

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

**DIRECT TESTIMONY
OF
DION I. PIFER
ON BEHALF OF THE
UNITED STATES POSTAL SERVICE**

REVISED: 08/11/06

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LIBRARY REFERENCES

USPS-LR-L-72 Supporting Materials Relating to Incremental Cost Model
(USPS-T-18)

1 **AUTOBIOGRAPHICAL SKETCH**

2

3 My name is Dion I. Pifer. I am a Mathematical Statistician with the United
4 States Postal Service. I've been employed with the Finance group of the Postal
5 Service since 1991.

6

7 I have a Bachelor of Science in Mathematics as well as a Master of
8 Science in Statistics from Virginia Polytechnic Institute and State University.

1 **PURPOSE AND SCOPE OF TESTIMONY**

2

3 The purpose of this testimony is to present incremental cost estimates for
4 base year 2005 and test year 2008. Incremental costs are developed for each
5 subclass and special service, as well as groups of subclasses. The procedures
6 used to calculate incremental costs are the same as those used in Docket No.
7 R2005-1 to calculate base year 2004 incremental costs.

8

9 Incremental costs for postal products were first presented in Docket No.
10 R97-1 in the testimony of witness Takis (USPS-T-41). In Docket No. R2000-1,
11 witness Kay presented incremental costs estimated with a new method (USPS-T-
12 23). Dr. Bradley (Docket No. R2000-1, USPS-T-22) described this new method
13 and provided the analytic basis for the calculations. Ms. Kay used this new
14 method in Docket No. R2001-1 for base year 2000 and test year 2003, as well as
15 in Docket No. R2005-1 for base year 2004 and test year 2006. This method will
16 also be used to calculate incremental cost estimates for base year 2005 and test
17 year 2008.

18

19 The incremental cost testimony is organized into four sections. The first
20 section describes the procedures used to estimate incremental costs in base
21 year 2005 and discusses any changes made from base year 2004. The second
22 section describes the procedures used to estimate incremental costs in test year
23 2008 and discusses any changes made from test year 2006. The third section
24 presents the results of the incremental costs analysis for base year 2005 and test
25 year 2008, and discusses those results for individual subclasses and groups of
26 subclasses. The fourth section compares incremental cost with PRC attributable
27 cost.

1 **MATERIALS ASSOCIATED WITH THIS TESTIMONY**

2

3 This incremental cost testimony is accompanied by supporting workpapers
4 and library references. The workpapers include a detailed discussion of the
5 procedures used to calculate incremental cost for each component. Printouts of
6 the model used to estimate incremental costs for base year 2005 and test year
7 2008 are included in the workpapers.

8

9 The Library References associated with this testimony are:

10 USPS-LR-L-72 Supporting Materials Relating to Incremental Cost
11 Model (USPS-T-18)

12

13 Incremental cost estimates are developed using inputs obtained from the
14 following witnesses in this case: Witness Milanovic (USPS-T-9) provides base
15 year costs (USPS-LR-L-4) and product specific cost inputs (USPS-LR-L-57);
16 witness Waterbury (USPS-T-10) provides test year costs and roll forward model
17 inputs (USPS-LR-L-6); witness Van-Ty-Smith (USPS-T-11) provides mail
18 processing cost pool inputs and administrative clerk product specific cost inputs
19 (USPS-LR-L-55); witness Smith (USPS-T-13) equipment and space-related cost
20 pools (USPS-LR-L-54) and piggyback ratios for final adjustments (USPS-LR-L-
21 52); and witness Page (USPS-T-23) provides test year final adjustment detail
22 (USPS-LR-L-59).

23

24 Incremental cost estimates are provided to rate witnesses O'Hara (USPS-
25 T-31), Taufique (USPS-T-32), Scherer (USPS-T-33), Mayo (USPS-T-34 &
26 USPS-T-39), Tang (USPS-T-35), Kiefer (USPS-T-36) & (USPS-T-37), Yeh
27 (USPS-T-38), Mitchum (USPS-T-40), and Kaneer (USPS-T-41).

1 **I ESTIMATING INCREMENTAL COST FOR BASE YEAR 2005**

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This section of testimony discusses the general methodology for estimating incremental cost and how it is used in the estimation of base year 2005 incremental cost. The procedures used to estimate base year 2005 incremental cost are discussed in this section, while specific details on the incremental cost calculations for each cost component can be found in the workpapers for this testimony.

The procedures used to calculate incremental cost for base year 2005 are the same as the procedures used to calculate incremental cost in Docket No. R2005-1 for base year 2004. There are a few changes in implementation of these procedures for some cost components, due to changes in the way volume variable costs are calculated.

The five-step process used to implement the algorithm for calculating incremental cost has not changed from base year 2004:

Step 1: Identify each cost component. If volume variable cost calculations are done at a more disaggregated level than the cost component, then the constituent cost pools are identified.

Step 2: Identify independent and dependent components. An independent cost component has a volume variability analysis and distribution key. A dependent cost component borrows its volume variability and distribution key from another component or group of components.

Step 3: Determine the correct incremental cost procedure to use in calculating incremental cost for independent components, and

1 calculate the incremental cost. The incremental cost calculations
2 are based on the type of cost component.

3

4 **Step 4:** Calculate volume related incremental cost for dependent
5 components.

6

7 **Step 5:** Identify product specific costs and add these to the volume related
8 incremental cost.

9

10 **A. Identify Cost Components**

11

12 The first step in calculating incremental cost identifies each cost
13 component used in volume variable cost calculations. It starts with the cost
14 components identified in the base year 2004 incremental cost model. I then
15 analyze the workpapers of witness Milanovic (USPS-T-9, Workpaper B) and the
16 testimony of other witnesses to determine if there are any changes in variability
17 analysis for base year 2005. These changes may incorporate new cost pools.¹

18

19 The following witnesses provide information on changes in volume
20 variability analysis for base year 2005: Witness Bradley (USPS-T-17) discusses
21 a new window service study; witnesses Bozzo (USPS-T-12) and Van-Ty-Smith
22 (USPS-T-11) discuss the treatment for mail processing cost pools and any
23 changes from base year 2004; and witness Smith (USPS-T-13) discusses the
24 treatment for space and equipment cost pools and any changes from base year
25 2004.

26

27

28

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¹ Postal Service costs are divided into 20 cost segments, which are in turn divided into cost components. Cost components may be made up of costs associated with individual operations within the cost component, which are referred to as cost pools. For convenience, the term cost pool will be used to refer to both cost pools and cost components.

1 **B. Find Independent and Dependent Components**

2

3 This step examines each cost pool to determine if it has an independent
4 variability analysis, or if it borrows its variability and distribution key from another
5 cost pool or group of cost pools. Volume variable costs are determined in this
6 way, so the incremental cost calculations follow that structure.

7

8 In witness Milanovic's workpaper A, the Cost and Revenue Analysis
9 (CRA) model, the total cost for a dependent cost pool is distributed to mail
10 products using a cost-weighted distribution key. This distribution key is the sum
11 of the costs, by mail product, for each of the cost pools in the key. The
12 dependent cost pool also receives the cost-weighted variability of the
13 components in the distribution key. Likewise, in witness Milanovic's workpaper
14 B, a cost pool within an individual cost component is distributed to mail products
15 using the cost-weighted distribution key. This key is the sum of the costs, by
16 product, in each of the cost pools comprising the key. The cost pool receives the
17 cost-weighted variability of the cost pools in the distribution key. If a cost pool is
18 distributed in the CRA in this manner, then the cost pool is classified as
19 dependent.

20

21 This step also identifies the cost pools that comprise the distribution key
22 for a dependent cost pool. This information will be used in the incremental cost
23 calculations.

24

25 Table 1 in my workpapers lists all of the independent cost pools used in
26 the base year 2005 incremental cost model. Cost pools used in base year 2004
27 but not in base year 2005, and new cost pools are highlighted.

28

29 Table 2 and 3 in my workpapers lists the dependent cost pools in the base
30 year 2005 incremental cost model. There are only a few changes in dependent

1 cost pools from base year 2004. One example of a change is the addition of
2 equipment-related cost pools for POS One and Carrier Scanners.

3

4 **C. Determine the Correct Incremental Cost Procedure**

5

6 Each independent cost pool is evaluated to determine the correct
7 incremental cost method. Each cost pool is categorized into the eight types
8 defined below² to determine if there are any changes from base year 2004.

9

10 ■ Type 1. The costs in this pool are fixed and common. There are no
11 incremental costs for this cost pool.

12

13 ■ Type 2. The costs in this pool are fixed, but some or all costs are
14 specific to one or more products. Incremental cost equals the specific
15 fixed costs.

16

17 ■ Type 3. The costs in this pool are variable, but all costs are distributed
18 to one product. The variability for the cost pool is one hundred percent.
19 Incremental cost equals accrued cost for this cost pool.

20

21 ■ Type 4. The costs in this pool are variable, and all costs are distributed
22 to one product. The variability for this cost pool is less than one
23 hundred percent. Incremental cost equals accrued cost.

24

25 ■ Type 5. The costs in this cost pool are variable, distributed to more than
26 one product, and the variability equals one hundred percent. There are
27 non-volume variable costs intrinsic to a product. The incremental cost
28 for the product with intrinsic costs equals the volume variable cost plus

² The eight types of cost components are described fully by Dr. Bradley in Docket No. R2000-1, USPS-T-22, Table 1.

1 the intrinsic costs. The incremental cost for the other products equals
2 their volume variable cost.

3
4 ■ Type 6. The costs in this cost pool are variable, distributed to more than
5 one product, and the variability is less than one hundred percent. There
6 are non-volume variable costs intrinsic to a product. The incremental
7 cost for the product with intrinsic costs equals the volume variable cost
8 plus the intrinsic costs. The incremental costs for the other products
9 containing volume-variable costs are determined with the constant
10 elasticity method.³ If there are no volume-variable costs in the cost pool
11 (i.e. the volume variability for the component is zero) then the
12 incremental cost will equal the intrinsic cost.

13
14 ■ Type 7. The costs in this pool are variable and distributed to more than
15 one product. The volume variability equals one hundred percent, and
16 there are no intrinsic costs. Incremental cost for all products will equal
17 volume variable cost.

18
19 ■ Type 8. The costs in this pool are variable and distributed to more than
20 one product. The volume variability is less than one hundred percent,
21 and there are no intrinsic costs. The incremental cost for these
22 components will be calculated with the constant elasticity method.

23

24 Change in type category from base year 2004 may require a change in the
25 incremental cost methodology used.

26

27 Table 1 in my workpapers lists the type assigned to each independent
28 cost pool in the base year 2005 incremental cost model. Any changes in
29 incremental cost treatment from base year 2004 are highlighted.

³ See Docket No. R2000-1, USPS-T-22, for a complete discussion on use of the constant elasticity method in calculating incremental cost.

D. Calculate Incremental Cost for Dependent Cost Pools

The incremental cost of dependent cost pools is calculated with a methodology that parallels the determination of the volume variable cost of these cost pools. Dependent cost pools borrow their variability and distribution keys from other cost pools. The incremental cost for a dependent cost pool will be directly proportional to the incremental cost for the related component(s), minus any product specific costs. The incremental cost for subclass (*i*) in dependent cost pool (*j*) that borrows its variability and distribution key (*DK*) from cost pool (*k*), is calculated with the following formula:

$$IC_{ij} = VVC_{ij} * \left[\frac{IC_{ik} - PS_{ik}}{VVC_{ik}} \right] \quad (1)$$

The distribution key for a cost pool may be comprised of several cost pools. The distribution key is generated in witness Milanovic's (USPS-T-9) workpapers by summing the costs by product across these cost pools. This distribution key is used both to distribute the costs to products and to determine the variability of the dependent cost pools. In this case, the volume variable costs for the dependent cost pools are first divided among the various independent cost pools that are used to form the distribution key. The incremental to volume variable cost ratio for the independent cost pool will be applied to that portion of the dependent pool costs that are associated with the independent cost pool. The last step adds up the portions of the incremental cost for the dependent cost pool by product that are associated with each independent cost pool. This is represented mathematically as:

$$IC_{ik} = \sum_{j=1}^n \left[VVC_{ik} * \left[\frac{VVC_{ij}}{VVC_{iDK}} \right] * \left[\frac{IC_{ij} - PS_{ij}}{VVC_{ij}} \right] \right] \quad (2)$$

1 **E. Identify Product Specific Costs**

2
3 Product specific costs are non-volume variable costs caused by the
4 provision of a product. Product specific costs for a mail product are incremental
5 to that mail product. Three of the cost pool types identified in section I.C include
6 product specific costs – specific fixed costs in type 2 cost pools and intrinsic
7 costs in type 5 and 6 cost pools.

8 A variety of sources are used to identify product specific costs, including
9 the statement of revenue and expenses (USPS-LR-L-57), witness Milanovic's
10 workpapers (USPS-T-9, Workpaper B), and special analysis (USPS-LR-L-72).

11 12 **F. Changes from Base Year 2004**

13
14 The procedures used to calculate base year incremental cost have not
15 changed since base year 2004. However, the actual implementation of
16 incremental cost may have changed if the methodology used to calculate volume
17 variable costs have changed. A summary of the major changes follows. Greater
18 detail on the incremental cost treatment for each cost pool can be found in Table
19 1 in the workpapers, which shows the incremental cost treatment given to each
20 cost pool in both base year 2005 and base year 2004.

- 21
22 ■ Witness Bradley (USPS-T-17) discusses the current method for
23 calculating the variability of window service cost pools. The overall
24 effect on incremental cost methodology is minimal with only three
25 changes. First, the variability of PO Box has changed from base year
26 2004. The variability is less than one hundred percent and since there
27 is only one mail class in this cost pool, incremental cost equals accrued
28 cost. Second, International Mail now has its own unique variability,
29 which is also less than one hundred percent. Thus, it is moved out of
30 the weigh-and-rate category and now incremental cost equals accrued
31 cost. Third, the incremental cost for Special Services now equals

1 accrued cost. In BY 2004, the incremental cost for Special Services
2 equaled volume variable cost. However, since the variability is one
3 hundred percent, this change has no impact on incremental cost, as
4 volume variable cost will equal accrued cost.

5
6 ■ Witnesses Bozzo (USPS-T-12) and Van-Ty-Smith (USPS-T-11) discuss
7 the current method for calculating the variability of mail processing cost
8 pools. In base year 2005, the BCS, PMPC, and FSM cost pools have
9 been eliminated and a few other cost pools now have updated
10 variabilities. However, there is no resulting change to incremental
11 costing methodology.

12
13 ■ Witness Smith (USPS-T-13) discusses the treatment of equipment
14 related costs. The variability for these cost pools will match the
15 associated mail processing equipment variability in cost segment 3.
16 The incremental cost analysis for the associated equipment related cost
17 pools may have changed to be consistent with the volume variable cost
18 treatment. New equipment cost pools introduced in base year 2005,
19 MERLIN, RCS/LCTS, and PARS are treated with the constant elasticity
20 method. Finally, new cost pools for POS One and Carrier Scanners are
21 dependent cost pools in base year 2005.

22
23 ■ Witness Smith also discusses the elimination of cost pools in space-
24 related components. There is no resulting change to incremental cost
25 methodology here.

26
27 ■ In R2005-1, Witness Kay (USPS-T-18) cited Witness McCrery's
28 testimony (USPS-T-29) regarding the changing nature of operations in
29 PMPCs. Witness Kay noted that there were no Priority Mail product
30 specific costs from PMPCs in the test year. In base year 2005, the
31 PMPC product specific cost has been eliminated.

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- Witness Milanovic (USPS-T-9) discusses components such as administrative clerk training and cost segment 6 CAG K which have no base year 2005 costs. These components receive no incremental cost treatment in base year 2005.

1 **II ESTIMATING INCREMENTAL COSTS FOR TEST YEAR 2008**

2
3 In this case, the methodology that was used in Docket No. R2005-1 for
4 test year 2006 will also be used to calculate test year 2008 incremental costs.
5 The roll forward procedure is used to calculate test year volume-related
6 incremental costs, which incorporates the same factors that are used to forecast
7 test year volume variable and product specific costs. This means that test year
8 incremental cost is calculated at the same level of detail that is available for test
9 year volume variable cost.

10
11 The roll forward model, described in the testimony of witness Waterbury
12 (USPS-T-10), works on the component level and not the cost pool level. For
13 example, mail processing costs for all cost pools are aggregated into one
14 component. This aggregated component goes through the roll forward process
15 as one unit. As a result, in the test year there is a lack of information on volumes
16 and cost drivers for the constituent cost pools. Therefore, test year incremental
17 cost calculations for mail processing will be done at the component level.

18
19 Test year volume-related incremental costs for subclass (*i*) in cost
20 component (*j*) are calculated with the following formula to roll forward base year
21 volume-related incremental cost (see Docket No. R2000-1, USPS-T-22, Section
22 IV-C):

$$23 \quad 24 \quad IC_{iT} = [IC_{ij} - F_{ij}] (1 + g_i) (1 + \pi_j) (1 + \eta_j) (1 + \phi_j) \quad (3)$$

25
26 where g_i represents volume growth, π_j represents cost level changes,
27 η_j represents non-volume workload changes, and ϕ_j represents the effect of
28 special programs.

29

1 Non-volume variable costs do not get a volume effect in the roll forward.
 2 Test year product specific costs are calculated by applying the appropriate roll
 3 forward factors to base year product specific costs.

4

$$5 \quad F_{ijT} = F_{ij}(1 + \pi_j)(1 + \eta_j)(1 + \phi_j) \quad (4)$$

6

7 Test year product specific costs are added to the test year volume-related
 8 incremental costs. Finally, total test year incremental cost for subclass (*i*) is
 9 calculated by adding together the incremental cost in subclass (*i*) for all
 10 components (*j*):

11

$$12 \quad IC_{iT} = \sum_{j=1}^n [IC_{ij} - F_{ij}](1 + g_i)(1 + \pi_j)(1 + \eta_j)(1 + \phi_j) + F_{iT} \quad (5)$$

13

14 **Changes from Test Year 2006**

15

16 There are no changes in methodology from test year 2006 to test year
 17 2008.

1 **III RESULTS OF INCREMENTAL COST ANALYSIS**

2
3 This section presents the results of the incremental cost analysis. The
4 results are presented for each major subclass, plus groups of subclasses, mail
5 classes, and special services. Results are also presented for a set of two-
6 subclass combinations. Incremental cost calculations are made for base year
7 2005, test year 2008 before rates, and test year 2008 after rates.

8 9 **A. General Results**

10
11 Tables 1A and 2A in Attachment A show, for each subclass, group of
12 subclasses, and special service:

- 13
- 14 ■ Base year 2005 total volume variable cost
- 15 ■ Base year 2005 total incremental cost
- 16 ■ Test year 2008 before rates total volume variable cost
- 17 ■ Test year 2008 before rates total incremental cost
- 18 ■ Test year 2008 after rates total and average unit (per piece) volume
- 19 variable cost
- 20 ■ Test year 2008 after rates total and average unit (per piece) incremental
- 21 cost
- 22

23 The subclasses, groups of subclasses, and mail classes in Table 1A
24 correspond to the subclasses, groups of subclasses, and mail classes presented
25 in the Cost and Revenue Analysis report (USPS-LR-L-2). Table 2A shows
26 incremental costs for additional selected pairs of subclasses. Total incremental
27 cost for a particular subclass, group of subclasses, or special service is the sum
28 of the product's incremental costs for all cost components. The workpapers to
29 this testimony present detailed incremental cost calculations for each cost
30 component.

1 There is a close similarity between average incremental cost and average
2 volume variable (marginal) cost for the majority of subclasses. Incremental cost
3 will be very close to volume variable cost if:

- 4
- 5 1) the amount of the driver in a subclass is not too large,
- 6 2) the volume variability is relatively high, and
- 7 3) product specific costs are not too great.

8

9 This point is illustrated in Table 2 of Docket No. R2000-1, USPS-T-22.
10 This table shows the difference between volume variable cost and volume-
11 related incremental cost with various proportions of the driver and percentages of
12 variability.

13

14 **B. Subclass Results**

15

16 This section examines the results of the incremental cost analysis for
17 individual subclasses. Average incremental cost for most subclasses is close to
18 average volume variable cost. Following the discussion in the previous section,
19 in those subclasses where there is a large difference, it will be due to one of
20 these three reasons:

- 21
- 22 ■ the proportion of the driver is large;
- 23 ■ marginal cost changes significantly as the driver changes (i.e. a low
24 volume variability); or
- 25 ■ product specific costs associated with the particular subclass.

26

27 This section discusses each of the subclasses where incremental cost
28 differs from volume variable cost, and highlights the reason for the difference.
29 Incremental costs in this section are for test year 2008 after rates, unless the
30 discussion requires costs for cost pools that are aggregated into components for

1 test year incremental cost calculations. In this case, base year 2005 costs are
2 provided.

4 **1. Priority Mail and Express Mail**

6 Table 1a shows the difference between volume variable and incremental
7 cost for Priority Mail and Express Mail. Total incremental cost for Priority Mail is
8 8.2% greater than volume variable cost, while the incremental cost for Express
9 Mail is 26.2% greater than volume variable cost. This difference is primarily due
10 to product specific costs. The following table shows the product specific costs for
11 Priority Mail and Express Mail by cost component.

13 TABLE 3.
14
15 PRODUCT SPECIFIC COSTS FOR PRIORITY AND EXPRESS MAIL (TY2008
16 AR), IN MILLIONS (\$000,000)
17

COST COMPONENT	PRIORITY MAIL	EXPRESS MAIL
C/S 3 Mail Processing	\$ 109.4	\$ 65.3
Admin Clerks	0	6.9
C/S 7 City Carriers	0	12.3
C/S 16 Advertising	40.4	5.4
C/S 18 Supplies & Services	8.0	0
Misc. Support	1.3	0
TOTAL	\$ 159.2	\$ 89.9

18
19
20 Mail processing (CS 3) contributes significant product specific costs to
21 both Priority Mail and Express Mail. The costs of providing dedicated manual
22 Priority Mail operations are considered incremental to that subclass, because
23 these operations would be discontinued if Priority Mail were eliminated. The
24 same is true for Express Mail.

25
26 There are also product specific advertising costs for both Priority Mail and
27 Express Mail.

1

2 **2. First-Class Mail, Periodicals, Standard Mail, and Package Services**

3

4 These four mail classes are discussed together because they have a
5 common feature – none of the individual subclasses have a material amount of
6 product specific costs.⁴ Yet, the relationship between volume variable and
7 incremental cost differs for the subclasses within these mail classes. This
8 section will compare the difference between volume variable and incremental
9 cost for the subclasses in First-Class, Periodicals, Standard Mail, and Package
10 Services that have the greatest volume variable cost. These are First-Class
11 Single Piece, Periodicals Outside County, Standard ECR, and Parcel Post.

12

13 Incremental costs for First-Class Single Piece and Standard ECR mail are
14 5.3% and 2.9% higher than volume variable costs, respectively. However,
15 incremental costs are only 1.2% and 1.5% higher than volume variable costs for
16 Periodicals Outside County and for Parcel Post, respectively.

17

18 If all other conditions are equal⁵, mail subclasses with a larger share of the
19 driver will have a larger difference between volume variable cost and incremental
20 cost. Table 4 compares the RPW volumes for selected mail subclasses with the
21 percentage increase of incremental cost over volume variable cost. The mail
22 subclasses with a higher percentage of RPW volumes have a larger percent
23 difference between incremental and volume variable costs.

24

⁴ Total First-Class Mail has a small amount of product specific cost, but it is an insignificant component of the difference between volume variable and incremental cost. There is also a small amount of product specific cost for advertising in total Standard Mail and Parcel Post, but it contributes little to the difference between incremental and volume variable cost.

⁵ The assumption of 'all else being equal' is important, because there are other factors that may contribute to the difference between volume variable and incremental cost. The presence of large amounts of product specific cost, as well as low volume variability, will also contribute to this difference.

This discussion relating RPW volume to the percentage increase in incremental cost is for illustrative purposes. For some cost components, the driver is not simply mail volume. For example, city delivery activity costs are driven by shape. Transportation highway costs are driven by the cubic feet of mail and transportation miles.

1 The incremental cost for Certified has very little product specific costs
 2 (other than \$33 thousand for advertising in CS 16); yet incremental cost is 5.3%
 3 higher than volume variable cost. Most of the \$21.2 million difference between
 4 incremental and volume variable cost in base year 2005 incremental cost comes
 5 from the accountables delivery cost pool in CS 7⁶.

6
 7 Incremental cost for the accountable cost pool is calculated along with
 8 deviation parcel delivery using the multi-driver version of the constant elasticity
 9 formula. Nearly 45% of the driver for delivering accountables is in the Certified
 10 special service. The large proportion of the driver in the Certified special service
 11 causes the large increase of incremental over volume variable cost.

12
 13 TABLE 6
 14 INCREMENTAL AND VOLUME VARIABLE COSTS FOR CERTIFIED (BY 2005),
 15 IN MILLIONS (\$000,000)
 16

Cost Component	Volume Variable Cost	Incremental Cost	Difference (%)
Accountable Delivery	\$ 56.8	\$ 69.8	22.9%
Deviation Delivery Travel	5.7	7.0	22.8%
Delivery Activities Support (Letter Routes only)	7.6	9.3	22.4%
TOTAL	\$ 70.1	\$ 86.1	22.8%

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 18
 19

⁶ This cost pool is aggregated into the CS 7 Delivery Activities component for use in the roll forward model. There is not enough information to determine the test year 2008(AR) costs in the individual cost pools. Therefore, this discussion uses base year 2005 costs.

1 **C. Product Groups**

2

3 Table 1a contains incremental cost estimates for product groups. These
4 product groups correspond to the groups listed in the Cost and Revenue Analysis
5 report (USPS-LR-L-2). These include the combination of presort and non-presort
6 First-Class letters, presort and non-presort First-Class cards, total First-Class,
7 total Periodicals, total Standard Mail, and total Package Services. In addition,
8 Table 1a includes incremental cost estimates for each of the Postal Service
9 business groups. These include Correspondence (all of First-Class Mail and
10 Mailgrams), Advertising (Standard Mail plus Bound Printed Matter), Expedited
11 and Package Services (Priority Mail, Express Mail, Parcel Post, and Media Mail),
12 and Special Services.

13

14 Note that incremental costs are not summed across subclasses. The
15 incremental cost for a group of subclasses is found by removing the portion of
16 the driver associated with the group of subclasses. **For this reason, the**
17 **incremental cost for a group of subclasses will be different than the sum of**
18 **the incremental costs for the individual subclasses within the group.**

19

20 Table 2a displays the results of incremental cost calculations on 11
21 additional pairs of subclasses. These calculations demonstrate the ease with
22 which incremental cost can be calculated for groups of subclasses.

23

24 Tables 1a and 2a present incremental costs for groups of subclasses for
25 base year 2005, test year 2008 before rates, and test year 2008 after rates. The
26 same methodology described previously is used to calculate test year
27 incremental costs. The volume variable cost for the group of subclasses is used
28 as the basis for the ratios.

29

1 **IV** **COMPARISON OF INCREMENTAL COST WITH PRC**
2 **ATTRIBUTABLE COST**

3

4 This section compares incremental costs with PRC attributable costs. The
5 differences between the USPS incremental costs relative to the PRC
6 methodology in the R2005 rate proceeding are best approximated by comparing
7 incremental costs to PRC attributable costs.

8

9 To the extent that, in response to Commission Rule 53, I discuss and
10 compare PRC versions of costing materials in this testimony, I do not sponsor
11 those materials, or in any way endorse the methodologies used to prepare them.
12 In its Order No. 1380 adopting the roadmap rule, the Commission included the
13 following statements regarding the role played by Postal Service witnesses under
14 these circumstances:

15

16 The comparison required by this exercise cannot be equated with
17 sponsoring the preexisting methodology. It merely identifies and
18 gives context to the proposed change, serving as a benchmark so
19 that the impact can be assessed. ...[W]itnesses submitting
20 testimony under Rule 53(c) sponsor the proposed methodological
21 changes, not the preexisting methodology. That they may be
22 compelled to reference preexisting methodology does not mean
23 that they are sponsoring it.

24

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

29

30 PRC attributable cost includes volume variable cost based on the PRC
31 costing methodology and product specific cost. USPS incremental cost includes
32 volume variable cost based on the USPS costing methodology, product specific
33 cost, and inframarginal incremental cost (the difference between incremental cost
34 minus any product specific costs and volume variable cost).

1 PRC product specific costs are a subset of USPS product specific costs.
2 The PRC does not include the product specific costs identified in cost segment 3
3 mail processing due to the difference in costing methodology nor does it include
4 product specific costs identified in cost segment 7 associated with Express Mail.
5

6 Table 3a compares USPS base year incremental costs with PRC base
7 year attributable cost, including a comparison of product specific costs. Table 4a
8 compares USPS test year before rates incremental costs with PRC before rates
9 test year attributable cost, including a comparison of product specific cost. Table
10 5a compares USPS test year after rates incremental costs with PRC after rates
11 test year attributable cost, including a comparison of product specific cost. In
12 reviewing these tables, recall, as noted earlier, that incremental costs cannot be
13 added, in the sense that the incremental costs of a larger aggregation of products
14 will differ from the sum of the incremental costs of the individual component
15 products. In contrast, attributable costs can be added.

ATTACHMENT A

TABLE 1A. BY 2005 AND TY 2008 VOLUME VARIABLE AND INCREMENTAL COST FOR SUBCLASSES AND CLASSES

LINE NO.	CLASS, SUBCLASS, OR SPECIAL SERVICE	BY 2005 VOLUME VARIABLE COST	BY 2005 INCREMENTAL COST	TY 2008 (BR) VOLUME VARIABLE COST	TY 2008 (BR) INCREMENTAL COST	TY 2008 (AR) VOLUME VARIABLE COST	TY 2008 (AR) INCREMENTAL COST
	COLUMN NUMBER	(1)	(2)	(3)	(4)	(5)	(6)
1	FIRST-CLASS MAIL						
2	SINGLE PIECE LETTERS	11,454,438	12,054,325	10,682,082	11,247,935	10,424,565	10,976,390
3	PRESORT LETTERS	4,967,469	5,143,893	5,243,284	5,435,161	5,263,368	5,455,917
4	TOTAL LETTERS	16,421,907	17,681,441	15,925,365	17,164,254	15,687,933	16,906,889
5	SINGLE PIECE CARDS	524,764	528,710	559,216	563,406	530,022	533,990
6	PRESORT CARDS	217,083	217,511	252,895	253,409	247,114	247,615
7	TOTAL CARDS	741,847	747,215	812,111	817,948	777,136	782,695
8	TOTAL FIRST	17,163,754	18,654,653	16,737,476	18,208,092	16,465,069	17,910,033
9	PRIORITY MAIL	3,304,897	3,572,848	3,675,860	3,954,386	3,173,506	3,433,890
10	EXPRESS MAIL	507,867	611,876	485,861	598,226	417,223	526,429
11	MAILGRAMS	2,151	2,152	(0)	(0)	(0)	0
12	PERIODICALS:						
13	WITHIN COUNTY	77,918	78,030	81,867	81,984	79,513	79,628
14	OUTSIDE COUNTY	2,305,743	2,333,993	2,337,552	2,366,601	2,262,206	2,290,303
15	TOTAL PERIODICALS	2,383,661	2,415,394	2,419,419	2,452,147	2,341,719	2,373,382
16	STANDARD MAIL:						
17	ENHANCED CARR RTE	2,758,777	2,838,896	3,128,261	3,219,457	2,780,815	2,862,079
18	REGULAR	8,265,484	8,555,932	9,924,809	10,278,793	9,835,815	10,186,117
19	TOTAL STANDARD MAIL	11,024,261	11,685,534	13,053,070	13,840,935	12,616,630	13,375,492
20	PACKAGE SERVICES:						
21	PARCEL POST	1,128,386	1,145,010	1,360,357	1,380,589	1,255,080	1,273,444
22	BOUND PRINTED MATTER	511,515	515,791	623,754	628,983	631,392	636,681
23	MEDIA MAIL	407,378	409,453	416,715	418,808	386,614	388,558
24	TOTAL PACKAGE SERVICES	2,047,279	2,107,295	2,400,826	2,471,928	2,273,085	2,340,157
25	U.S. POSTAL SERVICE	426,186	426,539	472,527		473,067	
26	FREE MAIL	55,580	55,608	67,760	67,793	67,954	67,988
27	INTERNATIONAL MAIL	1,423,720	1,504,858	1,490,975	1,580,532	1,410,183	1,498,926
28	SPECIAL SERVICES:						
29	REGISTRY	80,295	80,309	64,262	64,273	59,696	59,706
30	CERTIFIED	398,631	419,844	455,178	479,449	445,522	469,284
31	INSURANCE	109,765	110,202	99,672	100,071	77,447	77,841
32	COD	8,736	8,736	8,378	8,379	7,259	7,259
33	MONEY ORDERS	156,621	233,540	150,767	224,963	142,373	212,610
34	STAMPED CARDS	1,609	1,608	1,755	1,755	1,656	1,656
35	STAMPED ENVELOPES	10,526	10,548	10,121	10,142	12,924	12,952
36	SPECIAL HANDLING	9,744	9,747	9,828	9,869	9,639	9,680
37	POST OFFICE BOX	553,014	574,498	624,710	648,010	622,299	645,603
38	OTHER	322,597	332,510	373,162	382,924	346,841	356,020
39	TOTAL SPECIAL SERVICES	1,651,538	1,845,618	1,797,834	2,001,714	1,725,657	1,921,795
40	CORRESPONDENCE	17,165,905	18,657,063	23,781,239	25,695,169	23,134,296	24,999,007
41	ADVERTISING	11,535,776	12,244,977	12,197,395	12,998,267	11,872,115	12,647,080
42	EXPEDITED	5,348,528	5,827,691	19,414,335	20,166,073	18,415,415	19,128,759

TABLE 2A. BY 2005 AND TY 2008 VOLUME VARIABLE AND INCREMENTAL COST FOR SUBCLASS PAIRS

LINE NO.	CLASS, SUBCLASS, OR SPECIAL SERVICE	BY 2005 VOLUME VARIABLE COST	BY 2005 INCREMENTAL COST	TY 2008 (BR) VOLUME VARIABLE COST	TY 2008 (BR) INCREMENTAL COST	TY 2008 (AR) VOLUME VARIABLE COST	TY 2008 (AR) INCREMENTAL COST
	COLUMN NUMBER	(1)	(2)	(3)	(4)	(5)	(6)
1	PRIORITY & EXPRESS	3,812,764	4,244,088	4,161,721	4,617,986	3,590,729	4,021,168
2	PRIORITY & PARCEL POST	4,433,283	4,772,546	5,036,217	5,401,398	4,428,586	4,767,077
3	PRIORITY & BOUND PRINTED MATTER	3,816,412	4,111,963	4,299,614	4,611,949	3,804,897	4,097,592
4	PRIORITY & MEDIA MAIL	3,712,275	3,996,269	4,092,575	4,388,532	3,560,120	3,836,348
5	EXPRESS & PARCEL POST	1,636,253	1,777,452	1,846,218	2,004,362	1,672,303	1,825,251
6	EXPRESS & BOUND PRINTED MATTER	1,019,382	1,148,194	1,109,615	1,251,356	1,048,615	1,187,558
7	EXPRESS & MEDIA MAIL	915,245	1,041,917	902,576	1,039,994	803,837	937,752
8	PARCEL POST & BOUND PRINTED MATTER	1,639,901	1,678,451	1,984,111	2,031,190	1,886,472	1,930,990
9	PARCEL POST & MEDIA MAIL	1,535,764	1,565,620	1,777,072	1,811,783	1,641,694	1,673,363
10	BOUND PRINTED MATTER & MEDIA MAIL	918,893	931,085	1,040,469	1,054,350	1,018,005	1,031,661
11	FIRST CLASS & PRIORITY	20,468,651	22,811,071	20,413,337	22,729,887	19,638,575	21,868,843

TABLE 3A. COMPARISON OF BY 2005 INCREMENTAL COST WITH PRC ATTRIBUTABLE COST

LINE NO.	CLASS, SUBCLASS, OR SPECIAL SERVICE	BY 2005 INCREMENTAL COST	BY 2005 PRC ATTRIBUTABLE COST	BY 2005 PRODUCT SPECIFIC COSTS IDENTIFIED IN INCREMENTAL COST	BY 2005 PRODUCT SPECIFIC COSTS IDENTIFIED BY PRC
	COLUMN NUMBER	(1)	(2)	(3)	(4)
1	FIRST-CLASS MAIL				
2	SINGLE PIECE LETTERS	12,054,325	12,443,157		8,112
3	PRESORT LETTERS	5,143,893	5,212,385		9,176
4	TOTAL LETTERS	17,681,441	17,655,543		17,288
5	SINGLE PIECE CARDS	528,710	581,153		471
6	PRESORT CARDS	217,511	232,448		581
7	TOTAL CARDS	747,215	813,601		1,052
8	TOTAL FIRST	18,654,653	18,469,143	18,340	18,340
9	PRIORITY MAIL	3,572,848	3,614,678	155,802	57,427
10	EXPRESS MAIL	611,876	563,150	81,966	12,193
11	MAILGRAMS	2,152	2,180		
12	PERIODICALS:				
13	WITHIN COUNTY	78,030	82,583		7
14	OUTSIDE COUNTY	2,333,993	2,431,579		73
15	TOTAL PERIODICALS	2,415,394	2,514,162	79	80
16	STANDARD MAIL:				
17	ENHANCED CARR RTE	2,838,896	2,819,343		5,527
18	REGULAR	8,555,932	8,590,165		10,403
19	TOTAL STANDARD MAIL	11,685,534	11,409,508	15,930	15,930
20	PACKAGE SERVICES:				
21	PARCEL POST	1,145,010	1,146,573	83	83
22	BOUND PRINTED MATTER	515,791	534,936		
23	MEDIA MAIL	409,453	428,104		
24	TOTAL PACKAGE SERVICES	2,107,295	2,109,613	83	83
25	U.S. POSTAL SERVICE	426,539	-		
26	FREE MAIL	55,608	59,418		
27	INTERNATIONAL MAIL	1,504,858	1,515,611	66,911	29,267
28	SPECIAL SERVICES:				
29	REGISTRY	80,309	94,320		
30	CERTIFIED	419,844	421,809	37	37
31	INSURANCE	110,202	112,019	282	282
32	COD	8,736	8,679		
33	MONEY ORDERS	233,540	162,186	3,191	3,191
34	STAMPED CARDS	1,608	1,609		
35	STAMPED ENVELOPES	10,548	10,671		
36	SPECIAL HANDLING	9,747	1,008		
37	POST OFFICE BOX	574,498	541,140	1,232	1,232
38	OTHER	332,510	374,431	2,218	2,218
39	TOTAL SPECIAL SERVICES	1,845,618	1,727,871	6,960	6,960

TABLE 4A. COMPARISON OF TY 2008 BEFORE RATES INCREMENTAL COST WITH PRC ATTRIBUTABLE COST

LINE NO.	CLASS, SUBCLASS, OR SPECIAL SERVICE	TY 2008 BR INCREMENTAL COST	TY 2008 BR PRC ATTRIBUTABLE COST	TY 2008 BR PRODUCT SPECIFIC COSTS IDENTIFIED IN INCREMENTAL COST	TY 2008 BR PRODUCT SPECIFIC COSTS IDENTIFIED BY PRC
	COLUMN NUMBER	(1)	(2)	(3)	(4)
1	FIRST-CLASS MAIL				
2	SINGLE PIECE LETTERS	11,247,935	11,605,350		6,253
3	PRESORT LETTERS	5,435,161	5,486,327		7,073
4	TOTAL LETTERS	17,164,254	17,091,677		13,326
5	SINGLE PIECE CARDS	563,406	618,531		363
6	PRESORT CARDS	253,409	269,920		448
7	TOTAL CARDS	817,948	888,450		811
8	TOTAL FIRST	18,208,092	17,980,127	14,137	14,137
9	PRIORITY MAIL	3,954,386	3,983,819	160,809	50,291
10	EXPRESS MAIL	598,226	541,146	90,802	12,410
11	MAILGRAMS	(0)	(0)		
12	PERIODICALS:				
13	WITHIN COUNTY	81,984	86,726		6
14	OUTSIDE COUNTY	2,366,601	2,473,273		66
15	TOTAL PERIODICALS	2,452,147	2,559,999	71	72
16	STANDARD MAIL:				
17	ENHANCED CARR RTE	3,219,457	3,194,037		4,996
18	REGULAR	10,278,793	10,295,817		9,403
19	TOTAL STANDARD MAIL	13,840,935	13,489,855	14,398	14,398
20	PACKAGE SERVICES:				
21	PARCEL POST	1,380,589	1,383,017	75	75
22	BOUND PRINTED MATTER	628,983	651,576		
23	MEDIA MAIL	418,808	437,352		
24	TOTAL PACKAGE SERVICES	2,471,928	2,471,945	75	75
25	U.S. POSTAL SERVICE		-		
26	FREE MAIL	67,793	72,382		
27	INTERNATIONAL MAIL	1,580,532	1,586,840	74,933	32,641
28	SPECIAL SERVICES:				
29	REGISTRY	64,273	75,419		
30	CERTIFIED	479,449	481,784	33	33
31	INSURANCE	100,071	101,787	255	255
32	COD	8,379	8,333		
33	MONEY ORDERS	224,963	156,787	3,630	3,630
34	STAMPED CARDS	1,755	1,755		
35	STAMPED ENVELOPES	10,142	10,260		
36	SPECIAL HANDLING	9,869	1,058		
37	POST OFFICE BOX	648,010	611,468	1,114	1,114
38	OTHER	382,924	433,403	2,005	2,005
39	TOTAL SPECIAL SERVICES	2,001,714	1,882,053	7,036	7,036

TABLE 5A. COMPARISON OF TY 2008 AFTER RATES INCREMENTAL COST WITH PRC ATTRIBUTABLE COST

LINE NO.	CLASS, SUBCLASS, OR SPECIAL SERVICE	TY 2008 AR INCREMENTAL COST	TY 2008 AR PRC ATTRIBUTABLE COST	TY 2008 AR PRODUCT SPECIFIC COSTS IDENTIFIED IN INCREMENTAL COST	TY 2008 AR PRODUCT SPECIFIC COSTS IDENTIFIED BY PRC
	COLUMN NUMBER	(1)	(2)	(3)	(4)
1	FIRST-CLASS MAIL				
2	SINGLE PIECE LETTERS	10,976,390	11,336,913		6,253
3	PRESORT LETTERS	5,455,917	5,512,578		7,073
4	TOTAL LETTERS	16,906,889	16,849,490		13,326
5	SINGLE PIECE CARDS	533,990	586,903		363
6	PRESORT CARDS	247,615	263,398		448
7	TOTAL CARDS	782,695	850,301		811
8	TOTAL FIRST	17,910,033	17,699,791	14,137	14,137
9	PRIORITY MAIL	3,433,890	3,447,646	160,809	50,291
10	EXPRESS MAIL	526,429	466,801	90,788	12,416
11	MAILGRAMS	(0)	(0)		
12	PERIODICALS:				
13	WITHIN COUNTY	79,628	84,247		6
14	OUTSIDE COUNTY	2,290,303	2,395,339		66
15	TOTAL PERIODICALS	2,373,382	2,479,586	71	72
16	STANDARD MAIL:				
17	ENHANCED CARR RTE	2,862,079	2,870,502		4,996
18	REGULAR	10,186,117	10,202,443		9,403
19	TOTAL STANDARD MAIL	13,375,492	13,072,945	14,398	14,398
20	PACKAGE SERVICES:				
21	PARCEL POST	1,273,444	1,274,789	75	75
22	BOUND PRINTED MATTER	636,681	659,887		
23	MEDIA MAIL	388,558	405,997		
24	TOTAL PACKAGE SERVICES	2,340,157	2,340,673	75	75
25	U.S. POSTAL SERVICE		-		
26	FREE MAIL	67,988	72,639		
27	INTERNATIONAL MAIL	1,498,926	1,503,280	74,919	32,644
28	SPECIAL SERVICES:				
29	REGISTRY	59,706	70,173		
30	CERTIFIED	469,284	471,961	33	33
31	INSURANCE	77,841	79,488	255	255
32	COD	7,259	7,225		
33	MONEY ORDERS	212,610	148,546	3,630	3,630
34	STAMPED CARDS	1,656	1,656		
35	STAMPED ENVELOPES	12,952	13,113		
36	SPECIAL HANDLING	9,680	1,039		
37	POST OFFICE BOX	645,603	609,138	1,114	1,114
38	OTHER	356,020	407,988	2,005	2,005
39	TOTAL SPECIAL SERVICES	1,921,795	1,810,327	7,036	7,036