

RECEIVED
BEFORE THE
POSTAL RATE COMMISSION AUG 15 4 20 PM '97
WASHINGTON, D.C. 20268-0001
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

RESPONSE OF UNITED STATES POSTAL SERVICE
WITNESS SHARKEY TO INTERROGATORIES OF
NASHUA PHOTO INC., DISTRICT PHOTO INC., MYSTIC COLOR LAB, AND
SEATTLE FILMWORKS, INC.
(NDMS/USPS-T33-1-9, 10(a), 11-19)

The United States Postal Service hereby provides responses of witness Sharkey to the following interrogatories of Nashua Photo Inc., District Photo Inc., Mystic Color Lab, and Seattle Filmworks, Inc.: NDMS/USPS-T33-1-19, filed on August 1, 1997. An objection to interrogatory NDMS/USPS-10(b) was filed on August 11, 1997.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking


Richard T. Cooper

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-2993; Fax -5402
August 15, 1997

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T-33-1.

- a. Please confirm that if the Commission recommends all First-Class and Priority Mail rates as proposed by the Postal Service in this docket, then (i) the rate for an 11-ounce piece of First-Class Mail will increase from \$2.62 to \$2.63, (ii) the minimum rate for a two-pound piece of Priority Mail will increase from \$3.00 to \$3.20, and (iii) the "gap" between the two will become \$0.62, up 63 percent from the current gap of \$0.38.
- b. In your opinion, does the size of the above-described gap represent any kind of problem or issue in rate design? Please explain fully why it is or is not an issue. In your answer, please address all concerns about the gap raised by the Commission in its Opinion & Recommended Decision in Docket No. R94-1.
- c. In view of the importance attached to the gap by the Commission in docket No. R94-1, please explain why your testimony fails to mention it or to discuss the issue in any way.
- d. Please state the maximum gap that you consider to be acceptable (e.g., as an absolute amount, or as a percentage of the degressive rate of \$0.23 per ounce, or as a percentage of the rate for an 11-ounce piece of First-Class Mail, and explain your rationale for determining the maximum acceptable gap.

Response:

(a.)

(i) Confirmed

(ii) Confirmed.

(iii) Not confirmed. The gap becomes \$0.57, up 50 percent from the current gap of \$.38.

(b) The size of the gap represents an issue in rate design. As noted by the Commission in its Opinion and Further Recommended Decision in Docket No. R94-1, "The rates for Priority Mail must be designed with recognition of its dual function as a subclass for items subject to the postal monopoly which

Response of Postal Service Witness Sharkey to NDMS Interrogatories

weigh more than 11 ounces, and as a service option in the competitive market for package delivery" and that "a smooth transition between the two subclasses is a primary consideration in developing rates." At page 50.

- (c.) Although there is no explicit mention of the "gap" issue in my direct testimony, keeping the gap as small as possible, subject to the cost coverage target, was considered. This was a factor in passing along a less-than-average percentage increase in the two-pound rate.
- (d.) The maximum gap is not an arbitrary figure. Instead the gap results from the reconciliation of a variety of factors bearing on each of the respective classifications.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-2.

Your testimony at p. 26 notes that the two-pound rate for Priority Mail is proposed to be raised from \$3.00 to \$3.20, a 6.7 percent increase.

- a. Please confirm that for the three-, four-, and five-pound Priority Mail unzoned rates, you propose a 10.0 percent increase.
- b. For all zoned Priority Mail rates above five-pounds, what is the average proposed increase in rates (weighted by volume)?

Response:

(a) Confirmed

(b) 6.71 Percent

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-3.

- a. Please confirm that for a 30-pound piece of Priority Mail to zone Local 1,2,3, the current rate is \$16.45, the proposed rate is \$16.40, and the percentage change in rate is -0.30 percent.
- b. Please confirm that the maximum percentage increase for any zone-rated Priority Mail rate cell is 16.0 percent. If you do not confirm, indicate the rate cell with the largest percent increase.
- c. Please explain how you arrived at the cell-by-cell forecast of the Test Year After Rates volume of Priority Mail shown in USPS-33M, p. 1. In your answer, please explain whether (i) the forecast for two-pound volume is based on the 6.7 percent rate increase which you recommend, (ii) the forecast for three- to five-pound volume is based on the 10.0 percent rate increase which you recommend for those weights, and (iii) the forecast for zone-rated pieces is based on the average percentage rate increase which you recommend for zoned Priority Mail (as stated in your response to preceding question 2b).

Response:

- (a) Confirmed.
- (b.) Confirmed.
- (c.) The base year volumes by cell were multiplied by the ratio of the Test Year After Rates volume to the Test Year Before rates volume. The volume forecast is based on the average percentage increase in price for Priority Mail as a whole. Separate forecasts are not made for two-pound volume, three to five pound volume and zone-rated pieces. See Direct Testimony of Gerald L. Musgrave (USPS-T-8) for the presentation of volume forecasting of Priority Mail.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-4.

- a. Using the Priority Mail test year cost data supplied in the exhibits attached to your testimony, can you determine the average unit cost for (i) flat rate pieces, (ii) two-pound pieces, and (iii) three-, four- and five-pound pieces? Is so, please provide the result and show how the results were derived.
- b. At your proposed rates, what is the unit contribution for (i) flat-rated pieces, (ii) two-pound pieces, and (iii) three-, four-, and five-pound pieces?
- c. If you had not previously computed the above-requested unit costs, please indicate why you did not consider such information to be pertinent.

Response:

- (a.) The average unit cost for flat rate, two-pound and three-, four- and five-pound pieces cannot be determined using the Priority Mail test year cost data supplied in the exhibits.
- (b.) The unit contribution for flat rate, two-, three-, four and five-pound pieces cannot be determined using the Priority Mail test year cost data supplied in the exhibits.
- (c.) I did not calculate average unit cost and unit contribution at the rate element level. As a basis for rate design, piece-, weight- and distance-related costs are allocated to the rate elements and compared against proposed rates to assure that the allocated costs are covered. Comparison of proposed rates to allocated costs is a means to prevent unusually high or low markups above allocated costs.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-5.

- a. What cost justification is there (if any) for the lower percentage increase in your rate for two-pound Priority Mail?
- b. Please list and discuss all other rate design or competitive considerations that led you to recommend a 6.7 percent increase in the two-pound rate was significantly lower than (i) the 10.0 percentage increase for three- to five-pound unzoned parcels, and (ii) the percentage increase (weighted) for zoned-rated parcels weighing more than five pounds.

Response:

- (a) There is no explicit cost consideration for the lower percentage increase in the two-pound priority mail rate. However, see my response to MDMS/USPS-T-33-1.
- (b.) The proposed two-pound rate, which results in a somewhat less-than-average increase for Priority Mail, recognizes that the two-pound rate mail is most likely to contain monopoly protected letter mail and there is a need to minimize the price gap between it and 11 ounce First- Class letter rate. As over eighty percent of Priority Mail volume is paid at the two-pound rate, the percentage increase in the two-pound rate drives the average price increase for Priority Mail. In looking at the alternatives in light of these considerations, it became clear that raising the \$3.00 rate to \$3.20 , a rate increase close to the Priority Mail average increase of 7.4 percent, made sense. In turn, to meet the revenue target the three-, four- and five- pound rates were raised by ten percent. This results in a simple \$1.20 differential from the two- to three-pound rate and a 10 cent differential for the three-, four- and five-pound weight steps. As with all Priority Mail rates, zone rated Priority Mail rates were

Response of Postal Service Witness Sharkey to NDMS Interrogatories

designed with due consideration given to the percentage increase and the relationship of price to allocated cost. (See response to UPS/USPS-T33-11).

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-6.

- a. Would you agree that for any target contribution to institutional costs for Priority Mail, any reduction in the contribution from two-pound pieces (which constitute 80 percent of total volume) must be offset by a higher contribution from heavier weight pieces?
Please discuss fully any disagreement.
- b. Please explain fully your rationale why Priority Mail weighting more than two pounds should incur a higher-than-average increase in rates to facilitate a below-average increase in the two-pound rate.

Response:

- (a.) Yes, all things being equal.
- (b.) Once the two-pound rate was set at \$3.20, a 6.7 percent increase, an increase above the 7.4 percent average increase for the other rate elements became a mathematical imperative.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-7.

Please provide all data in the possession or control of the Postal Service on the weight distribution of Priority Mail weighing less than two pounds. If data are available by one-ounce increments, please provide them. Otherwise, provide the finest detail available.

Response:

**Base Year Priority Mail Pieces Less than two Pounds
Distributed to One-Ounce Increments**

<u>From</u>	<u>To</u>	<u>Pieces</u>
.01	1	4,511,621
1	2	22,607,153
2	3	18,209,674
3	4	12,139,319
4	5	10,280,146
5	6	9,606,999
6	7	8,687,850
7	8	9,592,256
8	9	10,740,753
9	10	12,191,598
10	11	17,540,938
11	12	71,843,509
12	13	62,796,732
13	14	54,836,926
14	15	47,776,658
15	16	41,582,499
16	17	36,994,308
17	18	34,602,518
18	19	30,350,540
19	20	28,256,023
20	21	25,231,289
21	22	24,679,574
22	23	21,602,347
23	24	20,011,970
24	25	17,960,567
25	26	16,297,358
26	27	14,764,884
27	28	14,579,122
28	29	13,486,697
29	30	12,937,711
30	31	11,989,284
31	32	11,069,493
Total		749,758,313

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-8.

Please provide all data in possession or control of the Postal Service showing Priority Mail's share of the two-day delivery market. If available, show the market share for different weight ranges; e.g., up to two pounds, more than two and less than five pounds, and over five pounds.

Response:

The Postal Service volume share of the two-day delivery market is estimated to be as follows:

Weight Category	Priority Mail's Market Share (by volume)
Packages Under 2 lbs.	74.1%
Packages 2 - 70 lbs.	57.2%

Overall the Postal Service share of the two-day market is estimated to be 64.7%.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-9.

- a. Please provide copies of all published rates of competitors (such as FedEx, USPS, TNT, or Airborne) in the possession of the Postal Service for delivery services that compete with Priority Mail (please include rates for UPS guaranteed three-day service if available).
- b. When you decide to propose a higher-than-average increase for zone-rated Priority Mail, what consideration did you give to the published two-day and three-day rates charged by FedEx, UPS and other competitors?
- c. What consideration did you give to discounts or negotiated or unpublished rates that competitors are known to give to shippers who regularly use their respective two-day services?
- d. What consideration did you give to the market share of Priority Mail By weight segment?
- e. Prior to finalizing your proposed rate design for priority Mail, did you assess the competitive situation with persons assigned responsibility for marketing Priority Mail?

Response:

- (a) The Postal Service has obtained published rates for FedEx, UPS, and RPS.

The FedEx and UPS rates were downloaded from their Web sites.

(www.ups.com and www.fedex.com). RPS rates were obtained by calling 1-800-762-3725. To prevent misrepresentation, rather than provide copies the Postal Service prefers that you obtain the published rates directly from the service providers.

- (b) When I developed the rates for zone-rated Priority Mail, as well as the flat rates through five pounds I did not make a detailed comparison between the proposed rates and competitor rates. In general, I was aware that FedEx and UPS had moved to distance-based pricing and

Response of Postal Service Witness Sharkey to NDMS Interrogatories

that was a consideration in the moderation in the size of the rate increases in the short haul zones.

- (c) I am aware that competitors give discounts to regular customers and, as a result, any rate comparisons between published rates would tend to underestimate the price competitiveness of proposed rates this market.
- (d) Market share of Priority Mail by weight segment was not a critical factor in the design of the rate proposal. My intent was not to design rates which captured market share. My intent was to design cost-based rates which reflect the nine statutory criteria of the PRA and were accessible to a wide range of customers.
- (e) Yes.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-10.

- a Has the Postal Service developed any data showing the extent of on-time performance as a result of its experiments with confirmation of Priority Mail? *Please provide copies of all summary performance data available from the delivery confirmation data base.*

Response:

(a.) The Postal Service has not developed any reliable on-time performance data as a result of its experiments with confirmation of Priority Mail.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-11.

- a. What was the effective date of the current requirement that all Priority Mail pieces weighing more than one pound must be entered at a post office counter?
- b. Will that requirement continue to be in effect during Test Year?

Response:

- (a) August 16, 1996.
- (b) Relaxation of the requirement is not foreseen in the near future.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-12.

For all zoned Priority Mail rates that you propose, please confirm that the rates in each cell consist of (i) a per-piece charge of \$2.33212 (USPS-33N, line 13, includes markup and contingency), plus (ii) a zoned pound charge as shown in USPS-330, columns 14, times the weight, plus (iii) an amount for delivery confirmation, rounded to the nearest five cents. If you do not confirm, please explain in detail how the zoned rates are developed for each individual rate cell. Also, please supply the amount added to each rate for delivery confirmation.

Response:

- (i) Not confirmed.
- (ii) Not confirmed.
- (iii) Not confirmed.

An initial set of rates are developed by allocating the per-piece charge cost of \$2.33212 (USPS-33N, line 13, includes markup and contingency) and the zoned pound charge (which includes the unzoned non-transportation cost per pound) shown in column (14) which included markup and contingency. The rates thus developed form the basis for designing the proposed rates. The delivery confirmation cost is treated as a burden on Priority Mail as a whole. Delivery confirmation costs are not allocated in this stage of rate design.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMA/USPS-T33-13.

- a. Please confirm that your proposed rates for Priority Mail include a full markup on all distance-related transportation costs. If you do not confirm, please explain how distance-related transportation costs are treated with respect to markup.
- b. When designing Priority Mail rates, please explain why distance-related transportation costs should be subject to a full passthrough plus a full markup, while dropship discounts in the Standard A subclass reflect only a partial passthrough of distance-related transportation costs.

Response:

(a.) Confirmed.

(b.) Design of Priority Mail rates involved the allocation of volume variable costs to rate elements in the rate schedule. The volume variable cost, in turn, is marked up. The design of dropship discounts entails the estimation of savings to the Postal Service if mail avoids postal transportation and a determination of how much of that savings should be "passed through" in the form of a discount.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-14.

Please provide as a library reference the contracts with commercial air carriers that is/are now in effect.

Response:

See Library Reference - LR-H-229, "Air Systems Contracts".

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-15.

Do distance-related air transportation costs shown in Exhibit USPS-33Q reflect the full amount of such costs, or only some fraction thereof? Please explain.

Response:

The distance-related air costs shown in Exhibit USPS-33Q reflect the full amount of such cost.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-16.

Why did you choose to distribute non-distance transportation costs to each zone instead of simply adding them to the pound rate (i.e., two cents per pound contingency and markup)?

Response:

Non-distance transportation cost are distributed on postage pounds across zones (Column 10 distributed on column 7, USPS-33O) to be consistent with the workpaper design. Non-distance transportation cost are then added to distance-related costs by zone to arrive at total transportation cost by zone. (Column 11, USPS-33O). The total transportation cost by zone is divided by postage pounds by zone to arrive at transportation cost per pound by zone (Column 12, USPS-33O) and adjusted for markup and contingency. The result is the same as simply adding non-distance related costs to the pound rate after adjusting for markup and contingency.

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-17.

- a. What percentage of two-pound Priority Mail is believed to be subject to the Postal Service's statutory monopoly?
- b. What percentage of three-pound, four-pound and five pound Priority Mail is believed to be subject to the Postal Service's statutory monopoly?
- c. What percent of zone-related Priority Mail is believed to be subject to the Postal Service's statutory monopoly?

Response:

(a.) The statutory monopoly covers letter mail which is sealed against inspection.

The protection is based on content. As such, without opening Priority Mail packages it is impossible to determine whether an item contains a letter. The Postal Service, therefore, does not have information on how much Priority Mail is subject to the Postal Service's statutory monopoly.

(b) See (a).

(c) See (a).

Response of Postal Service Witness Sharkey to NDMS Interrogatories

NDMS/USPS-T33-18.

Should the principles of Ramsey Pricing apply to rate design within a subclass such as Priority Mail? Please explain.

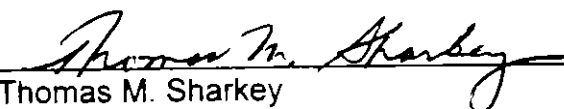
Response:

The issue of the appropriate allocation of institutional costs is one that customarily has been handled at the subclass level, and that is not directly the subject of my testimony. I understand, however, that many of the types of issues that would need to be addressed to respond fully to your question are discussed in Chapter 7 of the testimony of Peter Bernstein, USPS-T-31.

The principles of Ramsey Pricing are useful guideposts in the setting of rates at the subclass level. Rate setting below the subclass level should look to the pricing criteria in the PRA as the principle source of guidance.

DECLARATION

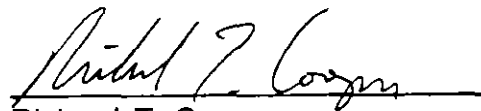
I, Thomas M. Sharkey, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.


Thomas M. Sharkey

Dated: 8/15/97

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.


Richard T. Cooper

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
August 15, 1997