

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS O'HARA
TO INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC.
AND VALPAK DEALERS' ASSOCIATION, INC.,
(VP/USPS-T31-1))

The United States Postal Service hereby files the response of witness O'Hara to above-listed interrogatory, filed on May 18, 2006.

The interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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VP/USPS-T31-1.

Please refer to page 13 of your testimony (USPS-T-13), at lines 16-19, where you say: "It is also worth noting that as the degree of preparation increases over time, all else equal, the coverage required to obtain the same contribution also increases. This is true for the system as a whole as well as for an individual subclass." You then go on to provide a numerical, but hypothetical, illustration of this phenomenon.

- a. Have you done any analysis of the absolute or the relative changes in the degrees of worksharing in the various subclasses of mail over time? If so, please present that analysis with its conclusions.
- b. The Commission provided a paper entitled, "Pricing Repositionable Notes (RPN) for Use in Postal Delivery Services: An Economic Analysis," by Professor Frank A. Wolak, dated January 16, 2006. See Docket No. MC2004-5, PRC-LR-1 Revised. In it, Professor Wolak looked to measures of consumers surplus for guidance on how RPNs should be priced. In other situations, the Commission has given weight to notions of efficient component pricing, which focus on getting the lowest-cost provider to do the work. Also, attention has also been given to the effectiveness of signals sent to mailers in rates and to the importance of marginal costs to the efficiency of resource allocation. Are you aware of any references to economic theory or to the economic literature which point to the efficacy of maintaining "the same contribution [on a per-unit basis]" from a subclass over time, as the costs of that subclass change? If you are, please provide those references.
- c. Please consider the following statement, not taken from any particular source: Requiring a pre-determined level of contribution from a subclass, either in total or on a per-piece basis, is an exercise akin to the schemes used by practitioners of fully distributed costing. Doing so is anathema to the economic principles of ratesetting, as it is a subtle way of identifying what appears to be responsibility and at the same time of diverting attention from pertinent factors that should guide decision making. It should be rejected on its face.
 - (i) Please indicate whether you agree or disagree with this statement, and explain the basis for any disagreement.
 - (ii) If you disagree with this statement, please provide references to economic concepts or literature pointing to any benefits you believe would result from adopting such a focus on maintaining contribution.
- d. Please suppose, in period 1, mailers submit mail requiring a wide range of services, including sorting, transporting, and delivering. Assume the Postal Service has adjusted its facilities and equipment to provide the desired services efficiently. Within the framework of this set of facilities and equipment, the Postal Service estimates its marginal costs, arrives at a level of total volume variable costs, and determines as a residual the level

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- of its institutional costs. Now, please suppose, in period 2, the only changes are that mailers submit their mail downstream, and that it requires much less sorting and transporting. As would be expected, assume the Postal Service modifies its facilities and equipment to provide the reduced level of services efficiently. Within this modified framework of facilities and equipment, the Postal Service again estimates its marginal costs, arrives at a level of total volume variable costs, and determines as a residual the level of its institutional costs.
- (i) Please provide any bases you have for expecting that the level of institutional costs in the second period would be higher than, would be the same as, or would be lower than the level of institutional costs in the first period.
 - (ii) If you do not have any bases for forming expectations, even qualitatively, do you have any bases for ruling out certain outcomes? If so, please explain any such bases and point to any way you believe the outcome would be constrained.
- e. Please suppose a firm in a certain city is providing delivery services in competition with the Postal Service, and the arrangement is that customers prepare their mail in a certain way and bring it to that city. The firm bases its rates on its direct costs and a level of contribution it believes workable. Please suppose also that the Postal Service's competing product is one that has, over the last five years, become highly workshared, due to investments by mailers in preparation activities and downstream entry. Please explain the extent to which you believe the appropriate competitive posture for the Postal Service in this situation would be to set rates equal to current costs plus a pre-determined contribution rooted in circumstances now five years old.
- f. In Docket No. MC95-1, Postal Service witness McBride, in regard to the then proposed ECR subclass, said: "As the Postal Service is faced with increasing competition for hard copy delivery, the most likely incursions into the existing customer and volume base will occur in those areas where the unit cost for delivery is less than the average but is not adequately reflect in price, giving competitors an opportunity to price their services to attract the lower cost Postal Service products out of the mailstream." USPS-T-1, p. 29, ll. 16-21.
- (i) Please explain any extent to which you disagree with this quote from witness McBride.
 - (ii) It could be suggested that your prescription for developing rates is one of preserving legacy contribution levels and "giving competitors an opportunity to price their services to attract the lower cost Postal Service products out of the mailstream." Please explain any extent to which you disagree with this suggestion.

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As you note, the cited portion of my testimony is a hypothetical example; in most such examples (including this one), the critical hypothesis is “other things unchanged” or “all else equal.” This simplifies the discussion and analysis, but any real-world application of the concepts discussed will necessarily be more complicated than the example.

- a. I have done nothing that could be called analysis, but even a general familiarity with mailer response when new worksharing opportunities were offered (e.g., barcoding (or automation) and dropship discounts) suggests to me that worksharing has increased substantially over the past two decades.

- b. I know of no literature that directly addresses the Postal Service case, but maintaining the same contribution as cost change is consistent with the Efficient Component Pricing (ECP) literature, which was developed in the context of public utility regulation and can be (and has been) applied to the Postal Service.

ECP is directed at providing the right price incentives to induce customers to do a particular operation (e.g., sorting mail from the 3-digit level to the 5-digit level) whenever they can do it at less cost than the Postal Service. To continue with the 3-digit/5-digit example, this will happen if the difference between the rate for mail presorted to the 3-digit level and the rate for mail presorted to the 5-digit level is equal to the Postal Service's cost of doing the additional step itself (i.e., 100% pass-through of postal

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cost differences to rate differences.

With 100% pass-through, increased mailer performance of the sort to 5-digits within a subclass will reduce subclass costs, but leave contribution unchanged. Customers doing the 5-digit sort are rewarded by the full amount of the Postal Service savings but no more; their contribution to institutional cost does not change.

- c. (i) I disagree. Fully-distributed costing distributes "overhead" costs (or institutional cost in a Postal Service context) in proportion to various products' volume-variable or attributable costs. For the Postal Service, eight of the nine pricing criteria provide guidance on how institutional cost should be distributed, and none of these eight suggest any particular relationship between a subclass' volume-variable cost and its appropriate share of institutional cost.

(ii) Please see my response to part (b) of this question. Also, I do not recommend "(r)equiring a pre-determined level of contribution from a subclass." As explained in my response to part (f) below; I do recommend pre-existing contribution levels as a better starting point than pre-existing cost coverages for determining how the level of contribution across various subclasses should modified by the application of the eight non-cost-related pricing criteria to changes circumstances.

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- d. (i) & (ii) Since the only things that change are (1) an increase in downstream entry and (2) the Postal Service adjustments needed to provide the reduced level of service efficiently, I would expect the level of institutional cost to be the same in both periods. Institutional cost is by definition not volume-variable, the fact that it is "residual" is calculated by subtracting total volume variable cost from Total Cost. Both Total Cost and total volume-variable cost will be lower in period 2, but the difference between them will be the same as it was in Period 1 (Among "others things unchanged," perhaps the most important would be the prices the Postal Service pays for the various inputs used by activities that make up institutional cost, e.g., cost per workhour, per kilowatt hour of electricity, etc.).
- e. Determining whether or not the Postal Service should maintain a pre-existing contribution level for this subclass requires a balancing all the statutory pricing factors across all the subclasses. Although reducing the unit contribution of this subclass would reduce total contribution as well (unless the reducing would draw volume from the competitor, which seems contrary to your assumptions), the reduced contribution might be above the contribution that would result from retaining the pre-existing unit contribution. For this to be the case, a small difference in price (from reduced unit contribution) would have to have a fairly large effect on the amount mail diverted to the alternate carrier.

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I only recommend pre-existing contribution levels a good starting point for determining the appropriate distribution of contribution in light current circumstances. Major changes in the alternatives available to users of a particular subclass over the past five years may well make for greater changes in the appropriate distribution of institutional cost. The question should be decided on the basis of how shifts in the distribution will affect the various subclasses, not from a "competitive posture" targeted on maintaining volume or market share per se.

- f. (i) I agree with witness McBride; note that he refers to "areas where the unit cost for delivery is less than the average but is not adequately reflected in price" (emphasis added). The unit cost of delivery is part of a product's volume-variable cost, both for products with a below-average unit cost of delivery and for products with an above-average unit cost of delivery.
- (ii) My discussion of contribution levels is not a prescription. My objective was to demonstrate by an "all-else-equal" example that preserving legacy contribution levels may be a better starting point for adjusting rates after worksharing has increased than preserving legacy cost coverages. In this situation, starting with cost coverages from the previous rate-case means starting with a distribution of institutional cost that differs from the distribution that was determined to comply with the pricing criteria of §3622(b) in that case.

In particular, the burden of institutional cost will be shifted to subclasses with above-average cost increases. In the example, above-average cost increases resulted from below-average increases in worksharing.

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However, above-average cost increases may result from limits on worksharing opportunities (e.g., dropship discounts are not available Medial Mail), or because the Postal Service has deployed new technology that reduces costs for some subclasses but has little effect on others (e.g., letter automation for subclasses that have very few letter-shaped pieces, such a Periodicals).

I do not recommend that legacy contribution level be carved in stone. But I do think that pre-existing contribution levels provide a good starting-point for developing a new set of contribution levels that respond to new conditions.