

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

DIRECT TESTIMONY OF JOHN P. KELLEY ON BEHALF OF THE UNITED STATES  
POSTAL SERVICE (USPS-T-15) - FINAL (August 14, 2006)

The United States Postal Service hereby files the final Direct Testimony of John P. Kelley on behalf of the United States Postal Service (USPS-T-29). This final testimony incorporates errata filed on July 27, 2006.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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**AUTOBIOGRAPHICAL SKETCH**

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My name is John P. Kelley. I am an economist in the Finance department at Postal Service Headquarters. I testified on costing issues regarding delivery and transportation in Docket No. R2005-1. I have been employed by the Postal Service since 1997. Prior to joining the Postal Service, I was employed as a statistician at the American Petroleum Institute as well as the Bureau of Labor Statistics. I received a B.S. in mathematics education from University of New Hampshire in 1986 and a M.A. in mathematics from Indiana University in 1990.

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**SPONSORED LIBRARY REFERENCES**

The following Library References are sponsored in my testimony:

**USPS-LR-L-35** Calculation of FedEx Day Turn Variability Factors

**USPS-LR-L-39** Distance Related Transportation Costs

**USPS-LR-L-40** Alaska Highway Costs

1 **I. PURPOSE AND SCOPE OF TESTIMONY**

2 The purpose of my testimony is to describe methodologies used in the following  
3 four analytical areas:

- 4     ▪ FedEx Day Turn Variability Model
- 5     ▪ Distance Related Transportation Costs
- 6     ▪ Alaska Highway Costs
- 7     ▪ Alaska Air Adjustment

8 **Inputs and Outputs by Section**

9 Below I list the inputs, and how the output is used for each library reference that I  
10 am sponsoring.

11 **i. FedEx Non-Fuel Transport Variability Factors – USPS-LR-L-35**

12 **Inputs**

13 None

14 **Outputs**

15 CRA Workpapers (USPS-LR-L-5) for witness Milanovic (USPS-T-9)

16 **ii. Distance-Related Transportation Costs – USPS-LR-L-39**

17 **Inputs**

18 CRA Workpapers (USPS-LR-L-5) from witness Milanovic (USPS-T-9)

19 **Outputs**

20 Roll Forward for Witness Waterbury (USPS-T-10)

21 Priority Mail Rate Design for Witness Scherer (USPS-T-33)

22 Express Mail Rate Design for Witness Berkeley (USPS-T-34)

23 Periodical Mail Rate Design for Witness Tang (USPS-T-35)

24 **iii. Alaska Highway Costs – USPS-LR-L-40**

25 **Inputs**

26 None

27 **Outputs**

28 CRA Workpapers (USPS-LR-L-5) for witness Milanovic (USPS-T-9)

29

1 **II. FEDEX NON-FUEL TRANSPORT VARABILITIES FOR DAY TURN**

2 The Postal Service contracts with FedEx to carry mail on its Day Turn network.  
3 Under the contract, the Postal Service incurs expenses relating to a variety of activities  
4 provided by FedEx. These expenses fall into three categories: handling; fuel; and non-  
5 fuel transport. Handling charges are incurred for each item handled and scanned at  
6 FedEx hubs. These are treated as fully variable with volume because the expenses  
7 increase proportionately with the number of scans. Similarly, a fuel charge is assessed  
8 for each cubic foot of capacity purchased. Since increases in mail volume result in  
9 proportionate increases in cubic feet of capacity required to handle the volume, fuel  
10 charges are also treated as fully variable with volume. As the contract was originally  
11 written, non-fuel transport charges were incurred at a fixed rate per cubic foot of  
12 capacity purchased. As with handling and fuel charges, these were treated as fully  
13 volume variable. In the fall of 2001, the Postal Service complied with a directive issued  
14 by the Transportation Security Agency to remove all mail in excess of a certain weight  
15 that had not been subjected to a pre-boarding security screening. This change resulted  
16 in a substantial increase in the cubic volume of mail flown on the FedEx Day Turn  
17 network. As a result, there have been addenda to the contract. Currently, instead of a  
18 flat rate for each cubic foot of capacity purchased, the addenda features a declining  
19 block rate structure. Throughout the base year, a declining block rate structure has  
20 been in place.

21 After a certain cubic capacity threshold is reached, the non-fuel transport charge  
22 for additional capacity decreases by a fixed amount to a lower rate per cubic foot. As  
23 more capacity is added and higher thresholds are reached the rate steps down. This

1 rate structure results in a marginal cost that declines with increases in capacity  
2 purchase. This means that in the higher tiers, the marginal cost is less than the  
3 average cost. The implication for the variability is straightforward. Volume variability is  
4 defined as the cost elasticity with respect to volume. When there is a single cost driver,  
5 the variability can be shown to equal the ratio of marginal cost (MC) to average cost  
6 (AC). Said otherwise, when  $MC < AC$  then the variability  $\frac{MC}{AC}$  is less than one.

7         Witness Bradley in Docket No. R2005-1 (USPS-T-31, Section II) presented the  
8 analytical method for calculating a variability when costs are characterized by declining  
9 block rates. On the basis of this theoretical construct, I will describe the development  
10 and application of the variability using FedEx operational and contractual data. The  
11 calculation of the variability is conceptually straightforward. Using actual invoicing data,  
12 I calculate the average daily cubic volume of mail by FedEx schedule **period**.<sup>1</sup> I then  
13 flow the schedule **period** average daily volumes through the rate tiers to determine the  
14 marginal cost. The marginal cost is simply the last tier rate. To find the variability, this  
15 marginal cost is multiplied by the average daily volume and then divided by the total  
16 cost for transporting the entire average daily volume based on the declining rate  
17 structure.

18         The variability calculation takes into account any changes in rates that may be  
19 due to new addenda, changes due to scheduled annual increases in contract rates,  
20 differences in rates and volumes for weekday service and weekend service, and a  
21 ceiling placed on additional expenses incurred by applying the annual scheduled  
22 increases to the rate tiers. Using this calculation, I derive the marginal cost of non-fuel

<sup>1</sup> FedEx schedule **periods** are the periods of time over which the Postal Service calculates tier based payments.

1 transport and the average of non-fuel transport for each schedule **period**. Aggregating  
2 across quarters, I calculate the quarterly marginal and average costs. The variabilities  
3 that result from this calculation are 0.7409, 0.7356, 0.7229, and 0.7583 for quarters one  
4 through four respectively. These factors are applied to the accrued costs for non-fuel  
5 transport charges in the Cost Segment 14 Excel workbook on the 'Inputs – Variabilities'  
6 worksheet which is used in the CRA Workpapers (USPS-LR-L-5) sponsored by witness  
7 Milanovic (USPS-T-9) These calculations are described in USPS-LR-L-35.

8         When the variability is less than one, there will be some non-volume variable  
9 costs incurred in the provision of the network. Witness Bradley (USPS-T-14) has  
10 explained that these non-volume variable costs should be included in the incremental  
11 costs of the group of products that caused the FedEx Day Turn network to arise.  
12 Witness Pajunas (USPS-T-45) indicates that the FedEx Day Turn network was created  
13 for the transportation of First Class Mail and Priority Mail. As a result, the non-volume  
14 variable cost of the FedEx Day Turn network are included in the incremental cost for the  
15 product group that comprises of First Class Mail and Priority Mail. Refer to USPS-LR-L-  
16 72 sponsored by witness Pifer (USPS-T-18) for more information about the incremental  
17 cost for the product group comprised of First Class Mail and Priority Mail.

18         To the extent that, in response to Commission Rule 53, I discuss and compare  
19 PRC versions of transportation costs, I do not sponsor those materials, or in any way  
20 endorse the methodologies used to prepare them. In its Order No. 1380 adopting the  
21 roadmap rule, the Commission included the following statements regarding the role  
22 played by Postal Service witnesses under these circumstances:

23                 The comparison required by this exercise cannot be equated with  
24                 sponsoring the preexisting methodology. It merely identifies and

1 gives context to the proposed change, serving as a benchmark so  
2 that the impact can be assessed. ... [W]itnesses submitting  
3 testimony under Rule 53(c) sponsor the proposed methodological  
4 changes, not the preexisting methodology. That they may be  
5 compelled to reference the preexisting methodology does not mean  
6 that they are sponsoring it.  
7

8 Order No. 1380 (August 7, 2003) at 7. Therefore, although I may be compelled  
9 to refer to the PRC methodologies and versions corresponding to the Postal Service  
10 proposals which are the subject of my testimony, my testimony does not sponsor those  
11 PRC materials.

12 The PRC version of cost segment 14 (USPS-LR-L-93) differs from the USPS  
13 version because the PRC version has a volume variability factor of one for non-fuel  
14 transport charges on the FedEx Day Turn network.

1 **III. DISTANCE-RELATED TRANSPORTATION COSTS**

2 In this section of my testimony, I sponsor USPS-LR-L-39. A required input for  
3 USPS-LR-L-39 is the CRA Workpapers (USPS-LR-L-5) report sponsored by witness  
4 Milanovic (USPS-T-9). USPS-LR-L-39 is used by the following witnesses: Waterbury  
5 (USPS-T-10) for Roll Forward; Scherer (USPS-T-33) for Priority Mail rate design;  
6 Berkeley (USPS-T-34) for Express Mail rate design; and Tang (USPS-T-35) for  
7 Periodical Mail rate design.

8 The rate designs for certain zone-related products rely the distinction between  
9 distance and non-distance-related transportation costs. The calculation of these costs  
10 follows the Commission's methodology used in prior cases. The base year calculations  
11 appear in an Excel workbook titled LR-K-39.xls as part of USPS-LR-L-39. Base year  
12 FedEx network costs are treated as non-distance-related in light of the fact that there is  
13 no mileage component to the rates FedEx charges for transportation service.

14 The PRC version of Distance Related Transportation Costs (USPS-LR-L-118)  
15 differs from the USPS version due to the different volume variability factor that is applied  
16 to the costs incurred by non-fuel transport charges on the FedEx Day Turn network.  
17 The PRC version uses a factor of one and the USPS version applies a factor less than  
18 one. USPS-LR-L-35 describes the manner in which the USPS version derives this  
19 factor.

1 **IV. ALASKA HIGHWAY COSTS**

2 Calculation of the Alaska Highway Costs is presented in USPS-LR-L-40. These  
3 are the costs of certain Alaska Highway contracts which are removed from the Intra-  
4 BMC cost pool and placed in a separate cost pool. These costs continue to be  
5 distributed based on the combined cost distribution of Inter-BMC and freight rail. Library  
6 Reference USPS-LR-L-40 contains the source documents and the quarterly  
7 aggregation of costs that constitute the Alaska Highway cost pool that are used.

1 **V. ALASKA AIR ADJUSTMENT**

2       The base year and test year Alaska Air adjustment factor is 0.0702. This is the  
3 same factor that was used in Docket No. R2005-1. The data required to update the  
4 factor was unavailable. For a description of the procedures used to derive the factor  
5 used in Docket No. R2005-1 refer to USPS-LR-K-36 sponsored by witness Nash  
6 (USPS-T-17).

## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

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August 14, 2006

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