

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

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POSTAL RATE AND FEE CHANGES  
PURSUANT TO PUBLIC LAW 108-18

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Docket No. R2005-1

RESPONSE OF UNITED STATES POSTAL SERVICE  
WITNESS SAMUEL T. CUTTING TO INTERROGATORY OF  
VALPAK DIRECT MARKETING SYSTEMS, INC, AND VALPAK  
DEALERS' ASSOCIATION, INC. (VP/USPS-T26-2)  
(June 3, 2005)

The United States Postal Service hereby files the response of witness Samuel T. Cutting interrogatory VP/USPS-T26-2, submitted on May 20, 2005.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

**VP/USPS-T26-2.** Please refer to file LR-K-107.xls of library reference USPS-LR-K-107, sheet "CompTab," Table 9, showing dropship-adjusted mail processing costs for the various categories of Standard ECR mail, and showing results at USPS and PRC costing (located in columns C and D, respectively, of the spreadsheet file).

- (a) Are these costs for (i) commercial ECR, (ii) Nonprofit ECR, (iii) a weighted average of the two, or (iv) something else (if so, please explain)? If separate costs for commercial ECR and Nonprofit ECR are available, please provide them.
- (b) At PRC costing, please consider the 3.431-cent cost of "Basic Letters" and the 3.115-cent cost of "Basic Flats." Please explain (i) the mail processing represented by these costs in step-by-step fashion, identifying the differences in the physical and preparation characteristics of the two mailstreams involved, and (ii) why the cost of ECR Basic letters is higher than the cost of apparently corresponding ECR Basic flats.
- (c) For the same costs referenced in preceding part b, please explain the costing procedures in step-by-step fashion through which they are developed, highlighting any ways in which the development for ECR Basic letters is different from the development for ECR Basic flats.
- (d) At PRC costing, the cost of ECR Basic letters is 1.101 times the cost of ECR Basic flats, as referenced in preceding part b (3.431/3.115). This counterintuitive outcome is even more pronounced at USPS costing, with the cost of ECR Basic letters becoming 1.307 times the cost of ECR Basic flats (3.776/2.889). Please explain what it is about USPS costing that makes this seemingly adverse outcome so much more pronounced.
- (e) At USPS costing and separately at PRC costing, please discuss the extent to which the cost estimates presented are estimates of marginal costs, including clear statements of any assumptions that are required to reach the conclusion that the estimates are estimates of marginal costs.
- (f) If the USPS cost estimates are not estimates of marginal costs, please (i) discuss the costing theory that guides them, and (ii) provide any estimates of marginal costs that are available.
- (g) Please explain the extent to which you would describe either the PRC costs or the USPS costs as bottom-up mail processing costs of the categories. If they are not in any sense inherent, as-is, or bottom-up costs, and instead are constrained in any way to have a constant mix or a constant profile, please explain the nature of the constraints.
- (h) One might expect pieces being delivery point sequenced ("DPS'd") to have higher mail processing costs and lower carrier in-office costs than if they were not DPS'd, and that the sum of these two costs would be lower, yielding the benefits of technology to the mailers using the DPS'd categories. Consistent with this expectation, it seems noteworthy that the mail processing costs shown for

RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

“Auto Basic Letters” (the category seemingly most likely to be DPS'd) are in all cases lower than the costs of “Basic Letters.” With these thoughts in mind:

- i. Please explain the role and influence of delivery point sequence procedures on the costs for all of the categories shown in Table 9, providing any available proportions of the categories that are DPS'd.
- ii. Please explain whether any of these proportions would be expected to change in the test year.

**RESPONSE:**

(a) As a result of Public Law No. 106-384, which was passed in October 2000, the Postal Service no longer collects or develops separate and distinct unit cost estimates for the Standard Mail commercial and nonprofit rate categories. Hence, the results developed in USPS-LR-K-84 (Postal Service version) and USPS-LR-K-107 (PRC version) represent a composite of commercial and nonprofit cost estimates.

(b) There are several reasons why the mail processing unit cost of Basic ECR letters (non-automation rate) is greater than that of Basic ECR flats. Some reasons are associated with differences in mail processing operations, while others are tied to differences brought about by incentives in the Standard Mail rate structure. Please see the response to POIR No. 3, Question 3(c) for further discussion of these issues.

(c) The procedures for the derivation of all cost estimates by ECR rate category and shape are described in USPS-LR-K-84 (Postal Service version) and USPS-LR-K-107 (PRC version). Within these procedures, Basic ECR letters and Basic ECR flats receive the same treatment. For each rate category and shape, IOCS tallies are used to

RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

develop base year mail processing costs. These costs are converted to test year levels using test year cost factors (piggyback factors, reconciliation factors, etc.), some of which are specific to cost pools and some of which are specific to the Standard Mail ECR subclass. The RPW system is used to develop base year volumes, which are converted to test year levels using the test year volume ratio specific to the Standard Mail ECR subclass. The resulting unit costs for each rate category and shape are adjusted for dropship cost avoidances using de-averaged data by shape and dropship entry point.

(d) Please see the response to POIR No. 3, Question 3(c) for a discussion of reasons why the unit cost of Basic ECR letters is higher than the unit cost of Basic ECR flats. As for why the difference is more pronounced in the Postal Service version than the PRC version, about half of the difference is due to differing mixed mail and not handling mail distribution methodologies, about a quarter of the difference is due to the PRC version having cost pool controls at the subclass level but not at the shape level, and the remaining difference is due to miscellaneous factors such as differing cost pool variabilities, test year cost factors, and dropship cost avoidances.

(e) The unit cost estimates in USPS-LR-K-84 (Postal Service version) and USPS-LR-K-107 (PRC version) are unit volume-variable costs which are equivalent to economic marginal costs. Please see the response to VP/USPS-T2-3 and VP/USPS-T2-11, as

RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

well as Appendix H of USPS-LR-K-1, for further discussion of marginal costs.

(f) N/A.

(g) The cost estimates in USPS-LR-K-84 (Postal Service version) and USPS-LR-K-107 (PRC version) are "bottom up" as defined in Docket No. R97-1, VPCW-T-1 at 10. In particular, the volume-variable costs that are calculated for each ECR rate category and shape can be added together to arrive at the CRA mail processing cost total for the Standard Mail ECR subclass as a whole. None of the disaggregated cost estimates is based on the subtraction of avoided cost from a base cost total as would be the case for "top down" costing.

(h) Although automation ECR letters ("Auto Basic Letters") are likely to undergo DPS processing, keep in mind that a significant portion of Basic ECR letters ("Basic Letters") also undergoes DPS processing. This is because Basic ECR letters are often captured at and/or backhauled to the plant for DPS processing. Delivery units work closely with plants to identify machinable ECR letter bundles and trays to incorporate these pieces into the DPS mail stream rather than having these pieces manually cased at the delivery unit. Hence, as explained in more detail below, DPS processing may not be the predominant reason for the measured cost differential between automation ECR letters and Basic ECR letters.

RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

Also, keep in mind that the cost estimates for USPS-LR-K-84 (Postal Service version) and USPS-LR-K-107 (PRC version) are for clerk and mail handler mail processing only. No costs for in-office carrier activities are included in these estimates (e.g., casing mail). Thus, if DPS processing were a major driver for the cost differential between these two categories, one would expect the mail processing unit cost for automation ECR letters to be *higher* (due to the extra clerk and mail handler cost) than the unit cost for Basic ECR letters.

(i) The clerk and mail handler sortation costs for mail pieces that are being delivery point sequenced are found in the mail processing cost pools associated with DBCS and DIOSS machines. Some of these cost pools, however, also account for non-DPS sortation on DBCS and DIOSS machines such as outgoing processing and incoming primary processing. As such, the information within USPS-LR-K-84 (Postal Service version) and USPS-LR-K-107 (PRC version) cannot be used to isolate the sortation cost of DPS activities alone.

Nevertheless, examining the costs within these cost pools may suggest a rough approximation of DPS processing costs for each disaggregated category. These levels are reported in the table below. The shares of DBCS/DIOSS costs for automation ECR letters and Basic ECR letters are highlighted in gray.

RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

**Standard Mail ECR Mail Processing Costs /1  
Test Year 2006**

**USPS-LR-K-84 (USPS Version) /2**

ECR Rate Category & Shape	Costs (\$000)			Shares		
	DBCS & DIOSS	All		DBCS & DIOSS	All	
	/4	Other	Total	/4	Other	Total
Auto Basic Letters	8,088	23,237	31,326	25.8%	74.2%	100.0%
Basic Letters	14,979	64,227	79,206	18.9%	81.1%	100.0%
High Density/Saturation Letters	14,132	23,312	37,444	37.7%	62.3%	100.0%
Basic ECR Flats	4,411	301,225	305,635	1.4%	98.6%	100.0%
Basic ECR Parcels	7	16,174	16,182	0.0%	100.0%	100.0%
High Density/Saturation Flats	58	46,194	46,252	0.1%	99.9%	100.0%
High Density/Saturation Parcels	17	1,177	1,194	1.4%	98.6%	100.0%
<b>Total</b>	<b>41,693</b>	<b>475,546</b>	<b>517,239</b>	<b>8.1%</b>	<b>91.9%</b>	<b>100.0%</b>

**USPS-LR-K-107 (PRC Version) /3**

ECR Rate Category & Shape	Costs (\$000)			Shares		
	DBCS & DIOSS	All		DBCS & DIOSS	All	
	/4	Other	Total	/4	Other	Total
Auto Basic Letters	10,472	22,096	32,568	32.2%	67.8%	100.0%
Basic Letters	16,334	55,113	71,447	22.9%	77.1%	100.0%
High Density/Saturation Letters	16,605	24,097	40,702	40.8%	59.2%	100.0%
Basic ECR Flats	3,879	322,646	326,526	1.2%	98.8%	100.0%
Basic ECR Parcels	0	15,233	15,233	0.0%	100.0%	100.0%
High Density/Saturation Flats	0	63,877	63,877	0.0%	100.0%	100.0%
High Density/Saturation Parcels	0	1,753	1,753	0.0%	100.0%	100.0%
<b>Total</b>	<b>47,290</b>	<b>504,815</b>	<b>552,105</b>	<b>8.6%</b>	<b>91.4%</b>	<b>100.0%</b>

Notes:

/1 Test year piggyback factors and cost ratios applied; dropship cost avoidances not removed.

/2 Source: USPS-LR-K-84, Workbook LR-K-84.xls, Worksheet 'Summary TY Data.'

/3 Source: USPS-LR-K-107, Workbook LR-K-107.xls, Worksheet 'Summary TY Data.'

/4 Cost pools: BCS/DBCS, N\_Auto, and LD41 (PRC version only).

Although the proportion of DBCS/DIOSS costs for automation ECR letters is somewhat

RESPONSE OF POSTAL SERVICE WITNESS CUTTING TO  
INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC  
AND VALPAK DEALERS' ASSOCIATION, INC

higher (25.8 – 32.2 percent) than the proportion for Basic ECR letters (18.9 – 22.9 percent), it seems unlikely that this difference substantially influences the unit cost differential. Perhaps a more plausible driver is that the population of Basic ECR letters may contain a large amount of non-machinable pieces and pieces that lack the necessary address elements to enable the application of a barcode. This is a result of the Standard Mail rate structure which encourages customers to prepare letter mail to qualify for automation rates (either 5-digit presort or automation ECR) rather than the Basic ECR rates when possible. Thus, of the letters that remain under Basic ECR rates, the portion that is not captured at and/or backhauled to the plant for DPS processing is likely to be made up of pieces that have characteristics that make them more costly to process.

(ii) As noted above, a portion of the costs of the DBCS/DIOSS cost pools is associated with DPS processing. The test year cost level of these cost pools is a function of the test year cost ratios as developed by witness Smith, USPS-T-13. These ratios are developed to reflect or approximate wage escalation, mail volume changes by subclass, and cost reductions and other program adjustments anticipated between the base year and the test year within each cost pool. Thus, the degree to which the proportion of DPS processing cost varies between the base year and the test year is directly tied to these cost ratios. Please see USPS-T-13 at 60 for more discussion about test year cost ratios.