

DOCKET SECTION

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

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POSTAL RATE AND FEE CHANGES, 1997

DOCKET NO. R97-1

RESPONSES OF MAGAZINE PUBLISHERS OF AMERICA WITNESS COHEN
TO INTERROGATORIES OF THE NEWSPAPER ASSOCIATION OF AMERICA
(NAA/MPA-T2-1-9)

(February 5, 1998)

Pursuant to the Commission's Rules of Practice, Magazine Publishers of America hereby submits the attached responses to interrogatories propounded by NAA to witness Cohen. (NAA/MPA-T2-1-9)

Respectfully submitted,


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**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-1. You state in your direct testimony at page 15, line 28, that Professor Bradley developed a "...state-of-the-art econometric variability analysis..." to measure volume variability of mail processing costs, and go on to state at page 16, lines 9-10 that "Witness Bradley was meticulous in his approach, performing numerous analytical and diagnostic calculations."

- a. Please specify all documents, including workpapers, that you relied upon to draw the above conclusions.
- b. As a part of your review of Professor Bradley's analysis, did you examine the data to assess its accuracy or reliability? If yes, please describe your examination of the data and what conclusions you drew based upon this examination.
- c. As a part of your review of Professor Bradley's analysis, did you examine the data that Professor Bradley excluded from his analysis? If so, did you determine whether the exclusion of these data was appropriate? Please explain.
- d. As a part of your review of Professor Bradley's analysis, did you investigate alternative specifications of his recommended models? If so, please describe these investigations and what conclusions you drew based upon these investigations.
- e. As a part of your review of Professor Bradley's analysis, did you perform any independent analysis, including but not limited to recalculation of the resulting cost variabilities by MODS operation, to verify the results of Professor Bradley's analysis? If so, please describe this independent analysis and provide a copy of the analysis.

Response:

(a) I based my statements on my review of witness Bradley's testimony, his discussion of his data scrubs in library reference USPS-LR-H-148, and discussions with professional colleagues familiar with Bradley's testimony.

(b) - (c) I did not perform an independent analysis of witness Bradley's data. However, I did review the procedures he used to edit his data. I directed a spot check of the information witness Bradley presented in Table H-148-1 describing the results of his data

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

scrubs for several direct mail processing operations and found the information presented therein to be accurate. Our review of his scrubs also supports witness Bradley's statement that the eliminated observations clearly contained some extreme values.

(d) It is not clear what is meant by "investigate" alternative specifications. If this means did I perform additional regression analyses with different functional forms or alternative sets of maintained restrictions than those presented by witness Bradley, the answer is I did not fit other models. However, I did look at the tests he conducted to evaluate his model. In my discussions with colleagues, we noted several good attributes of Bradley's model and tests including his use of the translogarithmic functional form, a flexible functional form which permits the data to largely determine the shape of the regression surface, his application of a Gauss-Newton regression to test for the presence of significant facility-specific effects, his use of Hausman's test to rule out the use of a random-effects model; and his correction for serial correlation in the residuals.

(e) Yes. Using witness Bradley's data and programs, provided in library references USPS-LR-H-148 and USPS-LR-H-149, I directed a replication of a subset of the results Bradley presented in his Table 7. We checked his results for Manual Letters, Manual Flats, FSM, OCR, and BCS and found them to be accurate. A copy of our results will be filed as a Library Reference (MPA-LR-6).

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-2. Please refer to pages 32-33 of your direct testimony. You discuss an alternative cost distribution for clerk and mailhandler costs and suggest this method is consistent with the methods used in previous rate hearings. Would your distribution methodology yield the same cost distribution as the methodology used by the Commission in R94-1 ? If no, please describe and quantify any differences by class and subclass of mail using your method and the method employed in R94-1.

Response:

I have not run the Commission R94-1 method since I started with witness Degen's method and modified it in ways that returned parts of witness Degen's approach to Commission accepted methods. I therefore cannot quantify differences by class and subclass between my method and the method employed by the Commission in R94-1. However, there are strong similarities between my method and the Commission method. There are also differences:

- The Commission methodology used IOCS tally information contained in IOCS Question 18 to partition the accrued cost of Clerks and Mailhandlers into its three components: mail processing, window service, and administration. Witness Degen did the same partitioning for BMCs and non-MODS facilities. However, for MODS facilities he used MODS Pay Data System costs to divide costs to component. This led to a shifting of costs from window service and administration to mail processing. In the methodology advocated by witness Stralberg and I, not-handling costs that would have been defined as window service and administration under the Commission methodology are shifted back to those cost components.
- The Commission methodology classified costs for some activity codes as mail processing fixed. Witness Degen determined attributable costs by applying witness Bradley's volume variability estimates to accrued costs from the Payroll Data System on a cost pool by cost pool basis. I have accepted witness Degen's implementation of

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

witness Bradley's variability calculations.

- The Commission methodology distributes mixed mail costs to subclass within CAG and basic function. Witness Degen performs separate distributions for MODS, non-MODS, and BMC facilities. I also perform separate distributions for MODS, non-MODS and BMC facilities, using CAG and basic function within facility type.
- The Commission methodology distributes overhead costs as the last step in the distribution process, distributing aggregate overhead costs in proportion to the distribution of all other mail processing costs. Witness Degen does not distribute overhead costs separately - he handles the category of not-handling costs at the same time as mixed mail costs, distributing not-handling costs for MODS, non-MODS, and BMCs separately, and confining the distribution within cost pools. Since witness Degen's program is my starting point, I also distribute not-handling costs at the same time as mixed mail costs separately for MODS, non-MODS and BMCs. However, my distribution is across cost pools, using CAG and basic function, an extension of the Commission's mixed-mail approach.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-3. In Docket No. R94-1, you and Witness Stralberg presented arguments for treating certain mail processing overhead costs as institutional costs and alternative options for distributing these costs across mail classes and subclasses. These arguments are similar to those you are presenting in the current proceeding. In R94-1, the Commission did not accept the suggestion to exclude mixed-mail data from the distribution of mail processing costs, concluding that, "Using the counted mixed-mail tallies as part of the direct tally base for distributing uncounted mixed-mail costs is the preferable approach." [p. 3072]

- a. Please describe any differences in the arguments you are putting forth in this proceeding compared to the arguments in your testimony in Docket No. R94-1.
- b. Do you believe that the Commission's decision was incorrect in Docket No. R94-1?
- c. What circumstances, if any, have changed to suggest that the Commission should reverse its previous decision in the current proceeding? Please explain.

Response:

(a) - (c) There appears to be some confusion as to the nature of my testimony in R94-1. My testimony in that Docket dealt with a proposal by United Parcel Service to use counted mixed-mail tallies as the sole basis for distributing uncounted mixed-mail tallies. I argued against this treatment of uncounted mixed-mail costs, pending more information, and the Commission agreed, using both counted and direct tallies to distribute uncounted mixed-mail costs.

Also in R94-1, Witness Stralberg testified on the possibility of treating some mail processing costs as institutional costs. The Commission declined to treat these costs as institutional but expressed concern that the USPS was not paying enough attention to unanswered questions about the IOCS and mail processing costs. As I noted in my testimony, the Commission raised concerns regarding the increase in the number and proportion of mixed-mail tallies, effects on costs of the shift to automated mail processing, and questions about the category "working but not handling mail" and about the level of

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

break time.

The situation in this Docket is somewhat different than in R94-1 since the Postal Service has proposed an entirely new attribution and distribution methodology. In my testimony I present two alternatives for the Commission's consideration, (1) an alternative cost distribution methodology and (2) treating a portion of mixed-mail and not-handling costs as institutional.

I believe there are a number of reasons why the Commission may want to consider both of my recommendations in this case. As I stated in my testimony, my alternative distribution of costs to classes and subclasses avoids unsupported assumptions to the greatest extent possible, uses all verifiable and relevant data collected in IOCS upon which reasonable inferences of causation can be based, and, pending the development of more complete information, follows past distribution practices. I believe my proposal is consistent with the Commission's Decision in R94-1, where they declined to institute a new cost distribution methodology without adequate support.

With regard to my suggestion to treat some volume-variable mail processing costs as institutional, I rely on both the lack of an established causal link between these costs and individual classes or subclasses of mail as well as substantial evidence that a portion of mixed-mail and overhead costs are due to postal inefficiency. I believe my effort to quantify the portion of volume-variable mixed-mail and not-handling costs due to inefficiency provides the Commission with a basis to treat such costs as institutional.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-4. You contend in your direct testimony at page 33, lines 23-26, that "...the Postal Service agrees that some mail processing costs are institutional costs," and go on to state that, "Based on witness Bradley's analysis, almost a quarter of all mail processing costs (direct, mixed mail, and not-handling) are treated as institutional."

- a. Please confirm that the Postal Service's recommendation to treat a portion of mail processing costs as institutional costs is based on Professor Bradley's conclusion, generated by his new methodology, that a portion of mail processing costs are not volume variable. If you cannot confirm, please discuss your response fully.
- b. Please confirm that none of the mail processing costs the Postal Service is categorizing as institutional in this proceeding would be considered volume variable using Professor Bradley's methodology. If you cannot confirm, please discuss your response fully.
- c. If you confirm parts (a) and (b) above, please discuss how Professor Bradley's testimony supports the notion of categorizing volume variable mail processing costs as institutional costs.

Response:

(a) Confirmed.

(b) Confirmed.

(c) I did not state that Professor Bradley's testimony discusses the potential treatment of volume-variable costs as institutional. What I stated is that witness Bradley's testimony opens the door to reconsidering distributing 100 percent of mail processing costs to classes and subclasses of mail. Treating volume variable mail processing costs as institutional can be justified on the basis of an inadequate causal link between these costs and classes and subclasses of mail.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-5. Please refer to your direct testimony, page 34, lines 1-2 and page 36, lines 15-18. Is it your testimony that all volume variable not-handling costs be treated as institutional costs or only those volume variable not-handling costs resulting from "inefficient" operations. Please discuss your response fully.

Response:

I propose that a portion (\$1 billion) of volume variable not-handling costs be treated as institutional costs in this case. These costs represent mixed-mail and not-handling costs that I estimate are due to inefficiency. As I stated in my testimony, for these costs, we neither have a basis for distribution to subclasses nor are we ever likely to find one. I would note that the first quote in this question, page 34, lines 1-2 describes witness Stralberg's testimony.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-6. In preparing your testimony, did you investigate possible inefficiencies in Postal Service operations related to any other cost categories besides mail processing, including, for example, transportation or carrier costs? Please explain your response.

Response:

No. My testimony continues an examination of mail processing cost questions first raised by Periodicals and other mailers in Docket No. R90-1 and discussed again in RM92-2 and R94-1 as well as in other venues.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-7. Assume, for example, that inefficiencies were found to exist in the transportation of mail between BMCS. If this were the case, would you recommend *that a portion of the inter-BMC transportation costs be classified as "institutional" costs*? Please explain your response.

Response:

Before I would venture to make a recommendation on how transportation inefficiencies should be handled, I would want to undertake a careful analysis of cost causation and distribution methodologies. However, in theory I would agree that if there is no causal link between a subclass of mail and the inefficient costs, then such costs should be treated as institutional costs. For example, if we assume that the average capacity utilization for a truck is ten percent for a year and that the reason for this low capacity utilization is that the Postal Service is unwilling to reduce capacity, then the cost of the 90% of the truck that is empty should not be attributed to the subclasses that take up the 10% of utilized truck capacity.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-8. Please refer to page 36 of your direct testimony. You cite a Christensen Associates study to derive your estimates of the proportion of mixed-mail and not-handling costs resulting from Postal Service "inefficiencies."

- a. Have the facilities in the top quartile of productivity experienced the same increase in not-handling costs as those facilities in the bottom 75 percent over the last ten years? Please discuss your response.
- b. Based on the results of the Christensen Associates study, please confirm that the bottom 75 percent of facilities experience some inefficiency in direct mail handling costs in addition to inefficiencies in mixed-mail and not-handling costs? If you cannot confirm, please explain your response.
- c. If part (b) is confirmed, should direct mail handling costs resulting from inefficient operations be attributed to classes or subclasses of mail? Why or why not?

Response:

(a) I do not have any data that would allow me to test whether the top quartile of facilities experienced the same increase in not-handling costs as those facilities in the bottom 75 percent over the last ten years.

(b) Christensen Associates did not discuss their benchmarking results with respect to IOCS direct, mixed-mail, or not-handling tallies. Given the magnitude of the potential improvements that they found, it is likely, however, that there is room for improvement in direct mail handling activities as well as mixed-mail and not-handling activities.

(c) In theory, if there is no causal connection between the subclasses of mail being handled and direct tally costs, such costs should not be attributed to the subclasses being handled. However, I was concerned in preparing my testimony that the Commission would be hesitant to ignore the known subclasses associated with direct tallies. Therefore, at the current time I recommend that the Commission classify volume-variable mixed-mail and

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

not-handling costs that are due to inefficiency as institutional costs, but accept the direct volume-variable costs in Degen's testimony. As I stated earlier, for the mixed-mail and not-handling costs we neither have a basis for distribution to subclasses nor are we ever likely to find one.

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

NAA/MPA-T2-9. Considering your arguments relating to inefficient mail processing costs:

- a. According to economic theory, how might the price signals sent to a consumer of an "inefficiently produced" product be affected when that product's price is artificially set at "efficient" levels?
- b. What are the consequences of these price signals in terms of overall economic efficiency?
- c. Assume that an inefficient producer of a product prices the product at the cost of producing the product inefficiently. Will this inefficient producer lose business to more efficient competitors? If no, please explain why not.
- d. If your response to part (c) above is yes, does this price signal promote efficiency by having consumers buy the product from the most efficient producer? Please explain your response.
- e. Now assume instead that an inefficient producer of a product prices the product at less than his actual cost of producing the product. Will this inefficient producer maintain business that would otherwise go to more efficient producers? Please explain why or why not.
- f. If your response to part (e) above is yes, does this price signal reduce economic efficiency by having consumers buy the product from a less efficient producer? Please explain your response.

Response:

(a) -(f) In a truly competitive market, if an inefficient producer charges consumers less for a product than it actually costs to produce it, several economic consequences result: consumers will buy more product from the firm and the firm will produce more product than is socially efficient; the inefficient producer may keep customers that it should have lost to more efficient competitors; and the inefficient producer may even take business away from more efficient competitors. All of these consequences would reduce economic

**Magazine Publishers of America Witness Rita Cohen
Responses to Interrogatories of NAA**

efficiency.

Again in a truly competitive market, if an inefficient producer prices a product at the cost of production, the inefficient producer will lose business to more efficient competitors. This would promote economic efficiency.

However, I would note that this situation is not applicable to the Postal Service for a number of reasons. First, the Postal Service is a monopolist in many of its markets. Thus, it is not subject to the same market pressures as those who produce in competitive markets. Even if it produces inefficiently, it will not lose its entire market share as would a producer in a perfectly competitive market. Second, the Postal Service, which must break even, does not price its products at marginal cost. If products were priced at marginal cost, the Postal Service would not recover enough revenue to cover expenses. Therefore, the rates charged customers are based on marginal costs (attributable costs) plus a markup (institutional cost contribution).

Also in this case, the Postal Service has performed incremental cost tests to ensure that rates are not below incremental cost for any subclasses. As long as each subclass of mail passes the incremental cost test, rates will not be below cost. I am not proposing any changes to the rates proposed by the Postal Service. Therefore, all subclasses will pass the incremental cost test, whether or not the volume-variable costs I suggest be classified as institutional costs are included in incremental costs.

DECLARATION

I, Rita D. Cohen, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

Rita D. Cohen

Dated: Feb 5, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


James R. Oregan

Washington, D.C.
February 5, 1998