

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

RESPONSES OF UNITED STATES POSTAL SERVICE WITNESS KIEFER
TO INTERROGATORIES OF VALPAK DIRECT MARKETING SYSTEMS, INC.
AND VALPAK DEALERS' ASSOCIATION, INC.,
(VP/USPS-T36-6-9))

The United States Postal Service hereby files the responses of witness Kiefer to above-listed interrogatories, filed on June 13, 2006.

The interrogatories are stated verbatim and are followed by the responses.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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AND VALPAK DEALERS' ASSOCIATION, INC.

VP/USPS-T36-6.

Please refer to your response to VP/USPS-T36-1(e). Within the context of the minimum-per-piece rate for basic letters in Regular Commercial Standard, you were asked how thinking about your "base piece rate" of \$0.140 was helpful to you in leading to the final minimum per-piece rate of \$0.292.

The first sentence of your response is: "Generally, by establishing piece and pound rates and applying these to both piece-rated pieces and piece-and-pound-rated pieces, consistency at the break point can be easily achieved."

- a. By "consistency at the break point," do you mean anything other than that an ordinary graph of per-piece postage vs. per-piece weight (with the former on the vertical axis and the latter on the horizontal axis) does not have a discontinuity at a weight equal to the break point? If you do, please explain with specificity what you mean by achieving consistency at the break point.
- b. If you want to avoid a discontinuity of the kind referenced in part a of this question, please confirm that in "establishing piece and pound rates," before you "apply" them, you have no choice but to honor the following equation: $\text{lb-rate} * 3.3/16 + \text{piece-rate-for-lb-rated-pieces} = \text{minimum-per-piece-rate}$. If you do not confirm, please discuss your reasoning and explain the freedom you see yourself as having in selecting the "piece and pound rates." (Note: nothing in this question is meant to preclude normal rounding practices.)
- c. You say that by "applying" the various rate elements to the pieces involved, "consistency at the break point can be easily achieved."
 - (i) Please explain how "applying" the "piece and pound rates" helps you achieve consistency.
 - (ii) Please confirm that, in selecting the "piece and pound rates," unless you purposefully honor the equation presented in part b of this question, consistency cannot and will not be achieved. Please explain fully any non-confirmation.

RESPONSE:

- a. I mean that there will be no discontinuity in rates at the break point weight.
- b. Confirmed.
- c. (i) As can be seen from my workpapers, the minimum per piece rates for various rate categories were derived using the formula set forth in subpart (b) of the question. In so doing, consistency in the rates at the breakpoint weight is achieved.
 - (ii) Confirmed.

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VP/USPS-T36-7.

Please refer to your response to VP/USPS-T36-1(e). The second and final sentence of your response is: "While letter-shaped pieces having weights greater than the break point do not pay piece and pound rates in the way nonletter-shaped pieces do, the parallel rate element structure used to develop the letter rates is useful in facilitating comparison between the proposed rates for letters and those for nonletter-shaped pieces."

- a. Would you agree that, over the break point, the only difference between the rates for letters and nonletters is that letters pay a lower piece rate, one that is adjusted downward to reflect the lower costs of letters? If you agree, is this what you meant when you said these letters "do not pay piece and pound rates in the way nonletter-shaped pieces do"? If you disagree or mean something different, please explain how "the way" is different.
- b. By "parallel rate element structure," do you mean to refer generally to the fact that, when plotted on a graph, the line for letters is parallel to and lower than the line for nonletters? If you mean something else, please explain. (Note: for purposes of this question, a "line" can be horizontal and then begin trending upward, but cannot be a curve and cannot have a discontinuity; also, two lines are parallel if the vertical distance between them is constant.)
- c. (i) Please explain how you found the "parallel rate element structure ... useful in" comparing the rates for letters and nonletters.
(ii) Does this usefulness refer to anything other than that the vertical difference between the two lines noted in part b is the difference in rates between nonletters and letters of the same weight? If it does, please explain.
(iii) In your "comparison" of the rates for letters and nonletters, did you give any consideration to the costs of each? If you did, please point with specificity to the costs you examined and to the role they played in establishing the differences. If you did not, please explain why costs would not be a relevant consideration in any "comparison" of the rates for letters and nonletters.
- d. Please consider the subject of VP/USPS-T36-1, that you "have developed a rate design methodology that differs from the 'formula' approach in use (with modifications) since Docket No. R90-1." (USPS-T-36, p. 12, l. 26 to p. 13, l. 1.) Since you confirm in your response to part c of that interrogatory that you used a "key" formula of some length, and since it seems apparent that you honored a formulaic relationship between the various piece and pound rate elements, to avoid a discontinuity in the rates, is it the case, as far as the rates for letters and flats are concerned, that the only difference between your approach and the earlier formula approach is that you removed from direct recognition in your calculations the cost information relating to differences between letters and flats? If you see any other differences between the approaches, please identify what they are.

RESPONSE:

- a. I can confirm that automation letters weighing more than the break point (but not over 3.5 ounces) pay a piece rate that is adjusted downward by the difference

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between the minimum per piece charges for letters and flats. While this difference reflects to some extent the cost differences between letters and nonletters, that factor need not be the sole factor affecting the difference. Heavy letters do not simply pay a "letter piece rate" plus a "letter pound rate" the way heavy flats pay a "flats (or nonletters) piece rate" plus a "flats (or nonletters) pound rate." Heavy letters essentially pay flats (or nonletters) rates with a per-piece discount. That is the kind of difference I was referring to.

- b. I meant that I chose a piece rate element for letters and for flats and I chose a pound rate element for letters and for flats. Then, to determine the minimum per piece rate for letters I applied the formula described in subpart 6(b) above ; to determine the minimum per piece rate for flats, I also applied the formula described in subpart 6(b) also. As already discussed, the rates for heavy letters and for heavy flats are not determined in strictly parallel fashion.
- c. (i) Please see work sheet WP-STDREG-26 in library reference USPS-L-36.. In the upper left one can see the input items labeled "Basic Rate Per Piece" and "Rate Per Pound." These are the rate elements for the base piece(s) that I was referring to in my response. As can be seen in the worksheet, I set the Rate Per Pound the same for letters and flats. Using the Trace Dependents function in Excel, one can verify that the Basic Rate Per Piece and Rate Per Pound rate elements for Machinable Letters directly affect only the minimum per piece rate cells for letters. Because of this, I could set the Rate Per Pound rate element for Machinable Letters equal to the Rate Per Pound rate element for Flats, while still maintaining the ability to adjust the base letter piece's minimum per piece charge by varying the Basic Rate Per Piece rate element. With the Rate Per Pound rate elements for both letters and flats set equal to each other, it becomes an easy matter to

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compare the base prices of letters and flats simply by comparing their Basic Rate Per Piece rate elements.

(ii) Please see my response to (c)(i). While I did not use graphical images when thinking about this issue, I believe that the graphical representation expressed in the question captures the essence of what I was referring to in my response to VP/USPS-T36-1(e).

(iii) Yes. Please see the line items labeled Mail Processing + Delivery Costs in row 7 of WP-STDREG-26. As can be seen in that workpaper, these cost numbers do not tie directly to other cells in this workpaper. Nevertheless, as I described in my response to VP/USPS-T36-1, subparts (f) and (g), these cost data elements were used in selecting the rate elements that produced the letter and flat prices, including the price differences between letters and flats.

- d. My response should not be interpreted to imply that I did not use mathematical formulas in preparing my rate design. One need only casually examine my workpapers to see what formulas were used and how they were used. While I have not cataloged all of the differences in approach between my rate design model and the model formerly used, several readily come to mind.
- As suggested in the question, letters and flats are not tied together by explicit formulas. Rate elements are chosen separately for each shape category. In the former model, this separation based on shape was still present, but it was effectuated by calculating a letter-flat cost differential and then exogenously altering its impact through a passthrough formula.
 - Mathematically, in the former model, the (single) pound rate element was chosen and the (single) piece rate element falls out of the solution of a formula. In my approach, piece rate elements and pound rate elements are chosen for the different rate categories separately. This does not

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mean that these choices are unconstrained. There are obvious constraints, like meeting revenue requirements, and maintaining appropriate rate relationships that limit the possible choice combinations.

- Another difference is that the latest version of the former model required the user to develop an artificial apportionment of the combined Regular/Nonprofit costs between the two subclasses for the purposes of rate development. No splitting of costs between Regular and Nonprofit Regular is required in my approach.

There may be other differences between the two approaches. I have not attempted to catalog all differences. My view is that both models produce sets of rates that meet revenue requirements and other necessary rate relationships such as the Regular/Nonprofit Regular revenue per piece ratio. Both require judgmental inputs such as cost passthroughs and rate differentials to be developed. In my view, the focus should be on the assumptions made and rates produced, not on the rate design models which are only the tools to convert the assumptions and data into rates.

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VP/USPS-T36-8.

Please refer to your response to VP/USPS-T36-2(e), which presented you with a per piece postage for mixed ADC machinable letters of 29.2 cents (equal in this case to the applicable proposed minimum-per-piece rate) and a cost for the same letters of 9.784 cents (which would increase to 9.856 cents if the information provided by witness Talmo in USPSLR- L-135 were incorporated; see response of witness Talmo (USPS-T-27) to VP/USPS-T36- 2(d), redirected from witness Kiefer, May 30, 2006), yielding a per-piece contribution of 19.42 cents (19.34 cents using the revised cost) and an implied cost coverage of 298.45 percent (296.27 percent using the revised cost), and asked for your confirmation or that you provide revised figures.

In your response to VP/USPS-T36-2(e), you did not confirm or provide any revised figures, except for the update provided by witness Talmo. You provided a three-sentence explanation, as follows, with numbering provided in brackets: “[1] I have seen no study that provides comparable numbers for the test year and that are consistent with the cost data confirmed in subparts (a) and (b), above. [2] I would also note that there is a potential problem with using an average price estimate for all Standard Mail letters to develop unit costs for a highly de-averaged rate category. [3] I do not know how much the unit costs, exclusive of mail processing and carrier costs, for a non-drop-shipped, minimally presorted letter might vary from the average unit cost, assuming one were available.”

- a. With regard to sentence 1:
 - (i) Please confirm that the cost data in parts a and b of the question are for the test year, as developed by other Postal Service witnesses. If you do not confirm, please describe the vintage of the costs at issue.
 - (ii) Please explain what “numbers” you would need for the test year that are consistent with the test year cost data in parts a and b.
 - (iii) Please explain the nature of the “consistency” that you think is important.
- b. With regard to sentence 2:
 - (i) Please explain where “an average price estimate for all Standard Mail letters” has been used “to develop unit costs for” any category of mail, whether de-averaged or not.
 - (ii) When you refer to “all Standard Mail letters,” do you intend to include ECR and the Nonprofit categories? If not, please clarify the letters to which you are referring.
 - (iii) Please clarify the nature of the “potential problem” about which you are concerned, indicating the likely magnitude of the problem and how likely it is to exist.
- c. With regard to sentence 3:
 - (i) When you refer to “the unit costs, exclusive of mail processing and carrier costs,” are you referring to the unit cost of 0.7135 cents shown in cell N11 of tab ‘Unit Costs’ of LR-L-135.xls in USPS-LR-L-135? If you are not, please clarify the unit costs to which you are referring.
 - (ii) Is it your suggestion that, if this unit cost were dropship-corrected, the comparison made would be in order and meaningful? If you are not suggesting this, please clarify what you mean.

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(iii) Please confirm that of the cost of 0.7135 cents, only 0.40 cents is transportation costs. Please explain any failure to confirm.

(iv) Please confirm that when dropship adjustments were made for ECR letters (see column I in tab 'Results' of workbook LR-L-84.xls in USPSLR- L-84), the adjustment ranged from 0.138 cents to 0.225 cents. Explain any failure to confirm.

(v) Please provide any reason you have for believing that the difficulties to which you refer are significant in magnitude and would change in a meaningful way the picture painted by the per-piece contribution and implied cost coverage figures provided in the question.

RESPONSE:

a. (i) Confirmed.

(ii),(iii) The consistency I was referring to was that the non-delivery, non-mail processing cost data should be (1) for the same test year and, (2) based on the same set of assumptions (for example, labor cost assumptions, etc.) that underlie the R2006-1 test year cost estimates. Ideally, the numbers should be for the same level of disaggregation as the other components. For example, the remaining unit costs should be for Mixed AADC letters. It may be the case that the remaining unit costs do not vary appreciably as the mail category is disaggregated (e.g. from all letters to Mixed AADC letters). I do not know if this is the case or not. My response was designed to reflect caution in proceeding when I did not know whether it was appropriate to mix these data from different years or different levels of aggregation.

b. (i) My response was overly broad. It should have read "...all Standard Mail Regular rate letters."

(ii) Please see my response to (i), above. Since CRA costs are reported only for the combined Regular and Nonprofit Regular subclasses, my understanding is that the costs in question included both these subclasses. ECR and Nonprofit ECR would not be included.

(iii) Average data for a large group may not always apply in a meaningful way to all members or subgroups of the larger group. In this particular instance, while I

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expressed reservations about applying average cost data for all letters to Mixed AADC letters, I think the total magnitude of the error introduced would be limited. That is why, for example, I indicated a willingness to accept the figures in the table as "ballpark estimates" to answer the substantive question in subpart (k) of VP/USPS-T36-1. With the updating of LR-K-119 as LR-L-135, the concerns about the likely size of error introduced were further reduced.

- c. (i) Yes.
- (ii) I was referring to all the ways that a Mixed AADC letter differs from the average Standard Mail Regular letter. Drop shipping is one difference. It may well be the only difference that is meaningful in this context. I don't know.
- (iii) Confirmed.
- (iv) Confirmed.
- (v) Please see my response to VP/USPS-T36-2(k), as well as my response to subpart (b) of this question, above.

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VP/USPS-T36-9.

Please refer to the following paragraph in your testimony, USPS-T-36, beginning on line 27 of page 30.

My proposed rate design will also eliminate the Automation Basic rate category for letters. This rate is currently available only for mail sent to sites that do not receive letters from the plant in delivery point sequence. I understand that the Postal Service intends to further centralize the sequencing operations in plants to the greatest extent possible, reducing the dependence on automated or manual sorting in delivery units. (See witness McCrery, USPS-T-42, Section II, Part A, discussion of CSBCS equipment). In this light a two-track pricing scheme for automation letter mail is not warranted. With elimination of this rate I assume, for purposes of revenue estimation, that ECR and NECR Basic Automation letters will migrate to the Regular and Nonprofit Regular subclasses and pay the applicable Automation 5-digit rates. This is the likely rate paid by those letters that are addressed to areas for which the plant delivery point sequences letter mail. [USPS-T-36, p. 30, l. 27 to p. 31, l. 10.]

- a. Would you agree with the general proposition that the primary reason the Commission separated Regular and ECR into separate subclasses in Docket No. MC95-1 was to help recognize differences in demand, elasticity, market characteristics, density, and costs? If not, please explain any extent to which you disagree.
- b. In terms of demand, elasticity, market characteristics, density, costs, and any other factors you believe relevant, please explain any extent to which you find Basic Automation letters in ECR to be any less worthy to be in ECR and to receive any advantages associated with ECR than any other letters or flats in ECR.
- c. Please explain any consistency you see in having (i) fairly developed rates in ECR for Saturation Automation letters, and (ii) fairly developed rates in ECR for High-Density Automation letters, but (iii) no rates at all in ECR for Basic Automation letters. Do you believe any consistency you see is in line with the Postal Service's broad interest in developing and encouraging Automation letter mail?
- d. Did you attempt to develop a suitable rate in ECR for Basic Automation letters and have difficulties? If you did, please state what those difficulties were. If you did not, please explain why not.
- e. As a suitable rate for ECR Basic Automation letters, did you consider an approach such as rating them at 1 cent below the rate for 5-digit Automation letters in Regular, to provide some recognition to the factors listed in part a of this question? If you did, please explain that consideration and why you rejected it.
- f. Please present and discuss any analysis done by you or the Postal Service on the costs of ECR Basic Automation letters and Regular 5-digit Automation letters, and explain any differences in these costs.
- g. Do you agree that eliminating Basic Automation letters from ECR is a classification change rather than a rate change? Please explain any disagreement.

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RESPONSE to VP/USPS-T36-9:

- a. While the Commission did not specifically call these “the primary reason” and gave other reasons as well to support its decision, I agree that differences in demand, elasticity, market characteristics and costs appear to have been important factors in the Commission’s decision.
- b. The decision to propose elimination of separate ECR Automation Basic rates was taken to support the Postal Service’s move to further centralize the delivery point sequencing of automation compatible letter mail at plants. It was not taken because current Automation Basic letters were in any way deemed “unworthy.” Under my rate proposals, these letters could still remain in ECR and receive any advantages that might accrue thereby, although they would not have a separate rate and would have to pay ECR Basic letter rates. For purposes of estimating revenue, I have assumed that current ECR Automation Basic letter mailers would rather choose to prepare and enter their automation compatible letters as Standard Mail Regular Automation 5-digit letters since the rates are significantly lower than ECR Basic letter rates. Although some mailers may move current Automation Basic letters to the Regular subclass, I do not believe that this move suggests that elimination of the ECR subclass for letters is warranted.
- c. Please see my response to subpart (b). The decision to propose to eliminate separate pricing for ECR Automation Basic letters is consistent with the Postal Service’s operational plans to sequence as many automation compatible letters as possible at plants. Since Automation Basic rates are only available at a limited number of locations, Automation Basic is not a rate category that is strictly parallel to the High Density and Saturation rate categories. Considering all the factors, I don’t see that identical rate treatment is a prerequisite. As indicated in my testimony and workpapers, I expect current ECR Automation Basic letter mailers to choose to shift their mail to another automation letter category. Therefore, my

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proposed pricing is in line with supporting the Postal Service's overall Standard Mail automation program, which includes centralized sequencing of automation letters. My proposed pricing for High Density and Saturation letters also supports the Postal Service's automation program since eligibility for these rate categories requires the mail pieces to be automation compatible (including barcoding).

Automation compatibility permits the Postal Service to easily sequence these mail pieces with other letter mail when operationally appropriate.

- d. No. My proposal was based on supporting operational decisions, not on difficulty in developing a rate.
- e. No.
- f. I did not perform any formal analysis that compares the costs of these two mail groups and I am unaware of any similar analysis performed by the Postal Service.
- g. I am not an attorney, so I can only answer this question from the perspective of a pricing Economist. The proposed change seems to me to have aspects of both a rate change and a classification change. Effectively Automation Basic letters that stay in ECR would have their rate changed and pay Basic letters rates. On the other hand, the proposed change is effected through a change in the DMCS. Whatever the legal categorization, I believe that this proposed change is a necessary change from the Postal Service's perspective to support centralized sequencing of letters wherever possible. In this light, as I indicated in my testimony, a two-track pricing system is no longer desirable. Because these pieces do have a relatively low-priced option available (moving to Standard Mail Regular 5-digit Automation rates), the change I am proposing does not unfairly target mail that currently pays Automation Basic rates.

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.

Nan K. McKenzie

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