

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

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

**RESPONSES OF UNITED STATES POSTAL SERVICE WITNESS O'HARA
TO INTERROGATORIES OF NEWSPAPER ASSOCIATION OF AMERICA
(NAA/USPS-T30-1 THROUGH 20)**

The United States Postal Service hereby files the responses of witness O'Hara to the following interrogatories of the Newspaper Association of America, dated August 27, 1997: NAA/USPS-T30-1 through 20.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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September 10, 1997

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
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NAA/USPS-T30-1. Please refer to page 4, lines 5-13 of your testimony.

- a. Please describe how "intrinsic value of service" differs from "economic value of service."
- b. Please describe all the non-economic values not included in the latter term.

RESPONSE:

- a. The cited portion of my testimony simply summarizes my understanding of how these terms have traditionally been utilized in discussing rate levels, with "intrinsic value of service" referring to identifiable aspects of the service provided to the various subclasses of mail and "economic value of service" referring to the degree to which volume responds to a price change. There is no intention to suggest that the various "intrinsic" aspects of service have only "non-economic" value.
- b. As I read the question, I am asked to describe all the non-economic values [of service] excluded from "economic value of service." Since my use of "economic value of service" refers only to the response of volume to a price change (own-price elasticity), all other aspects of service (whether labeled "intrinsic," "non-economic," or even "economic") are excluded to the extent they do not manifest themselves in the price elasticity.

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NAA/USPS-T30-2. Please refer to page 6, lines 2-3 of your testimony. If the Commission were to find the "improved cost information" flawed, and therefore used the previous cost methods, would you tend to prefer that it use cost coverages that produce the proposed rates, or somewhat lesser rates, for the affected subclasses.

RESPONSE:

The cited portion of my testimony notes that "somewhat higher percentage rate increases are proposed when the improved cost information indicates that a subclass's share of volume-variable cost is higher under the new cost methods than under the previous method." If the new cost methods are by assumption excluded from consideration, this in isolation would tend to indicate somewhat smaller proposed rate increases for these subclasses (and somewhat higher proposed increases for subclasses with a reduced share of volume-variable costs under the new cost methods); however, it is possible that other criteria would outweigh this tendency, leading to hypothetical proposed rate increases for some subclasses that were unchanged (or even reduced) from those actually proposed.

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NAA/USPS-T30-3. Please refer to page 7, lines 1-8 of your testimony and your response to OCA/USPS-T30-5(5). Does the availability of more alternatives tend to increase or decrease the cost coverage compared to the coverage where few alternatives exist? That is, if many other firms provide similar service at comparable prices, would you propose a lower cost coverage or a higher cost coverage than you would in the absence of these alternatives? Please explain.

RESPONSE:

Please see my response to ABP/USPS-T30-1, where I discuss the case of limited alternatives, and note that if limited alternatives result in a low elasticity, implying a high cost coverage under value of service (criterion 2), criterion 5 provides a basis for considering whether this high cost coverage should be mitigated. In my view, cases of limited alternatives provide the primary occasion for the application of criterion 5. In the case of widespread alternatives, as in your question, criterion 5 generally does not lead to a symmetrical result -- that is, if widespread alternatives result in a high elasticity, indicating a low coverage under value of service, criterion 5 does not generally indicate that this coverage should be increased.

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NAA/USPS-T30-4. Please refer to page 23, lines 5-6 of your testimony. If the elasticity of First Class Mail were due in part to the Private Express Statutes, what would be the significance of that fact?

RESPONSE:

The presumed effect of the Private Express Statutes in reducing the price elasticity of First-Class Mail provides a basis for mitigating, under criterion 5, the cost coverage that might otherwise be implied by this elasticity.

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NAA/USPS-T30-5. Please refer to page 23, lines 11-21 of your testimony. Did the fact that there are limited alternatives to First-Class letter Mail cause you to reduce or increase your proposed cost coverage for this subclass? Please explain.

RESPONSE:

Please see my responses to NAA/USPS-T30-3 and -4.

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NAA/USPS-T30-6. Please refer to page 35, lines 14-17 of your testimony. Did the fact that this Standard ECR mail has many alternatives cause you to reduce or increase your proposed cost coverage for this subclass? Please explain.

RESPONSE:

Although the Standard ECR cost coverage is very high, this is not due to any increase resulting from the existence of significant alternatives. Please see my response to NAA/USPS-T30-3, where I discuss the applicability of criterion 5 to the case of widespread alternatives.

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NAA/USPS-T30-7. Please refer to page 8, lines 4-7 of your testimony. You state that as a consequence of the significant increase in worksharing, the cost coverages for individual subclasses as well as the system as a whole will increase.

- a. Have you estimated what the cost coverages would be in the absence of worksharing? If yes, please provide these adjusted cost coverages.
- b. Please confirm that postal rate schedules, at present and as proposed, contain many more worksharing discounts and shape-based differentials than existed when the Commission and Postal Service first began to make use of markups and cost coverages for setting rates.
- c. Could one address, at least in part, the concern discussed at the cited pages of your testimony by "normalizing" cost coverages by (1) adding back the cost savings from worksharing to the attributable costs of each subclass and (2) then recomputing the cost coverages implicit in the proposed rates with these adjusted attributable costs? Please discuss.

RESPONSE:

- a. No.
- b. Confirmed that the number of rate categories has increased substantially since the Postal Reorganization Act was established.
- c. I am skeptical that this exercise could be carried out with enough precision even to provide a useful basis for discussion, much less serve as an aide to actually setting rate levels. For example, (1) estimated worksharing cost savings may not capture all important cost differences between workshared and non-workshared mail; (2) the calculated revenue (presumably at single-piece or "basic" rates) would probably not achieve breakeven with respect to

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the revenue-requirement (augmented by adding back the cost savings); and

(3) it is not clear what volume forecast should be used in such calculations.

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NAA/USPS-T30-8. Please refer to page 9, lines 1-12 of your testimony.

- a. Is it your opinion that the total institutional cost contribution of an individual subclass should remain unchanged when new worksharing discounts are introduced? If not, please explain why new discounts should allow a subclass to reduce its institutional cost contribution.
- b. Please confirm that maintaining the same cost coverage for a subclass while introducing new worksharing discounts that reduce attributable costs for the subclass necessarily will result in a lower unit cost contribution for that subclass. If you cannot confirm this statement, please explain why.
- c. Please explain why the reduced contribution from the hypothetical subclass with the greater than average reduced attributable costs presented in lines 11 -12 would "unfairly" burden other subclasses. In particular, please explain why you believe that outcome to be "unfair."

RESPONSE:

Note that the cited portion of my testimony refers to "increased worksharing" over time, not to the introduction of new worksharing discounts per se. Worksharing may increase over time without new discounts; for example, the adoption of worksharing by existing mail may take place gradually, and there may also be differential growth in different types of mail (e.g., presort vs. single-piece First-Class Mail).

- a. Not necessarily; coverages and contributions need to be evaluated against all the rate-setting criteria, taking into account the overall circumstances presented by each specific rate-case. My example (page 9, lines 3-12) does illustrate, however, that mechanically maintaining cost-coverages relative to the system average (by using coverage indexes, for example) will tend to

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shift the burden of contribution to institutional cost from subclasses with above-average increases in work-sharing to those with below-average increases. In this situation, I believe that previous coverages (or coverage indexes), determined to be fair and equitable at the time they were recommended, cannot be assumed to remain so at a later date, given differential increases in worksharing over the intervening period.

- b. Confirmed, but only to the extent that the new worksharing discounts do lead to reduced attributable costs by generating increased worksharing; new worksharing discounts that simply recognize worksharing that is already being performed will have no effect on unit contribution.
- c. Please see my response to part a.

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NAA/USPS-T30-9. Please refer to your testimony at page 17, lines 7-9. Did you consider the use of unit cost contributions as a starting point, at least, for determining rate levels under the new costing method? Please discuss why or why not, and indicate why your testimony does not address unit contributions.

RESPONSE:

As indicated, the cited portion of my testimony asks whether mark-ups and cost coverages developed under the previous method of measuring costs can be utilized, at least as a starting point, in determining rate levels under the new costing method. I did not use previous unit contributions for this purpose simply because rate levels have traditionally been discussed in terms of mark-ups and cost coverages.

In response to your question, however, I have briefly considered the use of a "unit contribution index." In the example in Table E-1 of my testimony, in which the decline in measured cost is the same for both products, a unit-contribution index would produce the exactly the same results as the mark-up index (Panel II of the Table), and thus would be subject to the same criticism (see page 19, lines 3-7 of my testimony).

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NAA/USPS-T30-10. Please refer to Exhibit USPS-30B and Exhibit USPS-30G. Please confirm the following unit cost contributions for test year 1998 after rates. If you cannot confirm these figures, please provide the correct figures and demonstrate how these figures were calculated.

- a. First-Class letter mail: Unit cost contribution = 17.55 cents
- b. First-Class single letters: Unit cost contribution = 17.17 cents
- c. First-Class worksharing letters: Unit cost contribution = 18.04 cents
- d. Standard Commercial Regular mail: Unit cost contribution = 7.52 cents
- e. Standard Commercial ECR mail: Unit cost contribution = 8.43 cents
- f. Total Standard Commercial mail: Unit cost contribution = 7.91 cents
- g. Please confirm that First-Class letter mail pays a unit cost contribution more than double the contribution of Standard Commercial mail.
- h. Please confirm that the average First-Class letter weighs approximately one-third the weight of the average piece Standard Commercial mail. If you cannot confirm this statement, please provide the average weight of First-Class letter mail and Standard Commercial mail.

RESPONSE:

a-g. Confirmed, except for part b, where my calculations round to 17.18 cents.

h. Confirmed; please see Exhibit USPS-5C, pages 15 and 18.

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NAA/USPS-T30-11. Please refer to page 36, lines 1-9 of your testimony.

- a. Please confirm that the movement of ECR basic letters to the Automation 5-digit rate in Standard Regular mail indicates that these two mail categories are direct substitutes for one another. If you cannot confirm this statement, please explain why.

- b. Please confirm that the desire to have a lower rate for Automation 5-digit letters within Standard Regular mail compared to the basic ECR letter rate significantly restricts your ability to set cost coverages for these two subclasses independently of each other. If you cannot confirm this statement, please explain how you can determine the cost coverage for Standard ECR mail independently of the cost coverage for Standard Regular mail.

RESPONSE:

- a. Not confirmed; the movement of this mail simply demonstrates that some mailers have choices as to how they prepare their mail and will respond to rate differentials, in the same way that other Standard Regular mailers may choose to mail certain items at First-Class Mail card rates.

- b. Not confirmed; although I mention this consideration among others, I cannot confirm that it "significantly restricts" my choice of cost coverages. The considerations mentioned in lines 2-4 of page 36 would have been sufficient to generate the cost coverage I proposed.

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NAA/USPS-T30-12. In Docket No. R90-1, the Postal Service, through the testimony of witness Mitchell, advocated setting rates and discounts in a manner that would minimize the total combined cost to the Postal Service and mailers. Is the minimization of total combined cost to the Postal Service and mailers still a goal of the Postal Service today in setting rates?

RESPONSE:

Yes, the Postal Service still regards the achievement of "lowest combined cost" to be an important consideration in setting rates; this consideration is primarily addressed in connection with rate design within a subclass.

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NAA/USPS-T30-13. Please refer to page 14, lines 3-5 of your testimony.

- a. Please confirm that rates for all subclasses are not equal to the marginal costs of the subclass. If you cannot confirm this statement, please indicate where rates equal marginal costs.
- b. Please confirm that the mailers decision about how much to mail is determined by the rate for the mail, not by the marginal cost of the mail. If you cannot confirm this statement, please explain how the marginal cost of the mail influences the mailer's decision.
- c. Please confirm that using incremental costs in place of volume variable costs as the attributable costs for markup purposes would only alter a mailers decision about how much to mail if the use of incremental costs resulted in different rates. If you cannot confirm this statement, please explain why.

RESPONSE:

- a. Confirmed.
- b. Confirmed.
- c. Confirmed; however, although the question appears to imply that costs do not affect rates, it is my expectation that the use of different measures of cost for determining markups would result in different rates.

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NAA/USPS-T30-14. Please refer to page 14, lines 10-16 of your testimony. You state that "any rate setting process based on something other than volume-variable costs ... will be constructing rates based on a cost concept that does not accurately reflect the cost consequences of the decisions that mailers will make in response to those rates." (footnote omitted)

- a. If volume variable costs are used in the rate setting process, please explain how rates that are not equal to volume variable costs "reflect the cost consequences of the decisions that mailers will make in response to those rates."
- b. Please confirm that the cost coverages proposed by the Postal Service in this proceeding are not equal to the cost coverages derived by Witness Bernstein's in his Ramsey pricing analysis. If you cannot confirm this statement, please illustrate how your proposed cost coverages equal Witness Bernstein's coverages.
- c. Please refer to page 14, lines 15-16 of your testimony. Please demonstrate that your proposed cost coverages based upon volume variable costs are "economically efficient." If you cannot do so, please explain why.
- d. Please demonstrate that setting rates based upon incremental costs will be less economically efficient than your proposed cost coverages and the resulting rate levels based upon volume variable costs. If you cannot do so, please explain why.
- e. Please confirm that the use of marginal costs in the rate setting process will result in "economically efficient" rates only if rates are set equal to marginal costs or Ramsey pricing is used.

RESPONSE:

- a. As is well-known, rates equal to marginal cost would not produce enough revenue to cover the total cost of providing postal services, but rates that are based on marking-up volume variable costs will better reflect the cost consequences of mailer response to these rates than rates based on marking up attributable or incremental costs. The example that immediately follows

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the cited paragraph in my testimony illustrates this; for the general principle of setting rates relative to volume-variable costs, see the testimony of witness Panzar, USPS-T-11, especially p. 28, lines 7-19.

- b. Confirmed.
- c. There are degrees of economic efficiency; setting prices equal to marginal cost is often referred to as a "first-best" solution, while Ramsey prices are "second-best," involving some loss of efficiency relative to prices that equal marginal cost. Prices that are above marginal cost but not equal to Ramsey prices will entail some additional loss of economic efficiency. This is true of my proposed cost coverages, which reflect all the criteria of the Act and do not aim solely at economic efficiency. However, if these coverages (or a suitably indexed version of them) were applied to attributable cost (calculated as the sum of volume-variable and specific-fixed cost in accordance with previous practice) or incremental cost, the loss of efficiency would be even larger, and unnecessarily so, as witness Panzar testifies (USPS-T-11, page 28, lines 14-15).
- d. Please see my response to part c.
- e. Not confirmed; please see my response to part c.

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NAA/USPS-T30-15. Please refer to your example on pages 14-15 of your testimony.

- a. Please confirm that the incremental costs for the one product are 22 cents per piece and the incremental costs for the other product are 18 cents per piece.
- b. Assume that these are the only two products offered by the firm. Please confirm that the costs remaining after subtracting the incremental costs of both products are the costs that cannot be avoided by eliminating one of the products and hence, these costs are common to the production of both products; that is, the remaining costs can only be avoided by eliminating both products.
- c. Assume that each product is charged a rate of 30 cents. Please confirm that the first product (with an incremental cost of 22 cents per piece) covers its average incremental costs and makes a contribution of 8 cents per piece to the common costs of the firm. If you cannot confirm this figure, please explain why not.
- d. Please confirm that the second product (with an incremental cost of 18 cents per piece) covers its average incremental costs and makes a contribution of 12 cents per piece to the common costs of the firm. If you cannot confirm this figure, please explain why not.

RESPONSE:

- a. Confirmed that these are the average incremental costs, given the volumes of both products implicit in the example.
- b. Not confirmed. Incremental costs are determined by treating each product in turn as the last service provided, and the incremental cost of each product in general depends not only on its own volume but on the volume of the other product. See USPS-T-11, pp. 24-26. Therefore, the figure obtained by adding these costs together and subtracting from total costs is not a meaningful measure of "common costs;" instead it is a measure of economies of scope (see USPS-T-11, p. 29).

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c-d. Not confirmed, since "common costs" as defined in part b are not
meaningful.

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NAA/USPS-T30-16. Please provide the Postal Service's delivery performance (that is, success in meeting delivery standards) for First Class Mail for Fiscal Years 1995 and 1996. Please state separately the delivery performance for overnight, two day, and three day service.

RESPONSE:

Quarterly EXFC data for the requested time period is presented below.

	<u>95:1</u>	<u>95:2</u>	<u>95:3</u>	<u>95:4</u>
Overnight	84.1	84.5	86.8	87.2
Two-day	75.5	75.0	79.1	80.1
Three-day	80.2	75.5	82.2	82.7
	<u>96:1</u>	<u>96:2</u>	<u>96:3</u>	<u>96:4</u>
Overnight	87.8	87.3	90.4	91.2
Two-day	79.5	75.5	80.0	80.3
Three-day	82.2	70.9	82.4	82.8

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NAA/USPS-T30-17. Please provide the Postal Service's delivery performance (that is, success in meeting delivery standards) for Standard (A) Mail (or, as appropriate, third class bulk business regular) for Fiscal Years 1995 and 1996. Please state separately the delivery performance for overnight, two-day, and three day service.

RESPONSE:

I am informed that the Postal Service has no nationally representative delivery performance data for third-class or Standard (A) Mail. Moreover, service standards for this mail are not stated in terms of "overnight, two-day and three day service;" service standards are described in the Postal Service's Request; see the page in Attachment G relating to Rule 54(n).

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NAA/USPS-T30-18. To your knowledge, does the Postal Service have any information regarding the delivery service provided to First Class and Standard (A) mail that is entered at destination offices? If so, please state your understanding of what that information is.

RESPONSE:

None, to my knowledge.

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NAA/USPS-T30-19. Please refer to page 36, lines 4 -9 of your testimony. Does the Postal Service's operational goal of encouraging ECR basic letters into the automation mailstream act as a ratemaking constraint by creating a "linkage" between the Standard Regular and ECR subclasses?

RESPONSE:

Please see my response to NAA/USPS-T30-11b. This situation is similar to a number of other cases where it is necessary to consider rate relationships across subclass boundaries for particular rate categories (e.g., the Priority Mail two-pound rate compared to both the 11-ounce First-Class Mail letter rate and Parcel Post rates; First-Class worksharing card rates compared to Standard (A) Regular letter rates). None of these cases is of sufficient importance to create a linkage between the subclasses in their entirety.

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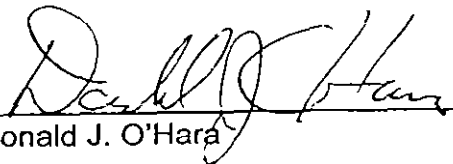
NAA/USPS-T30-20. Please refer to page 36, lines 4 -9 of your testimony. Does the Postal Service have an operational or revenue preference as to whether Standard (A) high-density and saturation letters are mailed at Standard Regular automation or Standard ECR rates? Please explain.

RESPONSE:

The operational preference for moving ECR letters into the automation mailstream noted in witness Moden's testimony refers only to ECR Basic letters, not high-density or saturation letters (USPS-T-4, p. 8, line 15 to p. 9, line 2). As for "revenue preference," the relevant consideration is revenue minus cost, or net revenue; although data do not permit precise net revenue calculations for this specific type of mail, the Postal Service has no reason to believe that having this mail entered as high-density or saturation Standard ECR letters (rather than as Standard Regular automation letters) entails a reduction in net revenue.

DECLARATION


I, Donald J. O'Hara, hereby declare, under penalty of perjury, that the foregoing Docket No. R97-1 interrogatory responses are true to the best of my knowledge, information, and belief.


Donald J. O'Hara

9-10-97
Date

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.

A handwritten signature in cursive script, appearing to read "Michael T. Tidwell", written over a horizontal line.

Michael T. Tidwell

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September 10, 1997