

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

POSTAL RATE AND FEE CHANGES, 2001

Docket No. R2001-1

RESPONSE OF UNITED STATES POSTAL SERVICE
WITNESS JAMES M. KIEFER TO INTERROGATORIES OF
UNITED PARCEL SERVICE
(UPS/USPS-T33-1-2, 5, 9, 10, 15(a) & (h), 16-19)

The United States Postal Service hereby files the response of witness James M. Kiefer to the following interrogatories of United Parcel Service: UPS/USPS-T33-1-2, 5, 9, 10, 15(a) & (h), 16-19, filed on November 19, 2001. Interrogatories UPS/USPS-T33-4, 11, 12, and 14 were redirected to the Postal Service; UPS/USPS-T33-3 and 13 were redirected to witness Moeller; USP/USPS-T33-6-8 were redirected to witness Kingsley; and UPS/USPS-T33-15(b)-(g) were redirected to witness Eggleston.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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UPS/USPS-T33-1. Refer to library reference USPS-LR-J-106, workpaper WP-PP-26.

(a) Confirm that the preliminary rate for a 3-pound DDU destination-entry Parcel Post parcel is 85.0 cents. If not confirmed, explain in detail.

(b) Refer to library reference USPS-LR-J-64, Attachment I, page 3 and USPS-T-15, Attachment 10.

(i) Confirm that City Carrier (C/S 6 & 7) costs for Parcel Post in the TYBR (Test Year Before Rates) are \$80,127,000 (excluding contingency), and that a piggyback factor of 1.423 applies to these costs. If not confirmed, explain in detail.

(ii) Confirm that Rural Carrier (C/S 10) costs for Parcel Post in the TYBR are \$31,120,000 (excluding contingency), and that a piggyback factor of 1.243 applies to these costs. If not confirmed, explain in detail.

(iii) Confirm that, after application of piggyback factors, the total City Carrier and Rural Carrier costs for Parcel Post in the TYBR are \$152,815,000 (\$80,127,000 times 1.423, plus \$31,120,000 times 1.243).

(iv) Confirm that dividing \$152,815,000 by 405,633,782 Parcel Post pieces in the TYBR (from library reference USPS-LR-J-106, workpaper WP-PP-1) yields piggybacked city and rural carrier costs of 37.7 cents per piece (excluding contingency) for Parcel Post, including DDU destination-entry parcels.

(c) Refer to library reference USPS-LR-J-64, Attachment A, page 1 and Attachment I, page 17. Confirm that the average mail processing cost, including piggyback, for DDU destination-entry parcels is 34.6 cents per piece (excluding contingency). If not confirmed, explain in detail.

(d) Refer to library reference USPS-LR-J-106, workpaper WP-PP-15. Confirm that the transportation cost for a 3-pound DDU destination-entry parcel is 6.2 cents per piece (excluding contingency). If not confirmed, explain in detail.

(e) Refer to library reference USPS-LR-J-106, workpaper WP-PP-20. Confirm that the delivery confirmation cost for each Parcel Select piece, including DDU destination-entry parcels, is 3.8 cents per piece (excluding contingency). If not confirmed, explain in detail.

(f) Confirm that the total of city and rural carrier, mail processing, transportation and delivery confirmation costs above for a 3-pound DDU destination entry piece is 82.3 cents ($37.7 + 34.6 + 6.2 + 3.8$) per piece (excluding contingency), and 84.7 cents per piece with a 3.0% contingency. If not confirmed, explain in detail.

(g) Refer to library reference USPS-LR-J-106, workpaper WP-PP-20 and workpaper WP-PP-1. Confirm that the mark-up included in the per-piece component of Parcel Post, including that applicable to DDU destination-entry parcels, is $\$564,137,378 \times (1.03) \times (15.26\%) / 405,633,782$ pieces, or 21.9 cents per piece. If not confirmed, explain in detail.

(h) Refer to library reference USPS-LR-J-106, workpaper WP-PP-21.

(i) Confirm that the total pound charge for a 3-pound DDU destination entry parcel is 16.51 cents per piece, including markup. If not confirmed, explain in detail.

(ii) Confirm that the total pound charge for a 3-pound DDU destination entry parcel includes a markup of 15.26%. If not confirmed, explain in detail.

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(iii) Confirm that with the markup factor of 15.26%, that a markup of 2.2 cents per piece has been included in the pound charge for a 3-pound DDU destination entry parcel. If not confirmed, explain in detail.

(i) Confirm that the cost of a 3-pound DDU destination entry piece plus the markup is \$1.09 (84.7 cents plus 21.9 cents plus 2.2 cents). If confirmed, explain in detail why the preliminary rate for a 3-pound DDU-destination entry of 85.0 cents is so much lower than the cost plus markup of this same piece. If not confirmed, explain in detail.

RESPONSE

(a) Confirmed.

(b) (i) Confirmed.

(ii) The figure \$31,120,000 cannot be confirmed, and is assumed to be a typographical error. The figure \$31,210,000 and the piggyback factor can be confirmed.

(iii) The product of \$31,210,000 and 1.243, added to the product of \$80,127,000 and 1.423, can be confirmed as \$152,815,000, approximately.

(iv) The results of the computation described can be confirmed.

(c) Confirmed, if one is referring to unadjusted costs.

(d) Confirmed.

(e) Not confirmed. The 3.8 cent per piece figure includes both a contingency markup and a general markup.

(f) Not confirmed for several reasons. First, the 3.8 cents already contains markups. Second, a 3% increase over 82.3 cents is 84.8 cents, not 84.7 cents. Third these cannot be characterized as the costs of a 3-pound DDU piece, since these "costs" have not been adjusted.

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- (g) The arithmetic can be confirmed, but the characterization of this figure as the markup per piece of Parcel Post cannot. It is an intermediate result in the rate development process without any clear meaning or significance.
- (h) (i) Confirmed.
- (ii) It can be confirmed that the preliminary pound charge for the described parcel includes a markup factor of 15.26%.
- (iii) It can be confirmed that 2.2 cents of the 16.5 cents is accounted for by multiplying by one plus the 15.26% factor.
- (i) Not confirmed. The supposed \$1.09 rate figure is incorrect and is the result of a flawed rate computation methodology. The \$1.09 figure was arrived at using a bottom-up approach that has several incapacitating flaws. First, the cost numbers used are based on test year projections before final adjustments. Second, the per-piece costs used do not remove weight-related non-transportation costs and so misstate the per-piece costs. Third, the Parcel Select Delivery Confirmation charge already contains a contingency and a markup and is marked up a second time in UPS's calculations. Fourth, the "rate" calculation does not take into account the impacts of revenue offsets, such as from surcharges. Fifth, the UPS approach uses my Cost Coverage Markup Factor, which was developed to achieve the target Parcel Post revenue, *within the context of my rate design*, in an inappropriate fashion. This factor was developed to mark up post-final adjustments costs that had been further adjusted for leakages, surcharges and other revenue offsets. Employing it to mark up raw,

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unadjusted cost data is an invalid use of this factor and is sure to produce false and misleading “cost” and “rate” projections.

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UPS/USPS-T33-2. Provide the workpapers containing the underlying calculations used to derive the figures contained in USPS-T-33, Attachment B, "Parcel Post Financial Summary".

RESPONSE

Please see USPS-LR-J-189, which consists of an electronic spreadsheet (UPS1Q2.XLS). All items except the last column and the items identified as "Changes by Rate Category" of Attachment B are derived in workpaper WP-PP-31. The items identified as Changes by Rate Category are derived in the UPS1Q2.XLS worksheet with the tab labeled "Rate Class Increases." The items in the last column of Attachment B are derived in the worksheet with the tab labeled "Constant Mix Increases" in the cells AE40 to AE44.

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UPS/USPS-T33-5. Refer to library reference USPS-LR-J-64, Attachment A, page 6.

(a) Confirm that there were approximately 38 million Parcel Post DDU-entry pieces in Base Year 2000. If not confirmed, explain in detail.

(b) Refer to library reference USPS-LR-J-106, workpaper WP-PP-1. Confirm that there are expected to be approximately 104 million Parcel Post DDU destination-entry pieces in the TYAR under the Postal Service's proposed rates. If not confirmed, explain in detail.

(c) Confirm that Parcel Post DDU destination entry pieces are forecast to be 28.1% of total Parcel Post volume in the TYAR. If not confirmed, explain in detail.

RESPONSE

(a) Confirmed.

(b) Confirmed.

(c) Confirmed.

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UPS/USPS-T33-9. Confirm that both Priority Mail and Parcel Post pieces will be offered free electronic delivery confirmation service under the Postal Service's proposal in this docket. If not confirmed, explain in detail.

RESPONSE

Not confirmed. The Postal Service's proposal offers no-additional-fee electronic Delivery Confirmation to Parcel Select pieces only. This service is not free to Parcel Select users. The cost of providing this service is recovered in Parcel Select rates. Neither "free" nor no-fee Delivery Confirmation is offered to non-Parcel Select Parcel Post. I am informed that electronic Delivery Confirmation is not offered free to Priority Mail customers. As with Parcel Select, electronic Delivery Confirmation is offered to Priority Mail users without paying a separate fee and its cost is recovered in Priority Mail rates.

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UPS/USPS-T33-10. Confirm that pieces below 1 pound could not be sent by Parcel Post prior to January, 2001. If not confirmed, explain in detail.

(a) Confirm that Priority Mail pieces below 1 pound could migrate to Parcel Post DDU destination entry beginning in January 2001. If not confirmed, explain in detail.

(b) Refer to library reference USPS-LR-J-106, workpaper WP-PP-7. Provide the share of 1 pound Parcel Post parcels separately for DDU destination entry and DSCF destination entry. If not available, explain why not.

RESPONSE

Prior to the implementation of Docket No. R2000-1 rates in January, 2001, pieces weighing below one pound were not eligible to use Parcel Post.

(a) Not confirmed for all Priority Mail pieces. Beginning January 7, 2001 certain Priority

Mail pieces that met the content restrictions for Parcel Post and that weighed under one pound became eligible for entry as Parcel Post, including for entry as DDU Parcel Post, provided all the other requirements for DDU Parcel Post entry were met.

(b) This information is not available. It is my understanding that the information systems used to estimate the shares of one and two pound Parcel Post parcels sample all drop-shipped parcels at the point of destination. These parcels do not bear markings that uniquely determine which Parcel Select rate category they were entered under, so the requested shares cannot be determined.

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UPS/USPS-T33-15. Refer to library reference USPS-LR-J-106 and library reference USPS-LR-J-64, Attachment A, page 1.

(a) Confirm that in your Parcel Post rate design you have applied a 100% passthrough for DBMC (Destination Bulk Mail Center) destination entry, DSCF (Destination Sectional Center Facility) destination entry, DDU (Destination Delivery Unit) destination entry, OBMC (Origin Bulk Mail Center) presort and BMC (Bulk Mail Center) presort worksharing cost avoidances in deriving preliminary rates. If confirmed, explain why a 100% passthrough was selected. If not confirmed, explain in detail.

(b) Confirm that the Postal Service proposes for the first time in this docket to apply a CRA multiplier to the derivation of the Parcel Post DBMC destination entry, DSCF destination entry, DDU destination entry, OBMC presort and BMC presort worksharing mail processing cost avoidances. If not confirmed, explain in detail.

(c) Confirm that application of a CRA multiplier increases the amount of these worksharing cost avoidances by 28.6%. If not confirmed, explain in detail.

(d) Confirm that the DDU destination entry mail processing cost avoidance in comparison to DBMC destination entry would decline from \$1.133 to \$0.881, or 25 cents per piece if the CRA multiplier were not applied. If not confirmed, explain in detail.

(e) Confirm that the DBMC destination entry mail processing cost avoidance in comparison to intra-BMC would decline by from 73.4 cents to 57.1 cents, or 16 cents per piece if the CRA multiplier were not applied. If not confirmed, explain in detail.

(f) Confirm that, in total, the mail processing cost avoided by a DDU destination entry parcel in comparison to an intra-BMC parcel would decline by 41 cents if the CRA multiplier were not applied.

(g) How confident are you that use of the new CRA multiplier provides a conservative estimate of the Parcel Post DBMC destination entry, DSCF destination entry, DDU destination entry, OBMC presort, and BMC presort worksharing cost avoidances? Explain the basis for your answer.

(h) Explain in detail how you took into account the first-time use of a CRA multiplier in selecting the passthroughs to use for the DBMC destination entry, DSCF destination entry, DDU destination entry, OBMC presort, and BMC presort worksharing cost avoidances.

RESPONSE

(a) Not confirmed for OBMC and BMC discounts. Regarding these discounts: these were not derived or reported as part of the preliminary rates I developed. In my constrained rates, I did use a 100% passthrough of cost avoidances for these discounts. The 100% passthrough of cost avoidances can be confirmed for DBMC, DSCF and DDU preliminary rates. It is generally my practice in rate design to first develop preliminary rates that reflect all reported cost savings.

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These preliminary rates are then adjusted, if needed, to incorporate considerations, such as rate change mitigation, that the preliminary rates do not reflect.

(b)-(g) Redirected to witness Eggleston for response.

(h) No adjustment was made. It was not necessary to make any adjustment for several reasons. First, as described in witness Eggleston's response to USPS-T33-15(g), redirected to her, the use of CRA adjustment factors in estimating Parcel Post costs is not new. The only new aspect is the application of these factors to the estimation of some Parcel Post worksharing cost avoidances. There is no reason to believe that applying these factors for the first time means that the factors, or the cost avoidances they are used to estimate, are in any way less reliable, or that they should be adjusted when developing rates. Second, as described in my testimony, preliminary Parcel Post rates were significantly adjusted, primarily to mitigate rate changes and ensure appropriate rate relationships among various rate categories. Even if, contrary to fact, making additional adjustments to reflect the first time use of CRA adjustment factors were deemed to be warranted, there is no reason to believe that, once the subsequent rate mitigation and rate relationship adjustments were undertaken, the resulting rates would have differed to any material degree from those I proposed.

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UPS/USPS-T33-16. Refer to your testimony, USPS-T-33, Attachment B.

(a) Confirm that the Test Year After Rates ("TYAR") contribution per piece for Parcel Post under the Postal Service's proposed rates is 44 cents per piece (\$3.24 minus \$2.80). If not confirmed, explain in detail.

(b) Confirm that, assuming a 100% passthrough of worksharing savings, the contribution per piece for workshared categories of Parcel Post should be the same as that of the non-workshared categories from which the workshared categories' rates are derived. If not confirmed, explain in detail.

(c) Refer to library reference USPS-LR-J-106, and your workpapers WP-PP-22, WP-PP-24, and WP-PP-26, which contain the calculation of preliminary rates for Inter-BMC ("Bulk Mail Center"), intra-BMC, DBMC ("Destination Bulk Mail Center") destination-entry, DSCF ("Destination Sectional Center Facility") destination-entry, and DDU ("Destination Delivery Unit") destination entry Parcel Post. What is the contribution per piece on average for the:

- i. Inter-BMC rate category using the preliminary Inter-BMC rates?
- ii. Intra-BMC rate category using the preliminary Intra-BMC rates?
- iii. DBMC destination-entry rate category using the preliminary DBMC destination-entry rates?
- iv. DSCF destination-entry rate category using the preliminary DSCF destination-entry rates?

RESPONSE

(a) Confirmed.

(b) Not confirmed. Other factors, such as rate change mitigation, affect the final rates proposed for all Parcel Post rate categories, and therefore the contributions per piece, for these categories. Taking into account these factors, there is no reason why contributions should be identical across all rate categories.

(c) (i) to (iv): I have not performed these computations, so I don't know what the requested values are.

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UPS/USPS-T33-17. Refer to library reference USPS-LR-J-106 and your workpaper WP-PP-21.

(a) Confirm that the “pound charges” by rate category derived in workpaper WP-PP-21 include the transportation charges by rate category derived in workpaper WP-PP-15. If not confirmed, explain in detail.

(b) Confirm that the pound charges derived in workpaper WP-PP-21 include a markup, through application of a markup factor of 115.26% to the underlying costs. If not confirmed, explain in detail.

(c) Confirm that Destination Bulk Mail Center (“DBMC”) destination-entry parcels, Destination Sectional Center Facility (“DSCF”) destination-entry parcels, and Destination Delivery Unit (“DDU”) destination-entry parcels represent workshared rate categories of Parcel Post. If not confirmed, explain in detail.

(d) Confirm that it is standard Commission practice in deriving worksharing category rates to deduct the passed-through worksharing cost savings from the rate assigned to the non-workshared rate category. If not confirmed, explain in detail.

(e) Assume the Postal Service’s cost of transporting an intra-BMC (“Bulk Mail Center”) parcel is \$1.00 and the Postal Service’s cost of transporting the same parcel when workshared and dropshipped to the DSCF is 20 cents, reflecting 80 cents of worksharing transportation cost savings. Assume a markup up of 20% is applied in deriving rates and a 100% passthrough is applied to worksharing cost savings.

i. Confirm that the standard Commission practice in building up rates would be to assign \$1.20 for the intra-BMC parcel and \$1.20 minus 80 cents, or 40 cents, for the workshared DSCF parcel. If not confirmed, explain in detail.

ii. Confirm that under your approach in workpaper WP-PP-21, in building up rates you would assign \$1.20 for the intra-BMC parcel and 24 cents for the workshared DSCF parcel. If not confirmed, explain in detail.

(f) Confirm that deriving rates by marking-up the underlying transportation costs for each individual non-workshared and workshared rate category is mathematically equivalent to marking up transportation worksharing cost avoidances. If not confirmed, explain in detail.

(g) Confirm that the Commission explicitly stated in its Opinion and Recommended Decision in Docket No. R97-1, at 489, that Parcel Post transportation worksharing cost avoidances should not be marked up in deriving Parcel Post rates. If not confirmed, explain in detail.

(h) Explain in detail why you have chosen to mark-up transportation worksharing cost avoidances in your derivation of Parcel Post rates. Include in your explanation why you believe the Commission’s traditional practices and its stated position in its Opinion and Recommended Decision in Docket No. R97-1 are wrong.

RESPONSE

(a) Confirmed.

(b) Confirmed.

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- (c) Confirmed.
- (d) This statement cannot be confirmed in the absolute. The Commission has accepted a range of practices for handling worksharing transportation costs, including applying a markup to separately derived transportation costs for destination-entry rate categories.
- (e)
 - (i) It can be confirmed that applying a 20% markup to a \$1.00 transportation cost results in a marked up value of \$1.20 for the hypothetical Intra-BMC piece and that deducting \$0.80 from that \$1.20 results in a value of \$0.40 for the hypothetical DSCF piece. That this is “standard Commission practice” cannot be confirmed in the absolute. See the responses to part (d) above and (h) below.
 - (ii) This calculation cannot be confirmed since it emerges from a false and misleading premise: that the markup under my approach would be the same as under the approach used in subpart (i). Under my approach, the markup applied to produce rates is endogenously derived to achieve a Parcel Post subclass revenue target. For this reason, if a markup of 20% were used in the subpart (i) approach, the markup would not also be 20% in my approach, but a different, higher number. Assuming one piece of Intra-BMC mail and one piece of DSCF mail, the combined revenue generated by these two pieces (based on marked-up transportation costs) using the subpart (i) approach would be \$1.60 (equal to \$1.20 plus \$0.40). Applying a 20% markup in my approach produces combined revenue of \$1.44 (\$1.20 plus \$0.24), falling short of the revenue target. A higher markup than 20% would be needed to achieve the same revenue, producing

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higher rate elements for both the Intra-BMC and DSCF hypothetical pieces than the rate elements cited in subpart (ii).

- (f) Not confirmed. In the process of deriving rates, markups are endogenously arrived at, as described in my response to question 17e(ii), above, so ratemaking using my approach is not mathematically equivalent to ratemaking by marking up the worksharing cost avoidances.
- (g) The Commission's Opinion appears to express agreement with UPS witness Luciani's explanation that witness Mayes' markup approach was "incompatible with the view that the DBMC rates are based on a discount." It cannot be confirmed that this limited statement supports UPS' broad interpretation.
- (h) The Commission has recently shown its willingness to accept the transportation cost markup approach for independently derived destination-entry transport costs, in addition to the discount approach. My use of the transportation cost markup approach in this docket follows the procedure adopted by the Commission in its own Parcel Post workpapers in Docket No. R2000-1.

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UPS/USPS-T33-18. Refer to library reference USPS-LR-J-106 and your workpaper WP-PP-19 (apparently mislabeled WP-BPM-19).

(a) Confirm that the \$1.461 per piece discount for Destination Sectional Center Facility ("DSCF") destination-entry parcels has been decreased by a factor of 6.04% multiplied by \$1.914. If not confirmed, explain in detail.

(b) Confirm that the \$1.884 per piece discount for Destination Delivery Unit ("DDU") destination-entry parcels has been decreased by a factor of 6.04% multiplied by \$1.914. If not confirmed, explain in detail.

(c) Explain the reasoning behind these adjustments and why you recommend that they be incorporated in the Commission's derivation of Parcel Post rates.

RESPONSE

(a) Confirmed.

(b) Confirmed.

(c) The DSCF and DDU per piece discounts were derived by adding together the per-piece savings for DSCF and DDU to the DBMC savings relative to Intra-BMC pieces. The figures for DSCF and DDU are weighted average savings for machinable and nonmachinable parcels combined. The adjustment I made was to reduce the DBMC machinable savings relative to Intra-BMC parcels by a term that reflected the additional DBMC costs due to DBMC nonmachinable pieces. This puts the DBMC-DSCF and DBMC-DDU differentials all on the same basis: a weighted average of machinables and nonmachinables. I recommend that the Commission use this adjustment since it would be incorrect to compare DSCF and DDU machinables plus nonmachinables to DBMC machinable parcels only.

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UPS/USPS-T33-19. Refer to your answer to PSA/USPS-T33-1(b).

(a) Identify each of the "different cost allocation algorithms used in the Priority Mail and Parcel Post rate design process" to which you refer.

(b) Describe each algorithm and compare and contrast its impact on Priority Mail and Parcel Post rates.

RESPONSE

(a) The "different cost allocation algorithms" I referred to are the different methodologies used to apportion total costs to piece and pound components during the ratemaking process. The Parcel Post cost allocation algorithms are the methodologies described in detail in my testimony and workpapers. Witness Scherer informs me that the Priority Mail methodologies are described in his testimony (USPS-T-30, Chapter III, Sections A, B and C), and in his workpapers.

(b) It is my understanding that both methodologies allocate all non-transportation costs, except for weight-related non-transportation costs, to the per-piece rate elements, although the Inter-BMC rate is significantly adjusted to reflect a substantial amount of revenue leakages and surcharges. I understand the Priority Mail methodology also makes a revenue leakage adjustment, but that this is relatively small. The transportation and weight-related non-transportation costs are allocated to the per-pound rate elements for both Parcel Post and Priority Mail. The Parcel Post methodology uses cube-weight relationships to allocate costs derived on a per-cubic foot basis to weight cells. I understand that Priority Mail weight-related costs are allocated to weight cells based on the number of pounds, rather than cubic feet. I have not done any studies that trace out in detail the impacts these different methodologies might have on rates. Nevertheless, what I have been given to understand about Priority Mail's methodology leads me to believe that the allocation

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of transportation and weight-related non-transportation costs based on cubic feet for Parcel Post, and based on pounds for Priority Mail, is likely to cause Priority Mail's rates to rise more steeply with weight than Inter-BMC's rates do, all else being equal.

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.

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