  
7 rates that preserve and foster competition.

8 In Section I of my testimony, I present a conservative estimate of cost savings  
9 from DAL conversion and the correct unit cost for on-piece addressed saturation.  
10 Using that information and relying on principles of Efficient Component Pricing, I  
11 develop an alternative set of ECR rates that demonstrates:

- 12       ▪ The on-piece-addressed Saturation flat piece-rate should be much lower  
13       than proposed by the USPS.
- 14       ▪ The piece-rate differential between Saturation letters and flats should be  
15       less than proposed by the USPS, not greater as proposed by Mr. Mitchell.
- 16       ▪ The piece-rate difference between Saturation and High-Density flats  
17       should be about the same as the USPS has already proposed and greater  
18       than advocated by Dr. Ingraham.
- 19       ▪ The ECR pound rate should be lower than proposed by either Mr. Mitchell  
20       or Dr. Ingraham.
- 21       ▪
- 22       ▪
- 23       ▪
- 24       ▪

25 Adoption of these elements would lead to a more efficient and competitively  
26 unbiased set of ECR rates.

27 I would emphasize that the Saturation Mail Coalition (SMC) and ADVO, Inc.  
28 (ADVO) support the ECR rates proposed by the Postal Service. That is not because  
29 the proposed rates are optimum. To the contrary, I agree with Mr. Mitchell and  
30 MOAA witness Prescott (MOAA-T-1) that the ECR cost coverage is too high and

1 needs to be mitigated over time. I further believe that other changes, such as  
2 narrowing the Saturation letter-flat piece-rate differential and reducing the pound  
3 rate, would be justified as shown in my rebuttal analysis. For the time being,  
4 however, the SMC and ADVO are willing to accept these rates – including the DAL  
5 surcharge which by itself has huge implications for Saturation flat mailers – as being  
6 balanced among competing interests. Further, the SMC has the hopeful expectation  
7 that the Postal Service will meet the industry halfway by allowing a “simplified but  
8 certified” addressing alternative on city delivery routes as described by SMC witness  
9 Gorman. This will enable maximum conversion of DALs and result in greater USPS  
10 cost savings than currently foreseen while minimizing the rate impact on Saturation  
11 flat mailers.

12           However, to the extent the Commission considers departures from the USPS-  
13 proposed ECR rates, it should avoid the severe rate distortions proposed by Mr.  
14 Mitchell, Dr. Ingraham, and Dr. Haldi. Rather, any changes for Saturation flats  
15 should be in the more economically-efficient direction shown in my analyses  
16 summarized above.

17           In Section II, I rebut Mr. Mitchell’s flawed notion that ECR letters and flats are  
18 “separate products” that warrant a pricing markup greater than the cost differences.  
19 His contention is based on glaring misconceptions about the nature of the markets in  
20 which ECR mail competes. Application of his concept would result in imposing the  
21 greatest rate burdens on the category of mail – Saturation flats – that is the most  
22 price-sensitive of any ECR rate category.

1           In Section III, I rebut Dr. Haldi's claims about the alleged impact of capacity  
2 constraints on Saturation letter and flat city carrier delivery costs.

3           In Section IV, I rebut Mr. Mitchell's implication, based on Dr. Haldi's delivery  
4 cost contention, that Saturation letters are unfairly "cross-subsidizing" Saturation  
5 flats. In particular, I demonstrate that the rates for Saturation flats more than cover  
6 even an extreme estimate of their incremental costs, and that under Mitchell's  
7 "standalone cost" test, it is Saturation flats that are being burdened by excessive  
8 rates.

9           Workpapers supporting the results presented in this rebuttal are included in  
10 ADVO LR-1. All workpapers cited in the text are Excel files that are included in  
11 ADVO LR-1. My qualifications are described in the Appendix.

12

1 **I. THE NAA AND VALPAK RATE DESIGNS ARE FLAWED**

2 NAA witness Ingraham (NAA-T-2) and Valpak witness Mitchell (VP-T-1)

3 propose alternative ECR rate designs that are conceptually and factually flawed:

4       ▪ The unit costs they use to develop the Saturation on-piece-addressed flat  
5 rate are incorrect and excessive, failing to account for the fact that on-  
6 piece-addressed flats will not use a DAL.

7  
8       ▪ The unit costs they use to develop all piece-rate differentials include  
9 weight-related costs for pieces over the breakpoint.

10  
11       ▪ Both propose pound rates that are too high.

12  
13       ▪ Neither properly adjusts ECR/NECR attributable cost to reflect the cost  
14 savings that will result from Saturation DALs eliminated from the system  
15 as a result of the USPS-proposed DAL surcharge.

16  
17       ▪ Neither of their rate designs provides for a DAL surcharge that should be  
18 applied to the High-Density flats that also use DALs.

19  
20 These flaws in Mr. Mitchell's and Dr. Ingraham's rates, if accepted, would lead to

21 inefficient, biased rates, and the unintended loss of important USPS volume and

22 institutional cost contribution from Saturation flat mailers. A better set of ECR rates

23 can be designed generally following Efficient Component Pricing (ECP) principles.

24 To illustrate the shortcomings of their proposals, I explain the proper

25 approach to ECR rate development, provide estimates of the correct cost of on-

26 piece-addressed Saturation flats and the maximum weight-related cost that the

27 pound rate is intended to cover, and present a more cost-based set of ECR rates.

28 Compared to their proposals, my more appropriate treatment of all the issues would:

29       ▪ Reduce the piece rate for Saturation on-piece-addressed flats;

30       ▪ Reduce the ECR pound rate;

31       ▪ Reduce the Saturation letter-flat piece-rate differential; and

- 1           ▪ Increase the High Density-Saturation flat piece-rate differential.

2 I do not claim that my illustrative rates are “optimum” because I believe the pound  
3 rate is still too high and I have not adjusted the piece-rate differentials to eliminate  
4 the impact of weight over the breakpoint. In addition, I agree with witness Mitchell  
5 that the ECR cost coverage is too high, although my rates are designed to cover the  
6 Postal Service’s proposed ECR institutional cost contribution. Nevertheless, by ECP  
7 standards, the rate relationships I present are directionally and more appropriately  
8 right. If the Commission decides it must make changes to the USPS-proposed ECR  
9 rates, then it should make them in this direction.

10 **A. ECP Principles Should Be Used To Develop The On-Piece-Addressed**  
11 **Flat Rate And The Pound Rate**

12 Under ECP, as espoused by Drs. Panzar and Sidak in this proceeding, rate  
13 differences within a subclass should reflect cost differences.<sup>1</sup> This is so that mailers,  
14 and businesses that use the services of those mailers, can make decisions that are  
15 based on true mailing costs. This is particularly important in the saturation  
16 advertising market where there is competition (1) between private delivery  
17 alternatives and the Postal Service and (2) among some categories of ECR mail:  
18 Saturation flats, Saturation letters, and High-Density flats.<sup>2</sup> Dr. Ingraham specifically

---

<sup>1</sup> Dr. Sidak uses the term ECP to apply to the correct pricing principles associated with developing worksharing rates that he believes apply to the ECR shape-based density-related differences. He agrees with Dr. Panzar that the same principles also apply to shape- and weight-related cost and rate differences as long as all categories are assumed to have the same “value.” (PB-T-1, pages 45-50; Sidak responses to ADV0/NAA-T1-4 and -5)

<sup>2</sup> See, e.g., SMC witness Gorman’s responses to NAA/SMC-T1-2 -5. Mr. Gorman uses a slightly different term for the market: the “saturation mail industry,” or 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.” Mr. Gorman notes that Saturation flat mailers,

1 notes the “potentially significant competitive rate advantage [Saturation mailers  
2 could have] over newspaper Total Market Coverage programs that rely on High-  
3 Density mail” if the incorrect USPS-proposed High-Density rate is implemented.<sup>3</sup>  
4 Mr. Mitchell simplistically and incorrectly denies rivalry between Saturation/High-  
5 Density flats and letters.<sup>4</sup>

6 Thus, in the saturation advertising market, Saturation flat mailers could be  
7 significantly hampered competitively vis-à-vis High-Density flats and Saturation letter  
8 mailers if an excessively high Saturation on-piece-addressed flat rate (relative to  
9 other ECR rates) is implemented. Indeed, the reason why the Saturation flat mailers  
10 accept the DAL surcharge is because the DAL cost can then be eliminated from the  
11 flat rate, thus ensuring that the competitive position of on-piece-addressed flat  
12 mailers is not hampered because other flat mailers use DALs.

13 The same is also true of the ECR pound rate. In the saturation advertising  
14 market, program mailers recognize the pound rate as their marginal cost of  
15 becoming successful (i.e., attracting advertisers to their packages). In some cases,  
16 the pound rate has become a form of “refusal pricing” since these mail programs, as  
17 they become heavier, develop a tendency to go to alternative delivery, as noted by  
18 Mr. Mitchell:<sup>5</sup>

---

Saturation letter mailers, and newspapers/private delivery firms that also use mail for TMC programs are all in that market. (Response to NAA/SMC-T1-3)

<sup>3</sup> NAA-T-2, pages 2-3, lines 18 ff.

<sup>4</sup> See, e.g., response to ADVO/VP-T1-6.

<sup>5</sup> VP-T-1, page 82, lines 22-26. See also Mr. Gorman’s testimony: “More than half of all shopper publications in the nation are delivered privately, outside the mailstream. Private delivery is also an option that is used for distribution of shared mail programs. While SMC’s members predominantly use the mail, the bottom line on our distribution choice is our bottom line. We must remain competitive to

1 Much of the mail that is candidate for being handled by alternative carriers  
2 weighs more than 3.3 ounces, and therefore pays the pound rates of either  
3 ECR or Regular. Private carriers have less difficulty competing for relatively  
4 heavy mail than for relatively light mail.

5  
6 However, because the ECR pound rate does not comport with ECP principles,  
7 mailers (and their advertisers) are getting incorrect signals about the true differences  
8 between postal and alternate delivery marginal costs. They are, therefore, making  
9 inefficient decisions. This is precisely the type of inefficiency Pitney Bowes witness  
10 Panzar warns about.<sup>6</sup>

11 **B. The Correct Cost for Saturation On-Piece-Addressed Flats And The DAL**  
12 **Cost Savings Should Be Used To Set Rates**

13 Based on USPS witness Kelley's LR L-67 unit delivery cost calculations, the  
14 total TYBR delivery cost associated with Saturation DALs is nearly \$187 million.<sup>7</sup>  
15 When DAL mail processing costs are added in, the total DAL costs increase to \$197  
16 million.<sup>8</sup> Because over 40% of Saturation flats currently use DALs, these DAL costs  
17 have a major upward impact on the Saturation flat unit cost if included within that  
18 cost. However, the purpose of the DAL surcharge is to encourage mailers to  
19 eliminate DALs: (1) providing the USPS with cost savings from eliminated DALs and  
20 (2) reducing the cost of Saturation flats that convert to on-piece addressing. These  
21 cost savings must be reflected in the rate design.

---

stay in business, and if postal delivery becomes unaffordable or unsuited to our needs, we will have no choice but to pursue other alternatives." (SMC-T-1, page 4, lines 13-19)

<sup>6</sup> PB-T-1, pages 45-47.

<sup>7</sup> USPS LR L-67, UDC Model.xls, Sheet 2.summary TY. See also Tr. 12.3511.

<sup>8</sup> Response to ADVO/USPS-T27-1.xls, ECR-BY&TYDAL, shows \$10,217,000 in TYBR DAL mail processing cost for Saturation flats.

1           No witness in this case disagrees with the Postal Service decision to institute  
2 a DAL surcharge to motivate Saturation flat mailers to eliminate costly DALs. While  
3 the cost of the DALs is clear, there has been some confusion regarding the cost of  
4 on-piece-addressed flats. None of the ECR rate design witnesses use the unit cost  
5 of on-piece-addressed Saturation flats. Instead, each incorrectly uses an averaged  
6 Saturation flat unit cost that includes the full cost of both on-piece-addressed and  
7 DAL-addressed flats (i.e., the total cost of all Saturation flats and all Saturation flat  
8 DALs divided by Saturation flat volume). I call this the “Averaged” Saturation flat unit  
9 cost.

10           **(1) The “Averaged” Saturation Flat Unit Cost Used By Ingraham And**  
11           **Mitchell Is The Wrong Basis For The On-Piece-Addressed**  
12           **Saturation Flat Rate**

13           All ECR rate design witnesses appear to recognize that they are using  
14 the “Averaged” Saturation flat cost. Mr. Mitchell, like USPS rate design witness  
15 Kiefer, tries to account for that fact by increasing the piece-rate difference between  
16 High-Density and Saturation flats more than the difference between their unit costs.<sup>9</sup>  
17 Dr. Ingraham, in contrast, attempts to recognize some test year cost savings (from  
18 DAL eliminations) in the “Averaged” Saturation flat cost by making some simplistic  
19 assumptions.<sup>10</sup> Each approach is a rough, imprecise attempt to recognize that on-

---

<sup>9</sup> USPS LR L-36, WP-STDECR-R0621.xls (Kiefer); VP-T-1, pages 175-176.

<sup>10</sup> Dr. Ingraham provides two alternative sets of rates: the first one assumes no DAL conversion while the second one assumes 75% DAL conversion. For the latter, he adjusts the “Averaged” Saturation flat cost to remove what he believes will be the cost savings associated with that conversion. Under that scenario, he develops a set of rates that arbitrarily assume that if 75% of the DALs leave the system, only 60% of his estimate of the total DAL cost will be saved (i.e., a cost elasticity of 1.25%). See NAA-T-2, pages 19-20, lines 15ff. For some reason, though, he does not recognize the city in-office or mail-processing DAL costs that are also averaged into the Saturation flat cost. Still, in both cases, his rate for Saturation on-piece-addressed flats covers the full cost of all DALs he believes will be left in the system in the test year.

1 piece-addressed Saturation flats cost less than the “Averaged” Saturation flat and  
2 should therefore be priced at a lower level.

3 In all three cases, their proposed piece-rates for on-piece-addressed  
4 Saturation flats still include the cost of DALs remaining in the test year and then the  
5 DAL surcharge covers some of that same DAL cost again.<sup>11</sup> This is unacceptable  
6 and results in the following:

- 7       ▪ On-piece-addressed Saturation flat mailers would be overcharged,  
8       potentially harming their competitive positions.
- 9       ▪ Even if all DALs are eliminated as a result of the new surcharge, on-piece-  
10       addressed Saturation flats would still cover the phantom DAL costs.
- 11       ▪ The on-piece-addressed Saturation flat rate would be skewed upward  
12       relative to the rates for all other ECR on-piece-addressed mail categories  
13       with which those mailers compete.
- 14
- 15
- 16

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

22       **(2) The Correct Unit Cost For Saturation On-Piece-Addressed Flats**  
23       **And Cost Savings From DAL Elimination**

24       The unit cost of on-piece-addressed Saturation flats (and the resulting  
25 cost savings from eliminating DALs) depends upon how the flats that convert from  
26 DALs to on-piece-addressing will be handled operationally. Mr. Kelley (USPS-T-30),  
27 who developed the unit delivery costs by rate category in USPS LR L-67, provided

---

<sup>11</sup> The DAL surcharge does not cover all of the unit cost of a DAL, but that was done to moderate the impact on mailers that continue to use DALs.

1 Dr. Kiefer (USPS-T-36) with only the “Averaged” Saturation flat unit delivery cost that  
2 assumes zero DAL conversion.

3 However, an on-piece-addressed Saturation flat (city plus rural) unit delivery  
4 cost can be estimated based on (1) the unit delivery cost model in USPS LR L-67  
5 and (2) the testimony of both USPS witnesses Kelley and Coombs. Mr. Kelley and  
6 Ms. Coombs have testified that they believe all city carrier costs caused by DALs  
7 can be saved if all DALs are eliminated and the flats are addressed on piece.<sup>12</sup>  
8 Thus, the city carrier delivery cost for Saturation flats (excluding DALs) does not  
9 change from that already estimated in USPS LR L-67.

10 More explanation for the rural delivery cost is required, though. On rural  
11 routes, Saturation flats can be taken out as either (1) city-style-addressed flats or (2)  
12 simplified address/boxholder flats. City-style-addressed flats cost substantially more  
13 than boxholder flats. The unaddressed flats associated with DALs are considered  
14 by the Postal Service to be boxholder mail. When DAL flats on rural routes convert  
15 to on-piece-addressing, there is a concern that they will then become city-style  
16 addressed flats (i.e., the cost of the flats will shift from low-cost boxholder to high-  
17 cost city-style-addressed flats). This concern arises from mailer reaction to  
18 legislation, passed a few years ago, that requires them to respect “do-not-deliver”  
19 (DND) requests.<sup>13</sup> As a result of that legislation, and without realizing that they were  
20 actually increasing postal rural delivery costs (and thereby their own postal rates),  
21 Saturation flat mailers have been switching away from simplified-address/boxholder

---

<sup>12</sup> USPS-T-44, page 13 (Coombs); and Tr. 12.3515-3516 and 12-3536-37 (Kelley).

<sup>13</sup> The Deceptive Mail Prevention and Enforcement Act, PL 106-168.

1 flats to city-style addressed flats in order to respond to an extremely limited number  
2 of DND requests.<sup>14</sup>

3           Recently, the Saturation Mailers Coalition and the Postal Service have been  
4 discussing procedures whereby Saturation flat mailers can mail boxholder flats on  
5 rural routes and still respond to the small number of DND requests on those routes.  
6 Their intent is to enable Saturation flat mailers to mail on-piece simplified-  
7 address/boxholder flats on rural routes and, thereby, avoid the unnecessary postal  
8 cost associated with city-style addressing of those flats.<sup>15</sup> The Postal Service has  
9 recently stated to the SMC that it is committed to implementing such a procedure  
10 that will enable mailers to identify DND addresses on rural routes so that they can  
11 utilize simplified addressing.

12           Consequently, there is no reason to believe that the rural delivery cost of  
13 Saturation flats, without the DALs, will differ from that already estimated in USPS LR  
14 L-67. In other words, the combined city plus rural unit delivery cost for ECR  
15 Saturation flats (minus DALs) in the USPS LR L-67 Unit Delivery Cost Model can be  
16 used as the Saturation on-piece-addressed flat delivery cost.

17           In subsection E at the end of this section, I provide a set of ECR rates  
18 whereby the Saturation flat piece rate is developed using the correct on-piece-  
19 addressed Saturation flat delivery cost. The ECR rates are also based on the  
20 conservative assumption that only 50% of Saturation DAL flats will convert to on-

---

<sup>14</sup> Based on discussions with and information from SMC members, the number of DND requests on rural routes is a tiny fraction of total addresses, ranging from a high of about one DND per carrier route down to less than a hundredth of a percentage point of addresses.

<sup>15</sup> See Mr. Gorman's response to NAA/SMC-T-2.

1 piece addressing in the test year (i.e., 50% of Saturation DALs will remain in the  
2 TYAR system).<sup>16</sup>

3 As discussed above, the total TYBR cost associated with DALs is \$197  
4 million. In developing the corrected rates, I assume 50% of those TYBR DAL costs  
5 are saved (corresponding to the 50% of DAL volume that is eliminated), adjust them  
6 to TYAR levels, and deduct them from the ECR attributable cost used in rate design.

### 7 **C. All ECR Flats Using DALs Should Also Pay The DAL Surcharge**

8 In this rate case, it has become apparent that some ECR High-Density mail  
9 also use DALs. I estimate that 4.86% of Hi-Density non-letters use DALs.<sup>17</sup>

10 However, the ECR rate design witnesses have applied the DAL surcharge only to  
11 Saturation DALs.<sup>18</sup> This is clearly incorrect. To the extent that Hi-Density (and  
12 Basic-Rate) flats also use DALs, they should also be subject to the same DAL  
13 surcharge that applies to Saturation flats.<sup>19</sup> This is the only reasonable way to  
14 ensure that postal rates remain unbiased with respect to the price signals provided  
15 to the saturation advertising market. In developing the rates presented below, I

---

<sup>16</sup> This is an extremely low, conservative estimate. Mr. Gorman estimates that there will be substantial reduction in the number of DALs in the system, in excess of 70%. (VP/SMC-T1-6). In fact, just two mailers, ADVO and Harte-Hanks, who have both announced their intention to convert from DALs to on-piece-addressing, represent over 87% of the estimated number of DALs in the system in R2005. (See ADVO-LR-1, R05\_DAL\_Estimates.xls.)

<sup>17</sup> Based on response to VP/USPS-2, revised 8/23/06, and calculated in ADVO LR-1, AC-WP-STDECR-R0621.xls, Inputs. The percentage is from a four-month period of March-June 2005.

<sup>18</sup> See USPS Request for a Recommended Decision, Attachment A, page 21, note 7. The DAL surcharge unfairly applies only to Saturation mail.

<sup>19</sup> Dr. Sidak agrees, response to ADVO/NAA-T1-6.

1 assume that the estimated TY High-Density DALs will be charged the 1.5-cent DAL  
2 surcharge.<sup>20</sup>

3 **D. The ECR Pound Rates Proposed By Dr. Ingraham And Mr. Mitchell Are**  
4 **Excessive**

5 Because the ECR pound rate is critical to High-Density/Saturation mailers in  
6 the saturation advertising market, it warrants serious consideration. The Postal  
7 Service recognizes that the ECR pound rate is too high and Dr. Kiefer's rate  
8 proposal reduces that rate very slightly. However, Dr. Ingraham uses the current  
9 pound charge of 64.3 cents rather than the Postal Service's proposed 64.1 cents on  
10 the ground that Kiefer offers no reason for changing the pound rate. Mr. Mitchell, on  
11 the other hand, adopts the Postal Service's proposed pound rate, but then  
12 substantially reduces all the piece rates because of his lower cost coverage  
13 proposal. To this point, no witness has attempted to determine any quantitative  
14 support for his proposed pound rate or to assess its impact on the market.

15 In ECR, the unit costs by shape and density level are based on total mail  
16 processing plus delivery cost, adjusted to reflect origin-entry level. Those unit costs  
17 by rate category, therefore, are an average of the costs for pieces below and above  
18 the 3.3-ounce breakpoint. This means that rate category unit costs include the effect  
19 of weight over 3.3 ounces for pound-rated pieces; but that cost effect should be  
20 recovered only in the pound rate. Recognizing these facts is important to  
21 understanding how the unit costs should be used in rate design and why the pound  
22 rate is excessive.

---

<sup>20</sup>To the extent the surcharge eliminates High-Density DALs from the system, the variable cost savings will exceed the revenue loss and the Postal Service contribution from ECR will be increased. For this reason, the adjustment to ECR rates is conservative.

1           Theoretically, when ECP principles are applied, (1) shape-density rates  
2 should be designed to so that average piece revenue equals average piece cost  
3 and, therefore, (2) each shape-density rate category generates the same average  
4 piece contribution to institutional cost.<sup>21</sup> Thus, the ECR pound rate should be based  
5 on the cost of weight over the breakpoint and the ECR piece rate differentials should  
6 be based on the unit cost differences among piece-rated pieces.

7           In practice, however, the pound rate has been arbitrarily selected and the  
8 piece rate differentials have been developed using unit cost differentials that include  
9 the cost impact of weight over the 3.3-ounce breakpoint. When the unit cost  
10 differentials are passed-through 100%, as Mr. Mitchell and Dr. Ingraham have done,  
11 those piece-rate differentials are overstated. This is particularly relevant to the letter-  
12 flat piece rate differentials because, relative to letters, a considerable amount of flat  
13 volume exceeds the breakpoint and pays the pound rate. When the pound revenue  
14 from flats is included in the average flat revenue by rate category, the average  
15 revenue difference between letters and flats substantially exceeds the average cost  
16 difference.<sup>22</sup> This is contrary to ECP principles and results in inefficient price signals  
17 that are biased against flats and pound-rated mail.

18           Part of this rate design problem is caused by the 100% passthrough of cost  
19 differences to piece rate differences. But, the major cause of the problem is that the

---

<sup>21</sup> See, e.g., PB-T-1, pages 45-47, responses to VP/PB-T1-10 and -29.

<sup>22</sup> This defect is hidden in Mr. 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.

1 ECR pound rate is too high.<sup>23</sup> Because of the breakeven constraint, if the pound  
2 rate is too high, then the piece rates, in combination, are too low.

3         Given the substantial impact of the pound rate on mailers in the saturation  
4 advertising market, it is particularly important to try to estimate the marginal weight-  
5 related cost for pieces over the breakpoint. An extreme estimate of the maximum  
6 ECR marginal weight-related cost can be made by simply assuming that all  
7 Saturation flat cost is weight-related. This yields an origin-entry pound cost of  
8 roughly 45.7 cents.<sup>24</sup> Importantly, this estimate can be considered well above an  
9 upper bound on the origin-entry pound cost. This is because both the unit cost used  
10 includes piece-related casing and delivery costs. Consequently, this estimate can be  
11 considered well above an upper bound on the origin-entry pound cost.

12         By comparison, the current origin-entry pound rate of 64.3 cents selected by  
13 Dr. Ingraham as well as the USPS proposed pound rate of 64.1 cents are excessive.  
14 And, Mr. Mitchell's retention of the USPS proposed pound rate of 64.1 cents, while  
15 reducing all other ECR piece rates, is completely unfounded and self-serving,  
16 permitting the full rate level reduction he is proposing to flow-through only to piece  
17 rates. The proposed pound rates clearly exceed an ECP-consistent rate.

---

<sup>23</sup> Mr. Mitchell recognizes this problem but still proposes 100% passthrough of the letter-flat unit cost differentials as well as a high pound rate. He implies that the 100% passthroughs are acceptable because weight-related costs are not large. (VP-T-1, pages 178-179, see especially footnote 65) Yet if that is the case (and I agree with him on this point), then he should have reduced the pound rate by at least the same amount as he reduced the piece rates.

<sup>24</sup> This estimate excludes DAL costs, adjusts the flat mail processing cost to reflect USPS response to POIR No. 21, Item 1, and uses the Saturation flat mail processing cost as described in the preceding footnote. This cost also includes origin-entry transportation cost. (ADVO LR-1, AC-WP-STDECR-R6021.xls, Inputs, rows 86-110.)

1 **E. ECR Rates Based On The Correct Saturation On-Piece Addressed Flat**  
 2 **Cost And ECP Principles**

3 The rates I have developed in ADVO-LR-1 (as shown in the table below)  
 4 demonstrate the effect of using the correct unit cost for Saturation on-piece-  
 5 addressed flats, recognizing the DAL cost savings, and lowering the pound rate  
 6 slightly. The latter is not as low as it should be, but it is a reasonable step in the  
 7 right direction. In developing these rates, I set piece rate differentials at 100% of unit  
 8 cost differentials, even though this passthrough overstates the true cost differences  
 9 among piece-rated pieces in the various ECR rate categories.<sup>25</sup> On the other hand, I  
 10 have kept the dropship discounts at the lower USPS-proposed passthrough  
 11 amounts, even though I agree with Postcom witnesses Glick and Pursley that 100%  
 12 dropship passthroughs are more appropriate.<sup>26</sup>

13 The resulting rates conservatively assume 50% conversion of DALs to on-piece-  
 14 addressing in the test year and the following features:

- 15 ■ Use of the de-averaged High-Density and Basic-Rate letter and flat delivery
- 16 costs
- 17 ■ Use of de-averaged High-Density and Saturation letter and flat mail
- 18 processing costs<sup>27</sup>

<sup>25</sup> As discussed in subsection D above, the unit costs used to derive the rate differentials are not precise because they reflect weight-related cost for pieces over the breakpoint. However, I do not have sufficient information to make any other decision concerning those piece-rate differentials. But I do know that the pound rate is exceedingly high and that it likely causes far more inefficiencies than the imprecision in the piece-rate differences.

<sup>26</sup> See POSTCOM-T-1 (Glick) and POSTCOM-T-2 (Pursley) and responses to USPS/POSTCOM-T2-2, -5, -6. In contrast to Mr. Glick's approach for Standard Regular, I believe that the 100% passthroughs in ECR should not be offset by a higher pound rate. The ECR origin-entry pound rate is too high already. However, strictly to ease the comparison to the other alternative sets of ECR rates, I simply accept the USPS-proposed dropship passthroughs.

<sup>27</sup> For High-Density/Saturation flats and letters, there is one mail processing unit cost estimate for each shape and that is then adjusted to origin-entry level. I de-average that dropship adjustment to reflect the average weight differences among these four shape-density categories. For flats, the de-averaged mail processing costs exclude DAL costs and are adjusted to reflect USPS response to POIR No. 21, Item 1. See ADVO LR-1, Wt\_Adj\_LR\_L-84.xls, ECR Drpshp Adj.

- 1       ▪ Utilization of the on-piece-addressed Saturation flat cost
- 2       ▪ The USPS-proposed DAL surcharge
- 3       ▪ A DAL surcharge applicable to all ECR flats that use DALs
- 4       ▪ Recognition of the Saturation DAL cost savings in ECR attributable costs
- 5       ▪ Retention of the Postal Service proposals with respect to Automation letters
- 6       and elimination of the DDU drop-ship discounts for all ECR letters
- 7       ▪ Retention of the original Postal Service ECR/NECR institutional cost
- 8       contribution amount<sup>28</sup>
- 9       ▪ Retention of the equal Basic-Rate letter and flat piece rates for the Postal
- 10      Service's automation policy reasons<sup>29</sup>
- 11      ▪ Development of parcel piece rates on the basis of the new information in
- 12      POIR No. 16, Item 1.<sup>30</sup>
- 13
- 14      The rates were also designed to generate the same ECR/NECR contribution
- 15      to institutional cost as proposed by the USPS. Due to the DAL cost savings, these
- 16      rates generate a volume-variable cost reduction of over 3% due to the DAL cost
- 17      savings and a 216.6% cost coverage.

---

<sup>28</sup> I do not attempt to develop any particular rate structure within NECR but simply adjusted a few NECR rates to ensure correct overall NECR vs. ECR rate level and total ECR/NECR contribution.

<sup>29</sup> Although the Basic-Rate letter piece rate is equal to the Basic-Rate flat piece rate, this does not mean that the High-Density and Saturation letter rates are too high, as Mr. Mitchell implies. (VP-T-1, page 122, lines 8-16). An adjustment is made so that the piece rates for the latter two rate categories are in proper relation to the piece rates of all other categories except that of the Basic-Rate letter.

<sup>30</sup> In order to develop a total ECR rate design, decisions must be made regarding parcel piece rates. The Saturation parcel rate is set at 9 cents more than the Saturation flat rate, based on a 100% passthrough of the estimated Saturation parcel mail processing plus delivery cost. The Basic/High-Density parcel piece rates were set at roughly 28 cents more than the corresponding flat rates but, even with the pound rate, they likely do not cover their costs. The parcel mail processing costs were adjusted per the USPS response to POIR No. 21, Item 1.

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

1  
2  
3

	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
<b>LETTERS</b>									
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	
<b>FLATS</b>						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
<b>PARCELS</b>						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

4  
5  
6

ADVO-LR-1, AC-WP-STDECR-R0621.xls

Despite the fact that these rates still are not in full accord with ECP principles, they align ECR rates more closely to their underlying costs, as compared to the other alternatives. Thus, they have less bias and improve economic efficiency by providing better price signals on which ECR mailers and participants in the saturation advertising market can make decisions.

11

1 **II. VP WITNESS MITCHELL'S PRODUCT PRICING CONCEPT IS NOT**  
2 **EFFICIENT RATEMAKING**

3 Essentially expanding upon his testimony on ECR rate design in R2005, Mr.  
4 Mitchell (VP-T-1) proposes the use of what I term "Product Pricing" that involves  
5 applying separate institutional cost markups for separate products within the same  
6 subclass. He claims that this is required because ECR letters and ECR flats, though  
7 both are included within the same subclass, are different products in terms of their  
8 cost and demand characteristics.<sup>31</sup> Consequently, he proposes an approach that  
9 would effectively mark up, by the same percentage, ECR letter and flat "products" in  
10 order to cover the ECR assigned amount of institutional costs. Apparently, he  
11 believes this approach would improve the resource allocation efficiency of ECR  
12 rates.

13 Further, he believes the markups should be applied to the most costly density  
14 level for each "product" – the origin-entered Basic-Rate piece cost. In practical  
15 terms, he would accomplish this by marking up the unit cost difference between  
16 origin-entry Basic-Rate Flats and origin-entry Basic-Rate Letters by the subclass  
17 markup percentage and assign this difference to the flat "product."<sup>32</sup> Then, within  
18 each shape grouping, he would use a modified Efficient Component Pricing (ECP)  
19 approach to determine the rates for the lower-cost rate categories in each product  
20 grouping.<sup>33</sup> In this rate proceeding, he proposes an ECR cost coverage of 177%

---

<sup>31</sup> VP-T-1, page 118.

<sup>32</sup> VP-T-1, page 178 and response to ADVO/VP-T1-5.

<sup>33</sup> VP-T-1, page 178, responses to ADVO/VP-T1-7 and -8.

1 but chooses to use 100% to mark up the origin-adjusted Basic-Rate letters and flats,  
2 which he claims is less than optimum.<sup>34</sup>

3 I have explained in Section I that his proposal to assign 100% of the full letter-  
4 flat unit cost difference to the minimum per piece rates, while retaining a high pound  
5 rate, clearly overstates the letter-flat piece rate differential and overstates the pound  
6 rate that is applied mostly to flats. In this section I explain why I disagree with his  
7 broader “Product Pricing” concept.

8 In summary, Mr. Mitchell’s “Product Pricing” concept is rife with problems and  
9 completely unacceptable:

- 10 ■ His letter vs. flat “product” distinction is dependent upon simplistic and  
11 incorrect assumptions regarding market and demand conditions. He ignores  
12 far more appropriate “product” groupings within ECR, for example High-  
13 Density/Saturation flats.
- 14  
15 ■ If resource allocation efficiency is the objective of his “Product Pricing”  
16 concept, then flats, particularly High-Density/Saturation flats, should be  
17 marked-up much less than letters. But, application of his concept would do  
18 just the reverse.
- 19  
20 ■ When developing rates within a subclass, the accepted approach, as clearly  
21 explained by Dr. Panzar in this proceeding, is to employ ECP principles that  
22 tend toward equalizing unit contributions from all subclass pieces.<sup>35</sup> This  
23 improves the productive/technical efficiency of subclass rates and avoids  
24 biasing rates in favor of any one mailer-competitor. However, ECR flats  
25 already make a larger unit contribution than do ECR letters and Mr. Mitchell’s  
26 “Product Pricing” concept would increase that letter-flat disparity even more.
- 27

28 As a result, Mr. Mitchell’s “Product Pricing” concept and implementation would not  
29 improve efficiency. This is particularly the case for High-Density/Saturation flat rates  
30 where his approach would cause the highest percentage markups and highest unit

---

<sup>34</sup> VP-T-1, page 178.

<sup>35</sup> PB-T-1, pages 45-50 and response to VP/PB-T1-29.

1 contributions, sending extremely inefficient price signals to mailers, advertisers, and  
 2 private delivery carriers in the saturation advertising market. The approach would  
 3 bias postal rates for some mailer/competitors in favor of others. And, for Saturation  
 4 flat mail that makes the greatest contribution to institutional cost within ECR, it would  
 5 unnecessarily restrict growth and encourage further diversion to private delivery  
 6 alternatives.

7 **A. Correct Measures of Efficient Pricing Refute Mr. Mitchell's Claim Of**  
 8 **Discriminatory Rates**

9 **(1) Correct Efficiency Measures**

10 Since Mr. Mitchell attempts to improve the economic efficiency of ECR  
 11 rates, it is appropriate to review how an improvement can be measured. With  
 12 respect to rate efficiency, there are two accepted economic ratemaking concepts  
 13 that apply:

- 14 **▪ Ramsey Pricing.** Ramsey pricing is used to allocate institutional cost  
 15 contribution among the various subclasses on the basis of postal own-  
 16 price elasticities and cross-price elasticities. In this approach, subclasses  
 17 that have high own-price elasticities should have a lower mark-up than  
 18 those with lower own-price elasticities. This results in efficient resource  
 19 allocation by “. . .maximizing the sum of *economic profits* accruing to  
 20 industry participants plus the *consumers' surplus* accruing to final  
 21 consumers.”<sup>36</sup> Mr. Mitchell's “Product Pricing” concept appears to be an  
 22 intra-subclass version of Ramsey Pricing.<sup>37</sup>  
 23
- 24 **▪ Efficient Component Pricing.** ECP is used to develop rates within a  
 25 subclass by setting rate differentials among various rate categories on the  
 26 basis of cost differentials. This results in productive or technical efficiency  
 27 whereby mailers can minimize their end-to-end distribution costs by  
 28 making their selections among the various postal services and products  
 29 on the basis of their actual cost differences.<sup>38</sup> In circumstances where

<sup>36</sup> PB-T-1, page 47, lines 13-16; see also Mr. Mitchell's extensive discussion in VP-T-1, pages 42-53.

<sup>37</sup> This is clear from Mr. Mitchell's preoccupation with efficiency of resource allocation and markups over cost. See VP-T-1, pages 42-53 and response to ADV0/VP-T1-10.

<sup>38</sup> PB-T-1, pages 45-47.

1 mailers within the subclass compete among themselves, the use of ECP  
2 principles can contribute to dynamic efficiency by avoiding rates that are  
3 biased for or against particular competitors. Mr. Mitchell uses modified  
4 ECP principles to develop piece rates within each of his “product”  
5 groupings.  
6

7 As discussed by Dr. Panzar, Ramsey Pricing requires the use of precise cost  
8 and demand information while ECP requires only precise information on costs of the  
9 various rate elements and categories. For ECR, there is only one postal own-price  
10 elasticity, developed by the USPS for use in determining TYBR and TYAR subclass  
11 volumes. That own-price elasticity should be considered a volume-weighted average  
12 of the price elasticities of each ECR mailer. With respect to costs, however, there is  
13 cost information for many of the ECR rate categories, although the information is not  
14 as precise as ECP requires.

15 When Ramsey Pricing is correctly implemented, subclasses (or products) with  
16 higher postal-price elasticities have lower cost markups than those with lower postal-  
17 price elasticities.<sup>39</sup> When ECP is correctly implemented within a subclass, all rate  
18 categories within a subclass have the same per piece cost contribution.<sup>40</sup> These are  
19 the appropriate benchmarks against which I review Mr. Mitchell’s proposed ECR rate  
20 impacts on efficiency.

## 21 **(2) Mr. Mitchell’s Rate Discrimination Claim Is Wrong**

22 To support his “Product Pricing” proposal, Mr. Mitchell chooses a third  
23 benchmark. He cites Dr. George Stigler to imply that rates for two products “like  
24 letters and flats, in the same subclass” are discriminatory if they do not have equal

---

<sup>39</sup> PB-T-1, page 48, lines 1-11.

<sup>40</sup> PB-T-1, pages 46-47, lines 3ff; see also response to VP/PB-T1-29.

1 price to cost ratios.<sup>41</sup> However, Dr. Stigler recognized that: “Some economists  
2 prefer the slightly different definition: prices are discriminatory if the difference in  
3 price is not equal to the difference in marginal cost.”

4       Actually, there are a number of highly respected economists in the regulated  
5 ratemaking field, in addition to Dr. Panzar, that prefer that alternate definition, as it  
6 relates to intra-subclass rates. In *Principles of Public Utility Rates*, Dr. James  
7 Bonbright et al. note obvious deficiencies in Stigler’s preferred definition:<sup>42</sup>

8       . . . the proportionality [revenue to cost] definition has obvious deficiencies.  
9 For it would embrace some rate relationships that have the same distorting  
10 influences in affecting consumer choice among alternative services which  
11 economists associated with the practice of discrimination. . . .

12  
13       One of the major objectives of sound public utility ratemaking policy is that of  
14 bringing rates for substitute services into proper relationship, so that  
15 consumers will not be led to make an economically distortionate choice  
16 between alternatives. . . . But as long as rates are . . . proportional to marginal  
17 costs, the price differentials will exceed the cost differences – an excess  
18 which may lead many consumers to make an uneconomic choice of the less  
19 costly alternative. Recognition of this situation has led some writers to reject  
20 the proportionality definition of nondiscriminatory rates in favor of a cost-  
21 differential definition.

22  
23       Further, Dr. Alfred Kahn in *The Economics of Regulation* concurs but  
24 provides a slightly different perspective on the appropriateness of rate differences  
25 equaling cost differences. It is particularly relevant where mailers in various ECR  
26 categories compete on virtually a daily basis with each other:<sup>43</sup>

---

<sup>41</sup> VP-T-1, pages 105-106.

<sup>42</sup> James C. Bonbright, Albert L. Danielsen, David R. Kamerschen, *Principles of Public Utility Rates*, Second Edition, Public Utility Reports, Inc., Arlington, Virginia, 1988, pages 524-525.

<sup>43</sup> Alfred E. Kahn, *The Economics of Regulation*, The MIT Press, Cambridge, Massachusetts, 1988, Volume I, page 174. “Natural entitlement” means having access to a natural advantage such as “. . . homeowners in the process of deciding on a new heating system, who have the opportunity to install oil at favorable rates, or by large users of communications services who have a choice of installing

1 Where the customers are in direct competition with one another *and* the  
 2 favored buyers enjoy no such “natural entitlement” to the lower rates, the  
 3 rates charged them should differ only by the absolute amount of the  
 4 differences in the incremental costs of serving them.

5  
 6 Thus, Mr. Mitchell’s implication that ECR letter and flat rates are unfairly  
 7 discriminatory if they do not have equal price-to-cost proportions is simply wrong.

8 **B. Mr. Mitchell’s Letter And Flat “Products” Are Not Based On Real-World**  
 9 **Market And Demand Conditions**

10 **(1) Mr. Mitchell’s Letter and Flat “Products” Are Constructed To Fit**  
 11 **His Purpose**

12 Mr. Mitchell provides a very vague and inconsistent explanation of  
 13 what he means by separate “products.”<sup>44</sup>

14 . . . if two categories tend to look like separate products, to be processed in  
 15 separate mailstreams, to have different costs, to be purchased in markets that  
 16 are arguably different, and to have relatively low cross elasticities, they tend  
 17 to be separate products.

18 Mr. Mitchell’s “Product Pricing” concept is an attempt to apply the simple  
 19 inverse elasticity (IER) rule of Ramsey Pricing to letter and flat “products” in the ECR  
 20 subclass.<sup>45</sup> Since Ramsey Pricing applies to subclass markups, he needs to  
 21 position his letter and flat “products” so that they appear to have sufficient cost-  
 22 based and market-based distinctions of the kind that warrant separate subclass  
 23 treatment. Unfortunately, although he claims that they serve different markets, he  
 24 needs to also assume that his two “products” each have the same average ECR  
 25

---

their own, private microwave systems.” (page 174) One could claim that High-Density/Saturation flats have access to a natural advantage – the availability of private delivery alternatives.

<sup>44</sup> Response to ADVO/VP-T1-6(a).

<sup>45</sup> The IER uses only own-price elasticities and assumes that there are zero cross-price elasticities.

1 postal price elasticity (and little cross-price elasticity) because he wants to apply the  
2 IER equal cost markups to each.<sup>46</sup> This is where his construct breaks down.

3 **(2) Mr. Mitchell Ignores Real-World ECR Letter And Flat Market And**  
4 **Demand Information**

5 Mr. Mitchell's product groupings and price elasticity assumptions show  
6 that he either does not understand or ignores the available market and demand  
7 information on ECR mail.<sup>47</sup> There is information in this case that sheds additional  
8 light on the relative market and demand characteristics of mail within the ECR  
9 subclass:

- 10 ■ Mr. Mitchell presents information that shows that Saturation flats, in particular,  
11 and ECR flats in general have greater price elasticity than other mail in the  
12 ECR subclass. He observes that private delivery is an available alternative for  
13 many Saturation flat mailers, that much of the mail that is a candidate for  
14 being handled by alternative carriers weighs more than 3.3 ounces or has  
15 more than 24 pages (e.g., catalogs), and that many ECR letters do not have  
16 private delivery available to them.<sup>48</sup> Moreover, Mr. Pete Gorman in this case  
17 also notes the extensive use that Saturation Shopper publications (i.e., flat  
18 shapes) make of private delivery.<sup>49</sup>
- 19
- 20 ■ There is a strong rivalry between ECR Saturation and High-Density Flat  
21 mailers for advertising customers and such customers can easily shift  
22 between a Saturation mail program and a newspaper TMC program. NAA  
23 witness Ingraham also explains the competition between Saturation and High-

---

<sup>46</sup> Responses to ADVO/VP-T1-10 and -11. If the "products" do not have the same price elasticity and/or if there is cross-price elasticity, then Mr. Mitchell cannot apply equal percentage markups to them and still claim that he is improving resource allocation efficiency. Separately, please note that in response to ADVO/VP-T1-11(d) which questions his assertions of low ECR letter-flat cross-price sensitivities, he cites USPS witness Thress's Standard letter-flat share equations do not recognize any cross-price sensitivities but there are no letter-flat share equations for ECR.

<sup>47</sup> In actuality, Mr. Mitchell admits that he knows little about the market and demand conditions for ECR mail. Tr.25.8952, -8954, -8961.

<sup>48</sup> VP-T-1, pages 57 (lines 1-2), 59-60, 82 (lines 22-26), 84-85, and response to ADVO/VP-T1-16. Despite this information, Mr. Mitchell claims that he has no information on "comparative price sensitivities" of ECR letters and flats. Response to ADVO/VP-T1-11 (a-b).

<sup>49</sup> SMC-T-1, page 4 (lines 13-15) and response to SMC-T1-3(d) and -4.

1 Density flat rate categories in the Total Market Coverage market.<sup>50</sup> This also  
2 supports the notion of greater price elasticity for flats than for letters.

- 3
- 4 ■ ECR letter-shaped mail sometimes becomes a rated “flat” by exceeding the  
5 3.3-ounce breakpoint and sometimes also exceeding the 3.5-ounce  
6 automation-compatibility breakpoint. Even Valpak mails letter shapes that  
7 exceed these breakpoints.<sup>51</sup> In R2005, Mr. Godfred Otuteye explained that  
8 Money Mailer, the second largest Saturation letter mailer in the system (after  
9 Valpak) often exceeds those breakpoints and its competitive positioning is  
10 very much affected by Saturation flat rates.<sup>52</sup>
  - 11
  - 12 ■ Mr. Pete Gorman from Harte Hanks states that Saturation letters are part of  
13 the saturation mail industry that also includes Saturation and High-Density  
14 flats.<sup>53</sup> Within this industry, these mailers compete with each other for many  
15 of the same advertisers (e.g., local retailers and service companies).<sup>54</sup> And,  
16 conversely, local retail and service companies may consider both letter and  
17 flat mail programs as potential means to deliver their advertising.

18 Accordingly, three important conclusions can be made from the above. First,  
19

20 Mr. Mitchell’s division of ECR mail into letter “products” and flat “products” is

21 extremely simplistic and likely would not fit the criteria for separate subclass

22 treatment.<sup>55</sup> Second, saturation advertisers make choices among ECR High-

---

<sup>50</sup> NAA-T-2, pages 2-3; response to NAA/SMC-T1-3. Mr. Mitchell also recognizes this strong rivalry. Tr 25.8954-55, -8992-93 and responses to ADVO/VP-T1-17 and -18.

<sup>51</sup> 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.

<sup>52</sup> See ADVO-RT-2 in R2005. Mr. Otuteye also offers similar testimony in this case in PostCom-T-8.

<sup>53</sup> He describes this industry as referring to 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, page 3 (lines 14-18), and response to NAA/SMC-T1-3.

<sup>54</sup> Response to NAA-T-3(i).

<sup>55</sup> When asked whether all ECR letters are one product and, separately, whether all ECR flats are one product, Mr. 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.

1 Density/Saturation letters and flats.<sup>56</sup> Third, the high degree of competition between  
2 High-Density and Saturation flats and between High-Density/Saturation flat postal  
3 service and alternative delivery services means that the own-price elasticities of  
4 High-Density/Saturation flats are higher than those of any ECR letter category.<sup>57</sup> Mr.  
5 Mitchell is wrong to assume that ECR flats and letters have the same own-price  
6 elasticity and he is wrong to assume that ECR High-Density/Saturation letters and  
7 flats do not compete in the same market against each other.

8 **(3) High-Density/Saturation Flats Warrant Separate Product**  
9 **(Subclass) Treatment**

10 By contrast to Mr. Mitchell's contrived product groupings, for purposes  
11 of separate (subclass) institutional cost markups, there is at least one, far more  
12 logical grouping within ECR that could be considered as a separate "product." This  
13 consists of High-Density/Saturation flats. They clearly have very similar postal cost  
14 characteristics and they serve the same saturation advertising market. They have  
15 considerable cross-price elasticities, high own-price elasticities, and have a viable  
16 alternative to postal delivery. They differ substantially from Basic-Rate mail and  
17 differ less substantially from High-Density/Saturation letters. If Mr. Mitchell's  
18 "Product Pricing" concept is accepted by the Commission, it should, at a minimum,  
19 consider High-Density/Saturation flats as a separate "product" warranting separate  
20 markups. Far better from an efficiency standpoint, if there are any ECR "products"  
21 that the Commission believes warrant separate markups, they should be converted

---

<sup>56</sup> Mr. Mitchell agrees. Tr. 25.8951-53, -8953, -8956-57, -8977.

<sup>57</sup> Mr. Mitchell also agrees that there are Saturation-to-High-Density flat program mail cross-overs that are influenced by postal rate differences. Tr. 25-8992-93, -9030-33. He also appears to recognize that there are relatively few, if any, Saturation letter mailers that use alternate delivery services. Tr.25.8973.

1 into separate subclasses where their true costs and market/demand characteristics  
2 can be explicitly recognized.

3 **C. Mr. Mitchell’s “Product Pricing” Concept Will Not Improve Rate**  
4 **Efficiency**

5 Mr. Mitchell develops a set of ECR rates based on his proposed 177% cost  
6 coverage. However, he does not fully implement his proposed “Product Pricing”  
7 approach. Instead of marking-up the origin-entered Basic-Rate letter and flat unit  
8 costs by 177%, as he claims is appropriate, he just passes through 100% of the cost  
9 difference between the two unit costs to their minimum-per-piece rate differences.

10 Mr. Mitchell then claims that letters are not receiving favorable treatment  
11 under his rate design and uses, as proof, the following comparison of letter and flat  
12 TYBR coverages at the origin-entered Basic-Rate and origin-entered Saturation  
13 levels for his proposed ECR rates.<sup>58</sup>

	<b>ECR Letters</b>	<b>ECR Flats</b>
Origin-Entered Basic-Rate	193.1%	194.5%
Origin-Entered Saturation	290.8%	232.5%

14  
15 These comparisons, however, provide no useful information on the bias or efficiency  
16 of Mr. Mitchell’s rates for two reasons. First, regardless of which efficiency  
17 benchmark is selected, he does not make the correct comparison between cost and  
18 revenue. Second, as discussed above, his efficiency benchmark of equal cost  
19 coverages is wrong.

---

<sup>58</sup> VP-T-1, page 182.

1           **(1) Correct “Product” Cost And Revenue Comparison**

2           If one wants to compare cost coverages (markups) or unit contributions  
3 for individual “products,” the comparisons should be based on total product revenue  
4 and total product variable cost, not on the cost and revenue from one rate  
5 element/category within each “product,” as Mr. Mitchell has done.<sup>59</sup> The following  
6 shows the correct ECR letter and flat “product” comparisons using Mr. Mitchell’s  
7 proposed ECR rates:<sup>60</sup>

8                           **Cost Coverage And Unit Contributions From VP-Proposed Rates –**  
9                           **100% Letter-Flat Passthroughs To Piece Rates**

	<b>Cost Coverage</b>	<b>Unit Contribution</b>
ECR Letters	182.9%	5.7 cents
ECR Flats	188.5%	8.1 cents
Hi-Density/Saturation Letters	238.8%	6.1 cents
Hi-Density/Saturation Flats	239.5%	8.5 cents

10

11           **(2) Comparison To The Correct Efficiency Benchmark**

12           The greater cost coverage and higher unit contributions from flats  
13 indicate that Mr. Mitchell’s proposed rates diverge considerably from both the  
14 Ramsey Pricing/IER and the ECP benchmark. As discussed above, under Ramsey  
15 Pricing/IER, more price-elastic products should have lower markups/coverages  
16 compared with less price-elastic products. This means ECR flats and particularly  
17 ECR High-Density/Saturation flats should have lower markups than ECR letters.  
18 The reverse is true of Mr. Mitchell’s rates.

<sup>59</sup> As discussed in ADVO-RT-1 (pages 13-17) in R2005-1, a “product’s” total costs and total revenues must be compared. Mr. Mitchell compares only total costs of origin-entry letters and flats.

<sup>60</sup> See ADVO LR-1, WP-100-R06LR-L-84Product\_Costs.xls, VP Results w-DALs. The costs include all transportation, mail processing and delivery costs. They also include all DAL costs and revenues. If there is a conversion of roughly 75% of DALs in the test year, then Mr. Mitchell’s flat rates generate even higher flat cost coverage. Mr. Mitchell’s incorrect treatment of the Saturation flat on-piece-addressed rate is discussed in Section I above.

1 Under the ECP approach, each rate category should have an equal unit  
 2 contribution. However, Mr. Mitchell's rates clearly bias postal rates in favor of letter  
 3 competitors and to the benefit of private delivery carriers. Clearly, Mr. Mitchell's  
 4 proposed flat rates include a much larger unit contribution. In large  
 5 part, the bias against flat rates is caused by Mr. Mitchell's proposal to retain a high  
 6 pound rate while decreasing the piece rates considerably.<sup>61</sup>

7 Finally, to show the even greater distortions that implementation of Mr.  
 8 Mitchell's broader concept would generate, I have for illustrative purposes adjusted  
 9 his rate design to reflect his insistence that the ECR cost coverage of 177% (rather  
 10 than just 100%) should be applied to both the origin-entered Basic-Rate letter and  
 11 flat unit costs. If that were done, the resulting coverages and unit contributions  
 12 would be as follows:<sup>62</sup>

13 **Cost Coverage And Unit Contributions From VP-Proposed Rates –**  
 14 **177% Letter-Flat Passthroughs To Piece Rates**

	<b>Cost Coverage</b>	<b>Unit Contribution</b>
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

15 These figures assume that all DALs and DAL revenues remain in system.  
 16

<sup>61</sup> As noted in Section II, Mr. Mitchell's proposed ECR pound rate is excessive. To investigate the impact of that pound rate, his rate design was adjusted to reduce the pound rate from 64.1 cents to 55.0 cents. Making that one change, and letting the rest of his rate design accommodate it, resulted in the following:

	<b>Cost Coverage</b>	<b>Unit Contribution</b>
ECR Letters	187.2%	6.0 cents
ECR Flats	185.6%	7.9 cents
Hi-Density/Saturation Letters	245.4%	6.4 cents
Hi-Density/Saturation Flats	237.7%	8.4 cents

These should be compared to Mr. Mitchell's rates with 100% passthroughs. It shows that lowering the pound rate improves rate efficiency considerably, under either measure, but still not as much as it can be improved. WP-100-R06LR-L-84Product\_Costs.xls., VP Results w-DALs&Lower Lb Rate.

<sup>62</sup> ADVO LR-1, WP-177-R06LR-L-84Product\_Costs.xls, VP Results w-DALs.

1           This last set of results shows that Mr. Mitchell's full-blown concept yields even  
2 greater coverage and unit contribution from the so-called "flat products" and even  
3 less from the "letter products" than compared to his actual rate proposal. Using  
4 either the Ramsey Pricing (coverage) or ECP (unit contribution) benchmark, Mr.  
5 Mitchell's full "Product Pricing" implementation generates even greater bias and  
6 economic inefficiency than evident in his actual proposal.

7           Clearly Mr. Mitchell's full-blown "Product Pricing" concept, as applied to separate  
8 ECR letter and flat "products," does not improve rate efficiency and, when compared  
9 to Mr. Mitchell's flawed partial concept implementation, would further reduce rate  
10 efficiency by:

- 11           ▪ Providing incorrect price signals to mailers, advertisers and private delivery  
12 carriers,
- 13           ▪ Biasing rates for some mailer/competitors in favor of others,
- 14           ▪ Increasing rates for those portions of the subclass that are lowest cost and at  
15 most risk for diversion to private delivery alternatives, and
- 16           ▪ Encouraging inefficient entry of competitors to the Postal Service.
- 17
- 18
- 19
- 20

1 **III. VP WITNESS HALDI'S ASSERTIONS ON THE IMPACT OF CITY CARRIER**  
2 **CAPACITY CONSTRAINTS ARE UNREALISTIC**

3 Valpak witness Haldi (VP-T-2) claims that the city delivery cost of Saturation  
4 flat mail is too low and the delivery cost of Saturation letter mail has been forced  
5 upward because of the presence of Saturation flat mail. He implies that city carriers  
6 are reaching or have reached their capacity to carry out to the street what are called  
7 "sequenced bundles:" mailer-sequenced Saturation mail that has not been cased but  
8 simply taken to the route for delivery. Based on that implication, Dr. Haldi argues  
9 that:<sup>63</sup>

- 10     ▪ City carriers may have no further low-cost "sequenced bundle" capacity to  
11     handle additional (marginal) Saturation flat mailings so those mailings will be  
12     handled as higher-cost cased flats at least a portion of the time.  
13  
14     ▪ The Postal Service is "bumping" all Saturation letters to DPS processing  
15     because it wants to reserve its low-cost "sequenced bundle" capacity for  
16     Saturation flats.  
17

18     Dr. Haldi does not try to quantify the supposed "understatement" of Saturation  
19 flat city delivery cost but he makes it appear large and he implies that Saturation  
20 letter costs will increase as a result of being DPSed.

21     Dr. Haldi greatly exaggerates the capacity constraint problem and  
22 misconstrues the reason for DPSing Saturation letters. First, the Postal Service has  
23 sufficient "sequenced bundle" capacity to handle all Saturation mail suitable for such  
24 handling. Saturation flats will continue to be carried out as "sequenced bundles."  
25 Second, many Saturation letters are not suitable for "sequenced bundle" treatment  
26 because of their physical characteristics, so the Postal Service has appropriately  
27 decided to DPS as many of them as possible. This is the low-cost procedure for

---

<sup>63</sup> VP-T-2, pages 56-73.

1 Saturation letters. Although there may be some Saturation letters that could be  
2 handled as “sequenced bundles,” it would be extremely inefficient for the Postal  
3 Service, at the plant, to try to determine which Saturation letters were suitable and  
4 which were not; so the most efficient decision is to DPS all of them. The Postal  
5 Service decision to DPS Saturation letters has nothing to do with city carrier  
6 “sequenced bundle” capacity or the presence of Saturation flats. More importantly,  
7 however, as more of Saturation letters are DPSed, their average delivery cost  
8 should decline from its current level.

9 **A. The “Sequenced Bundle” Capacity Limitations**

10 City carriers usually have only two categories of mail to deliver: (1) DPSed  
11 letters provided to the carriers as they leave for their route and (2) non-DPSed  
12 letters and flats that have been cased together in a vertical flat case by the carrier.  
13 However, the mechanism for delivering this mail differs according to the type of  
14 delivery sections the carriers serve. When delivering to foot and park-and-loop  
15 delivery sections where the carriers walk to multiple delivery points, they carry each  
16 category of mail as a bundle while they walk, pulling mail for each delivery point from  
17 the bundles as needed. When delivering to other delivery sections (curbline,  
18 dismount, centralized, NDCBU), the carriers simply pull the mail from trays in their  
19 vehicle when they arrive at a delivery point (or set of delivery points). In some  
20 cases, they may take trays to a delivery point with multiple addresses (e.g., indoor  
21 centralized or NDCBU deliveries). Most carriers have more than one type of delivery  
22 point and more than one type of delivery section on their routes.

1 For foot and park-and-loop delivery sections, carriers may carry a third bundle  
2 of mailer-sequenced (uncased) Saturation mail. Due to labor agreement rules,  
3 though, they may not be required to carry more than three bundles of mail while  
4 walking. For other delivery sections, where mail is pulled from trays for delivery, the  
5 labor agreement specifies no constraint on the number of mailer-sequenced,  
6 uncased mailings the carriers may deliver.

7 **B. Dr. Haldi's Marginal Flat Delivery Cost Concern Is Exaggerated**

8 Due to the third-bundle rule for foot and park-and-loop delivery sections and  
9 the limit on the number of trays a motorized carrier can access from while still in his  
10 vehicle, Dr. Haldi implies that city carriers have reached or are on the brink of  
11 reaching their capacity to handle low-cost "sequenced bundles" and that any  
12 marginal (new) Saturation flat mailing will be cased at the higher cased flat cost.<sup>64</sup>  
13 However, unlike in his R2005 testimony, Dr. Haldi does not directly try to estimate  
14 how much higher the Saturation flat city delivery cost should be. That is left to the  
15 imagination.<sup>65</sup>

16 What Dr. Haldi chooses to ignore is the available evidence provided by the  
17 Postal Service. This evidence was provided in both this case and in R2005-1 and,  
18 since much of it was discussed in the last case and is summarized below.

---

<sup>64</sup> VP-T-2, pages 63, 65, 66.

<sup>65</sup> VP-T-2, pages 69-80.

1           **(1) USPS Techniques To Expand “Sequenced Bundle” Capacity**

2           The USPS has considerable capacity to handle all mail that, in its  
3 opinion, can be most efficiently handled as “sequenced bundle” mail:

- 4
- 5           ▪ For the curblines, centralized/cluster box, and dismount deliveries that  
6           account for over 60% of all city delivery points,<sup>66</sup> city carriers can take out  
7           multiple Saturation mailings as “sequenced bundle” mail.<sup>67</sup>
  - 8
  - 9           ▪ For park-and-loop and foot deliveries, city carriers can take out more than  
10           one Saturation flat mailing when they collate them into a single  
11           “sequenced bundle.”<sup>68</sup> However, they do not usually carry Saturation  
12           letter mailings out as “sequenced bundles” because, physically, some of  
13           them (depending upon their dimensions and weight) may be difficult to  
14           handle that way.<sup>69</sup>
  - 15
  - 16           ▪ For all deliveries, city carriers, if they have too many Saturation mailings to  
17           handle as “sequenced bundles” on one day, may defer some of those  
18           mailings to the next day or two.<sup>70</sup>

---

<sup>66</sup> R2005-1, USPS witness Lewis identified 55.7 % from curblines and centralized/cluster box deliveries. (USPS-RT-2, page 5) The percentage of dismount deliveries was not separately provided in that response. However, if 30% of deliveries on dismount routes were considered dismount, then another 5% of delivery points would be included in the above, making the figure over 60%. See also response to VP/USPS-T30-21 in R2005-1.

<sup>67</sup> VP-USPS-T44-5, -9, -17; Tr. 13.3746, 3750, 3753-3754; in R2005, see Tr.6.2420-2421 and 11.5995-5998 (Lewis). Dr. Haldi questions this ability and implies that only one “sequenced bundle” mailing may be taken out on such delivery sections (VP-T-2, pages 63-66). But he ignores the available evidence and exaggerates. Carriers have considerable flexibility in how they organize the mail within the trays they use for such delivery sections. Tr. 13.3745, 3746, 3747, 3751, 3752-53 (Coombs).

<sup>68</sup> USPS-T-44, page 13, responses to VP/USPS-T44-3, -13; in R2005, see Tr.11.5976. Valpak has questioned the ease of collating Saturation flats that may not cover every delivery point on a route. However, Ms. Coombs has explained that there are only rare occasions where a carrier may be unable to collate two sets of Saturation flats. This is because carriers know their delivery addresses and know the lists used by the program mailers in their area. Tr. 13.3757-3758.

<sup>69</sup> In R2005, USPS witness Lewis explained that it is difficult for city carriers to handle two letter bundles on foot and park-and-loop delivery sections and that carriers and their supervisors generally avoid carrying two letter bundles for such deliveries. R2005, USPS-RT-2, pages 3-4, Tr.11.5951-5954, 5975-5976, -5990, and USPS response to ADVO/USPS-9. See also responses to VP/USPS-T44-8, -9, -22 and -33 in this proceeding.

<sup>70</sup> Tr. 13.3758 and response to VP-T44-3. In R2005, response to ADVO/USPS-8 and Tr. 6.2429-6430 in R2005. There is also considerable coordination between the USPS and Saturation mailers, particularly those that mail on a regular, high frequency basis. And, some Saturation mailers accept and account for the fact that there may be not just a two-day delivery window but a three-day window for their mail, depending upon drop time and coordination arrangements.

1           **(2) Evidence Of Capacity To Handle Extra Bundles**

2           USPS witness Coombs in this case has emphasized repeatedly that  
3 city carriers only rarely have to deliver more than one Saturation flat mailing on a  
4 particular day because of the ability to defer such mailings two to three days.<sup>71</sup> Her  
5 testimony is also corroborated by the R2005 rebuttal testimony of USPS witness  
6 Lewis.

7           In R2005, Mr. Lewis conducted an informal field survey to estimate the actual  
8 number of delivery days when city delivery carriers might have to deliver more than  
9 one Saturation mailing, regardless of shape.<sup>72</sup> Based on his results (that assumed a  
10 DAL mailing was two separate “full coverage” mailings), Mr. Lewis estimated that  
11 23% of the office-delivery-days had more than one “full coverage [Saturation]  
12 mailing.” Separately, he also noted that less than 44.3% of delivery points in the city  
13 carrier system were on foot or park-and-loop delivery sections.<sup>73</sup> Thus, he estimated  
14 that: “system-wide, the city delivery network appears to experience a constraint in its  
15 ability to handle sequenced full-coverage mailings as additional bundles only about  
16 10% of the time (44.3% of delivery points times 23% of days).”<sup>74</sup>

---

<sup>71</sup> Responses to VP-T44-3, -13, -17, -18, -21; Tr. 13.3750-3750.

<sup>72</sup> USPS-RT-2 and LR K-150 in R2005. His data showed that in three weeks of data collection at seventy-eight delivery offices scattered through the country, there were 791 “full coverage mailings” (i.e., Saturation mailings) over 1,328 office-delivery days. Of those 1,328 office-delivery days, 310 had more than one “full coverage mailing” that required delivery on the same day. Of those 310 days, 230 days had only a DAL-plus-wrap mailing that was considered as two “full coverage mailings” requiring delivery on the same day. The remainder of the 310 office-delivery days had two or more single-piece and/or two-piece mailings that had service commitment dates requiring them to be delivered on the same day. His result that 23% of office-delivery-days with more than one Saturation mailing figure is calculated as 310/1,328.

<sup>73</sup> See footnote 66 above.

<sup>74</sup> R2005, USPS-RT-2, page 8.

1           It should be noted that when Mr. Lewis used the term “constraint,” he meant  
2 that the carrier has two Saturation mailings to deliver to either foot or park-and-loop  
3 deliveries and he can only use three bundles. Yet, as explained repeatedly by Ms.  
4 Coombs and Mr. Lewis, in those circumstances, the carrier may be able to collate  
5 the two mailings, if they are both flat-shaped. Thus, based on Mr. Lewis’s data, the  
6 potential for casing a marginal (new) Saturation flat mailing because of a carrier’s  
7 “sequenced bundle” capacity limitation is small.<sup>75</sup>

### 8       **C.     DPSing Of Saturation Letters Is Not Caused By Saturation Flats**

9           Dr. Haldi complains that the USPS proposal to eliminate the discount for  
10 destination entry of ECR letters at DDUs will lead to a consistently higher delivery  
11 cost for Saturation letters. He blames this on the Postal Service attempt to reserve  
12 all “sequenced bundle” capacity for Saturation flats.<sup>76</sup> He misunderstands DPSing  
13 and misconstrues this issue.

#### 14           **(1)     Saturation Letters Are Not Suitable For “Sequenced Bundle”** 15           **Treatment On Many Delivery Sections**

16           As mentioned above, Saturation letters do not generally have the  
17 appropriate physical characteristics to make “sequenced bundle” treatment efficient  
18 on foot and park-and-loop delivery sections. Their relatively small dimensions and  
19 light weights make them difficult for foot and park-and-loop carriers to hold firmly in  
20 the crook of their arm, as they do with the physically larger and heavier Saturation

---

<sup>75</sup> In R2005, using the 2002 CCSTS data, I also provided evidence that the number of delivery days where a carrier might face a “third bundle” constraint is relatively small. See ADVO-RT-1, pages 33-35, and ADVO LR-2.

<sup>76</sup> VP-T-2, pages 68ff.

1 flats. And, holding the extra letter bundle between the fingers of their hand, along  
2 with the DPS bundle, is a much more difficult technique. Thus, for such delivery  
3 sections, carriers would likely case Saturation letters.<sup>77</sup> For Saturation letters  
4 delivered to those segments, DPSing will reduce their delivery costs

5 For other types of delivery sections, though, the physical characteristics of  
6 letters do not prevent them from being carried as “sequenced bundles” in the case of  
7 curblines, dismount, and centralized delivery sections. To that extent, Saturation  
8 letters, when appropriate, have benefited from the low “sequenced bundle” costs,  
9 consistent with USPS statements on this matter.<sup>78</sup>

## 10 (2) Saturation Letters Will Benefit From Increased DPSing

11 This “sequenced bundle” treatment for Saturation letters, however, will  
12 decline as more zones are converted to DPS. But this has nothing to do with the  
13 presence of Saturation flats or city carrier “sequenced bundle” capacity limitations.  
14 Rather, it is due to the fact that DPSing of Saturation letters is the lowest-cost option  
15 on many city delivery sections and on all rural routes. DPSing is an “all or nothing”  
16 approach for any one route (and likely for any one zone). It would be extremely  
17 inefficient for either a processing plant or the DDU to attempt to segregate  
18 Saturation letters by type of route and delivery section in order to send those on foot  
19 and park-and-loop delivery sections to the plant for DPSing while keeping the

---

<sup>77</sup> See footnote 69 above.

<sup>78</sup> See Tr.13.3746-3747 (Coombs) and, in R2005, response to ADVO/USPS-9.

1 remainder for “sequenced bundle” treatment.<sup>79</sup> This practical constraint underlies  
 2 the Postal Service policy of sending as much Saturation letter mail to the plant for  
 3 DPSing as possible and, now, eliminating the DDU discount for Saturation letters in  
 4 order to encourage their direct plant entry.

5 To determine the potential impact of DPSing on Saturation letters, I adjusted  
 6 the base year unit delivery cost for Saturation letters to assume 100% DPS letters.  
 7 Relative to its current unit cost, 100% DPSing provides a cost savings of close to a  
 8 penny or almost 28% of current cost.<sup>80</sup>

	<b>BY City Plus Rural Delivery Cost w/Piggybacks (Per CCS plus RCS Unit Basis)</b>
Current Saturation Letter	3.51 cents
Saturation Letter Assuming 100% DPS Treatment	2.53 cents
Current Saturation Flat (ex DAL)	3.72 cents

9 ADVO LR-1, DPS\_SavingsVP.22.REV.8.10.attach.xls, Unit Costs

10 Despite Dr. Haldi’s worry that delivery costs for Saturation letters in the future could  
 11 be higher than those for Saturation flats, there is no evidence of that occurring.<sup>81</sup>

<sup>79</sup> R2005, Tr. 11.5991-5993, -6011 (Lewis). The effort would require coordination with the DDUs, special tray and possible piece sort schemes, lower-volume DPS runs, and less full containerization – all of which could impose a considerable cost.

<sup>80</sup> This is due to three key reasons. (1) Nearly 34% of Saturation letters on city letter routes are now being cased and DPSed letters have a unit delivery cost that is more than 50% less than that for cased letters. (2) Less than 10% of Saturation letters on city routes are “sequenced bundle” mail and their city delivery cost is nearly 70% of that for a DPSed letter. (3) And, DPSed letters on rural routes are the lowest-cost mail handled by rural carriers. (USPS LR-67, VolAdj.USPS.xls, SaturationVols, and UDCMODEL.USPS.xls, 6.Rural cost; ADVO LR-1, DPS\_SavingsVP.22.REV.8.10.attach.xls)

<sup>81</sup> There may be slightly more mail processing cost for Saturation letters as a result of increased DPSing but there will also be some savings. They include: (1) dock transfer and transportation costs saved from fewer DDU-entry Saturation letters to transport back to the plant and (2) savings associated with greater DPS run volumes, fewer container handlings, and greater volumes per container. The latter would clearly make DPSing of Saturation letters a benefit to the other letters in the system.

1 **IV. VP WITNESS MITCHELL’S IMPLICATION THAT SATURATION LETTERS**  
2 **ARE SUBSIDIZING SATURATION FLATS IS SPECIOUS, SELF-SERVING,**  
3 **AND WRONG**

4 In VP-T-3, Mr. Mitchell expresses the concern that it is not fair that city  
5 carriers principally handle Saturation flats as low-cost “sequenced bundle” mail while  
6 Saturation letters are handled either as higher-cost DPS or cased mail. He raises  
7 the specter of “cross-subsidy” and asks for redress from the Commission.

8 Mr. Mitchell’s concern is based on Dr. Haldi’s claim that Saturation letters  
9 have been permanently bumped to DPSed status, in favor of Saturation flats that will  
10 continue to be delivered as “sequenced bundle” mail. According to Dr. Haldi, if  
11 Saturation flats did not exist, Saturation letters would be treated as low-cost  
12 “sequenced bundle” mail by city letter carriers. But instead, according to Dr. Haldi,  
13 they are handled as higher-cost cased and DPSed mail.

14 I explain in the previous section the reasons why Dr. Haldi’s argument is  
15 incorrect and that, in fact, Saturation letters will benefit from being DPSed. But Mr.  
16 Mitchell’s “fairness” argument is so specious that it warrants comment. Indeed, his  
17 argument in VP-T-3 contradicts his own test of “fairness” in VP-T-1. In the latter, he  
18 contends that if rates for a category of mail exceed their stand-alone costs, then that  
19 mail is being treated unfairly. For Saturation flats in particular, he explains his belief  
20 that their rates exceed stand-alone costs and are, themselves, being treated unfairly  
21 (burdened with costs from other mail categories).

22 Although he acknowledges that treating Saturation flats, rather than  
23 Saturation letters, as “sequenced bundles” generates the greatest overall system

1 cost savings,<sup>82</sup> Mr. Mitchell states that he believes that Saturation letter mailers will  
2 “find it in their interest to say.”<sup>83</sup>

3 . . . We are subsidizing the saturation flats. If they were not here, our rates  
4 would be lower. We were expecting to share in economies of joint product,  
5 and we have been hurt instead. This is not fair.

6  
7 Mr. Mitchell then proceeds to explain the incremental cost test for a cross-  
8 subsidy. In the incremental cost for a subclass or specified grouping of mail (such  
9 as Saturation flats), revenues lost must exceed the system-wide cost saved if that  
10 subclass or grouping is eliminated, in order for that subclass or grouping to be  
11 subsidy-free. He states that fairness requires that there be no cross-subsidies.<sup>84</sup>

12 Although he does not implement the incremental cost test, he proposes  
13 “potential solutions” to his contention that Saturation letters are being treated  
14 “unfairly.”<sup>85</sup>

- 15       ▪ Impose a delivery cost on both Saturation letters and Saturation flats as  
16       though neither were carried as an extra bundle and then let any benefits  
17       from extra bundles accrue to Saturation pieces as a group.  
18       ▪ Impose a delivery cost on both Saturation letters and flats as though both  
19       were carried as an extra bundle.  
20

21  
22 He proposes that the Commission consider these fairness issues, perhaps through a  
23 special inquiry or rulemaking.

---

<sup>82</sup> VP-T-3, pages 4 (lines 3-5), 7-8, 9.

<sup>83</sup> VP-T-3, pages 8-9.

<sup>84</sup> VP-T-3, pages 10-11.

<sup>85</sup> VP-T-3, page 12.

1 **A. Saturation Letters Are Not Subsidizing Saturation Flats**

2 Mr. Mitchell's subsidy contention can be disproved by assuming the extreme  
 3 case under Dr. Haldi's argument: absent Saturation flats, Saturation letters would  
 4 be shifted from DPS processing so that some may be delivered as "sequenced  
 5 bundles." Under that incorrect assumption, the incremental costs of Saturation flats  
 6 would include not only the actual operational costs of the flats themselves, but also  
 7 the cost difference between the actual Saturation letter costs and Saturation letter  
 8 costs incurred if Saturation flats were not present in the system. However, even in  
 9 this extreme example, Mr. Mitchell is incorrect.

10 The table below compares Saturation flat revenues to costs under the  
 11 extreme assumption that all Saturation letter mail processing and delivery costs are  
 12 "caused" by the presence of Saturation flats (i.e., could be eliminated if Saturation  
 13 flats did not exist).

14 **TYBR Volumes, Costs and Revenues (000s)**  
 15 **– ECR/NECR Commercial and Non-Profit**

	<b>Sat Letters</b>	<b>Sat Flats</b>
Mail Processing Cost (Section_IV_LR L-84.xls)	\$39,068	\$64,193
City plus Rural Delivery Cost (AC-UDCModel.USPS)	143,364	568,072
Total MP plus Delivery Cost	182,432	632,265
All Letter and Flat MP and Delivery Cost Assigned to Flats Only		814,697
Roug Estimate of All Other Flat Costs		100,000
TYBR Incremental Letter and Flat Cost (USPS-T-18, Table 1A, factor of 1.0291)		941,315
USPS Proposed Revenues (USPS LR-L-36)		1,854,308
Mitchell Proposed Revenues		1,486,420

16 All spreadsheets in ADVO LR-1. These figures assume all DALs remain in the system

17

1 As can be seen, the proposed revenues from Saturation flats, either under the  
2 USPS proposal or under Mitchell's proposal, more than cover the incremental cost of  
3 both Saturation flat and letter mail processing plus delivery (\$941,315,000). Thus,  
4 Saturation letter mailers cannot possibly be subsidizing Saturation flat rates or claim  
5 that they are being treated "unfairly."

6 Further, contrary to the putative Saturation letter mailers' "complaint," the  
7 table indicates that the presence of Saturation flats in the system makes a much  
8 larger contribution to institutional cost than indicated under this extreme case. This  
9 large Saturation flat contribution means that all other mail, including Saturation  
10 letters, benefit from the presence of Saturation flats in the system. In other words, if  
11 all Saturation flats were eliminated from the system, rates for other mail categories,  
12 including possibly Saturation letters, would need to increase to absorb the  
13 contribution loss. That would lead to volume decreases that would further  
14 exacerbate the initial contribution loss and contribute to an increasing rate spiral.

15 **B. Mr. Mitchell's Own Stand-Alone Cost Arguments Imply That Saturation**  
16 **Flats Are Burdened by Mail From Other Rate Categories**

17 Mr. Mitchell's implication that Saturation flats are being subsidized in some  
18 way by Saturation letters contradicts his arguments that ECR rates, particularly  
19 those for Saturation flats, may exceed their stand-alone costs.<sup>86</sup> He points out that  
20 the presence of a considerable amount of private delivery of saturation advertising  
21 implies that the standalone delivery of Saturation flats is viable at a cost that is lower  
22 than the postal Saturation rate. In particular, private carriers deliver mostly pieces

---

<sup>86</sup> VP-T-1, pages 57-60 and 82-85.

1 that are eligible to be mailed as High-Density/Saturation flats, not letters.<sup>87</sup> Mr.

2 Mitchell states:<sup>88</sup>

3 . . . it is presumed to be unfair for a product to end up with a rate that is higher  
4 than the rate that would be possible if a stand-alone organization were set up  
5 to produce only the product in question.

6

7 In other words, Mr. Mitchell's argument in VP-T-1 that Saturation (flat) rates may

8 exceed stand-alone Saturation (flat) average cost is contradictory to his specious

9 argument in VP-T-3 that Saturation letters may subsidize Saturation flats.<sup>89</sup>

10

---

<sup>87</sup> Testimony of Pete Gorman, SMC-T-1, page 4. Mr. Mitchell also acknowledges this fact. Tr.25.8973

<sup>88</sup> VP-T-1, page 58, lines 10-12.

<sup>89</sup> See also response to USPS/VP-T1-16 where he explains that the stand-alone test identifies cross-subsidies – i.e., if a product's rate is greater than its stand-alone cost, then it is subsidizing another product. And, Mr. Mitchell states that it is “. . . unfair for the rates of a product produced within a joint operation to be higher than they would be if the same product were produced in a separate, stand-alone operation.”



1 carrier-out-of-office costs and third-class/fourth-class Bound Printed Matter drop-ship  
2 discounts, and I also prepared and presented rebuttal testimony on third-class  
3 presort discounts. In Dockets C89-3/MC89-1, I helped prepare and presented direct  
4 testimony on the proposed local saturation subclass. In Docket R90-1, I assisted in  
5 preparation of city carrier out-of-office cost and institutional cost coverage testimony  
6 and prepared and presented rebuttal testimony on third-class rates. In the R90-1  
7 Remand, on behalf of a third-class mailer's group, I presented two pieces of rebuttal  
8 testimony in Docket R94-1 and rebuttal testimony in MC95-1. In Docket R97-1, I  
9 presented testimony in response to Presiding Officer's Notice of Inquiry No. 3 on city  
10 delivery carrier load time costs and rebuttal testimony on carrier costs and rate  
11 design issues. In Docket R2000-1, on behalf of several mailers and mailing groups,  
12 I presented testimony on city delivery carrier costs. I also presented rebuttal in that  
13 docket concerning ECR rates. In Docket R2005-1, I presented rebuttal on ECR  
14 rates.

15 Over the course of my nearly 30-year involvement in postal ratemaking  
16 matters, I have had numerous opportunities to observe postal operations and  
17 analyze their cost aspects. I have also become familiar with economic costing and  
18 pricing concepts, both generally and as applied to postal ratemaking.

19 My education includes a B.S. in Biology from the University of Virginia, an  
20 M.S. in Biology from George Mason University, and additional course work in  
21 economics, mathematics, and statistics.