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

COMPLAINT OF TIME WARNER INC. ET AL.
CONCERNING PERIODICALS RATES — Docket No. C2004-1

RESPONSES OF TIME WARNER INC. ET AL. WITNESS ROBERT W. MITCHELL TO MH/TW ET AL.-T1-39-44
(July 9, 2004)

Time Warner Inc., Condé Nast Publications, a Division of Advance Magazine Publishers Inc., Newsweek, Inc., The Reader's Digest Association, Inc., and TV Guide Magazine Group, Inc. (collectively, Time Warner Inc. et al.) hereby provide the responses of witness Mitchell (TW et al.-T-1) to McGraw-Hill interrogatories MH/TW et al.-T1-39-44, filed June 25, 2004.

Each interrogatory is stated verbatim and followed by the response.

Respectfully submitted,

s/________________________
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Response of Witness Mitchell to MH/TW et al.-T1-39

MH/TW et al. – T1-39: With reference to your response to MH/TW et al. – T1 – 3:

> (a) Please explain fully the basis for your statement that "['i]f the volume reduction is large, there is a possibility that the marginal [transportation] cost will decline, due to scale effects," and reconcile your statement with the statement by witness Stralberg in response to MH/TW et al. – T2 – 8 that "when volume declines dramatically the marginal costs might increase for the volume that remains."
>
> (b) Please explain fully the basis for your statement that a large reduction in volume may result in "lower volume variability of the Postal Service's transportation systems."
>
> (c) Please explain fully the basis for your statement that a lower volume variability of the Postal Service's transportation systems "would result in lower unit transportation costs, not higher ones."
>
> (d) Please explain fully the empirical basis for your statement, regarding the unit cost of handling sacks when mailers shift to pallets, that "the percentage decrease in the numerator [cost] is the same as the percentage decrease in the denominator [volume]," and reconcile your answer with the testimony by witness Stralberg in response to MH/TW et al. – T2 – 8 that: "Regarding sack sorting and other sack handling operations, there may be some disagreement over how volume variable those costs are. I do not know the answer to that question."

RESPONSE

(a) The first paragraph of my answer to MH/TW et al. – T1 – 3 defines unit cost. The numerator is the volume variable transportation cost and the denominator is the associated volume. The second paragraph of the same answer suggests that large volume declines might cause the unit cost to decline, because of a proportionate decline in the numerator that is larger than the proportionate decline in the denominator. This possibility is based on my belief that, faced with a large volume decline, the elasticity factors developed in the Commission's transportation analysis might tend to decline. That analysis is discussed in the Commission's and is based in large part on the analysis presented in several cases by Postal Service witness Bradley. See Docket No. R2001-1, USPS-T-18; PRC Op. R2001-1, March 22, 2002, at 167-92; and PRC Op. R97-1, May 11, 1998, at 204-18.

The response of witness Stralberg that you cite refers to *dramatic* volume declines and says that the marginal costs *might* increase. I would not argue that some increase in marginal costs could not occur. Speculating about extreme positions, however, may not inform the questions being faced. Other parts of Stralberg's same response provide particularly insightful comments about more realistic issues concerning the transportation of Periodicals. These deserve greater attention.

(b) Until an altered future arrives and the analysis is done, it is not possible to know the outcome for sure. My line of reasoning assumes continuous curves and focuses on likely behavior in the limit. The first limit is a presumption that a large volume *increase* would lead to *increases* in the elasticity factors. One could certainly argue that as there become multiple, full runs every day of the largest transport equipment available, all of the elasticities would be 1.0. The second limit is to reduce the overall volume levels to very low levels. There I see a transportation system where, say, a 10 percent volume increase might cause an increase in cost of only a few percentage points.

(c) The context of my statement is: "If the volume reduction is large, there is a possibility that the marginal costs will decline . . ." I then state, in effect, that if this occurs: "This would come about from a lower volume variability of the Postal Service's transportation systems, and would result in lower unit transportation costs, not higher ones." By definition, the marginal cost at issue equals the total accrued cost of all postal transportation times the variability times the distribution-key proportion divided by the Periodicals volume. The upward effect of variability on marginal cost is obvious.

(d) The basis for my statement is in the fourth and fifth lines of my answer to part “b” of subject response, where I say that “economies of scale are not generally believed to exist” in sack handling operations. This is consistent with the Commission’s analysis of cost segment 3.

I do not see any conflict with witness Stralberg’s response to MH/TW et al.-T2-8. When he says that “there may be some disagreement over how volume variable those [sack sorting or sack handling] costs are,” I understand Stralberg to be acknowledging that questions have been raised by the Postal Service in several recent cases about whether the variabilities of some manual operations might be less than 100 percent. The Commission has found, however, that the costs are fully variable.

Response of Witness Mitchell to MH/TW et al.-T1-40

MH/TW et al. – T1 – 40: With reference to your response to MH/TW et al. – T1 – 7, please explain whether you are suggesting that the "value of the service received" may not be the same for the 3-digit pallet and the 3-digit sacks, and explain fully the reasons for your answer, and reconcile it with your response to MH/TW et al. – T1 – 1.

RESPONSE

As you note, I suggested only that the value of service received *may* be different, not that it *would be expected* to be different. Whether it is different in any particular situation is an empirical question. My discussion would not be complete if I did not allow for the possibility that it could be different. There is no conflict with my response to MH/TW et al. – T1 – 1, which is a hypothetical for the purpose of explaining the concept of efficiency. It too allows for the possibility of differences in the value of service.

Response of Witness Mitchell to MH/TW et al.-T1-41

MH/TW et al. – T1 – 41: With reference to your response to MH/TW et al. – T1 – 11(b), please explain fully how "[a]ll of the 23.8 cents" is included in the DADC, DSCF and DDU pound rates when each of those rates is less than 23.8 cents.

RESPONSE

Conceptually, the explanation is reasonably simple. The first-cut pound rates, to which your earlier question (MH/TW et al. – T1 – 11) refers, are per-pound transportation costs, by zone, and are 0 at the DDU level, 0 at the DSCF level, very low at the DADC level, and a little higher at each succeeding zone. Then (a) the non-distance-related transportation costs are *added* to the DSCF and above zones, (b) the 23.8 cents (which includes the editorial benefit and the non-transportation costs to be recovered from the pound rates) is *added* to all zones, and (c) the per-pound portions of the non-transportation cost avoidances are *subtracted* for the DADC level, the DSCF level, and the DDU level. Whenever the per-pound portion of the non-transportation cost avoidances "c" is larger than the sum of the first-cut transportation costs and the non-distance-related transportation costs "a," the resulting rates are less than 23.8 cents. It would be appropriate to view the removal of "c" as removing a portion of the non-transportation costs in "b," but not as removing any of the editorial benefit in "b." You might want to note that the spreadsheet of Docket No. R2001-1 leaves something to be desired, since some of the numbers were hard-wired to obtain the settlement rates.

Response of Witness Mitchell to MH/TW et al.-T1-42

MH/TW et al. – T1 – 42: With reference to your response to MH/TW et al. – T1 – 11(a):

> (a) Please confirm that according to your analysis of PRC LR-9 in Docket R2001-1, the full revenue leakage associated with the unzoned editorial pound rate is $214.3 million. If you do not confirm, please explain fully.
>
> (b) Please confirm that the above-referenced $214.3 million represents the difference between revenue generated by the flat editorial pound rate and the revenue that would be generated by editorial pounds if, in lieu of the flat editorial pound rate, editorial pounds were assessed the zoned pound charges that apply to advertising matter. If you do not confirm, please explain fully.
>
> (c) Please confirm that no portion of the above-referenced $214.3 million is recovered from the flat editorial pound charge. If you do not confirm, please explain fully.
>
> (d) Please confirm that a Periodical comprised of 100% editorial content would not pay any portion of the above-referenced $214.3 million, regardless of whether it was mailed a relatively short distance or a relatively long distance. If you do not confirm, please explain fully.
>
> (e) Please confirm that under the current rate structure, the above-referenced $214.3 million is to be recovered fully from the zoned pound charges for advertising content. If you do not confirm, please explain fully.
>
> (f) Please confirm that the extent to which a Periodical mailer pays any portion of the above-referenced $214.3 million depends solely on the advertising percentage of the Periodical, and not at all on the distance that it is mailed. If you do not confirm, please explain fully.

RESPONSE

(a) Confirmed.

(b) Confirmed.

(c) Not confirmed. Since the flat editorial pound is, in Docket No. R2001-1, 77.8 percent of the zones 1&2 advertising pound rate, which has been elevated by the 23.8-cent figure, it follows that the flat editorial pound rate is elevated by 18.5 cents per pound (0.778 * 23.8).

Consistent through all rate cases since Reorganization, including Docket No. MC95-1 but excepting Docket No. R2001-1, the flat editorial pound rate has been set at 75 percent of the zones 1&2 advertising pound rate. In Docket No. R2001-1, the Postal Service proposed an alternative way of specifying how much of the overall revenue was to come from the editorial pound rate, and the 75-percent proportion was increased to 81.2 percent. During the settlement discussions, adjustments were made that reduced the 81.2-percent proportion to 77.8 percent. At the same time, many of the cells in the spreadsheet were hard-wired, so that the sheet in the Commission's Library Reference 9 is not really a working spreadsheet.

Using the 77.8-percent figure, however, the effect can be illustrated. Suppose there are only three zones, 1, 2, and 3, with zone 1 taking on the characteristics of zones 1&2, and suppose further that the direct transportation cost for transporting mail is 3 cents (per pound) for zone 1, 5 cents for zone 2, and 9 cents for zone 3. These costs are estimates of actual per-pound marginal costs and are not influenced by whether the material being carried is advertising or editorial. Now add a non-distance-related transportation cost of 1 cent per pound and increase these three figures to 4, 6, and 10 cents. If the editorial pound rate were to be set at this point, it would be set at 0.778 * 4 cents = 3.112 cents per pound (although it would be rounded).

Now find the sum of 4 times the pounds of advertising in zone 1 plus 6 times the pounds of advertising in zone 2 plus 10 times the pounds of advertising in zone 3 plus 3.112 times the pounds of editorial. This sum provides a revenue-so-far figure. Subtracting this revenue-so-far from the revenue desired from the pound rates yields a deficit. Part of the deficit is due to the fact that a lower rate is being given to the editorial pounds.

The next step is to increase the pound rates by enough to make up the deficit, accounting for the fact that the editorial pound rate will be increased by only 77.8 percent of any resulting increase for advertising. Suppose it is calculated that the advertising pound rates need to be elevated by 5 cents per pound (a figure which corresponds to the 23.8-cent figure in your question designated MH/TW et al.-T1-12). The new rates for advertising become 9, 11, and 15 cents (5 cents added to each of the above figures of 4, 6, and 10). The zone 1 rate is now known to be 9 cents per pound, so the flat editorial rate will be 0.778 * 9 = 7.002 cents per pound (which will be rounded to 7.0 cents). It is clear that 7.002 cents per pound (for editorial) is much higher than the 3.112-cent figure calculated above, and specifically that the difference between 7.002 and 3.112 (7.002 – 3.112 = 3.890) equals 0.778 * 5 cents. In other words, the editorial pound rate has been elevated by 3.890 cents per pound (before rounding).

The figure of $214.3 million is a measure of the extent to which the editorial pound rate is reduced. (Drawing on the above illustration, it corresponds to (9.0 – 7.0 0) * zone-1 editorial pounds + (11.0 – 7.0) * zone-2 editorial pounds + (15.0 – 7.0) * zone-3 editorial pounds.) The proposed rates do not change this measure; they simply give it in an improved way.

(d) Not confirmed. Please see my response to part “c” above.

(e) Not confirmed. Please see my response to part “c” above.

(f) Not confirmed. Please see my response to part “c” above.

MH/TW et al. – T1 – 43: With reference to your response to MH/TW et al. – T1 – 13(b), please explain fully and precisely what "additional amount" – beyond the flat editorial pound charge – is paid by editorial pounds to recover revenue leakage associated with the flat editorial pound charge.

RESPONSE

The total number of pounds of Outside County Periodicals, TYBR, is 4,355,054,865 (see cell B52 of sheet 'Test Year BR' in the Commission's Library Reference 9, Docket No. R2001-1). Since editorial pounds are going to pay only 77.8 percent of any elevation in the pound rates, it is convenient to work with weighted pounds, equal to 77.8 percent of the editorial pounds plus 100 percent of the advertising pounds, which is 3,810,631,220 pounds. The figure of $214.3 million divided by the weighted-pound figure is an elevation of 5.62 cents per pound. The editorial pound rate is elevated 77.8 percent of this amount, which is 4.37 cents per pound. This is the "additional amount" you seek. When this amount is multiplied by the total number of editorial pounds, the result is $109.3 million. In other words, the benefit to editorial matter, in the pound rates, is $214.3 million, $109.3 million of which is paid by editorial itself.

These figures outline a particularly perverse characteristic of the flat editorial pound rate. Suppose there were *no* flat editorial pound rate and *no* pound-rate editorial benefit of any other kind either. The figure of $214.3 million would then be revenue that would be used to lower *all* pound rates. Specifically, $214.3 million is 4.92 cents per total pound (214,300,000/4,355,054,865, expressed in cents). Therefore, the full weight of the publication would pay the current advertising pound rates less 4.92 cents per pound, these rates being, after rounding, 15.4 cents at the DSCF level, 17.4 cents at the DADC level, and 19.9 cents at the zones 1&2 level.

Under the flat editorial pound rate, a 100 percent editorial publication pays 19.3 cents (per pound) at each of the DSCF level, the DADC level, and the zones 1&2

level. Under the no-editorial-benefit rates just described, the same 100 percent editorial publication would pay, in the same order, 15.4 cents, 17.4 cents, and 19.9 cents. It is clear, then, that without any per-pound editorial benefit at all, all-editorial publications, compared to their current situation, would be 3.9 cents per pound better off at the DSCF level (accounting for 40.59 percent of Outside County volume), 1.9 cents per pound better off at the DADC level (accounting for 8.5 percent of Outside County volume) and only 0.6 cents per pound worse off at the zones 1&2 level (accounting for 9.36 percent of Outside County volume). In other words, due to the skewed nature of the way the benefit is provided, editorial matter is paying so much of the editorial benefit that much of it would be better off not having the benefit at all. It could be argued that a substantial portion of editorial matter is paying a *penalty* for being editorial. The rates proposed in the Complaint do not have this infirmity.

Response of Witness Mitchell to MH/TW et al.-T1-44

MH/TW et al. – T1 – 44: With reference to your response to MH/TW et al. – T1 – 14, please put aside the assumption adopted in your testimony that all local and regional publications have an average proportion of advertising content, and answer the interrogatory as asked.

RESPONSE

Removed from its context, your question is whether a local or regional publication with a "high" proportion of editorial content, printed and entered near the location of its readership, might have a cost coverage that is below 100 percent and at the same time whether this cost coverage (that is below 100 percent) might be lower than the cost coverage for a local or regional publication with a "high" advertising proportion that is printed and entered a considerable distance from the location of its readership.

As it stands, the question refers, without being specific, to high proportions and considerable distances. For discussion purposes, let's assume the high-editorial publication is 100 percent editorial and the high-advertising publication is 100 percent advertising, and further that the former is entered in the DSCF and the latter in zone 8. And let's recognize that high-editorial publications are considerably lighter in weight-per-piece than the average publication, so that the zone rates play a lesser role in their postage (see my response to MH/TW et al. – T1-24b). As noted on line 12 of page 37 of my testimony, the average cost coverage on editorial matter is 84.7 percent and on advertising matter is 129.5 percent, and these would apply if the billing determinants of both the editorial and the advertising were the same as the billing determinants of the subclass as a whole.

The editorial piece would be expected to have a much higher cost coverage in the DSCF than in zone 8, due to the nature of the flat editorial pound rate and to the fact that the non-transportation cost difference among the zones are not recognized in the rates. Also, I showed in my response to MH/TW et al. – T1 – 43 that the flat editorial pound rate at the DSCF level is higher that would be a more cost-based rate under a structure without a flat editorial pound rate and without any other editorial pound benefit. Particularly for a lightweight piece, however, and due in part to the fact that there is also a per-piece editorial benefit, it seems doubtful that the DSCF coverage would be enough higher than 84.7 percent to cross 100 percent. Therefore, the suggestion in your question is probably correct. The coverage on the advertising piece would not vary as much by zone as the coverage on the editorial piece; since some of the cost differences are recognized in rates, however, it would vary, and it would be lower in zone 8. It seems unlikely that the figure of 129.5 percent would decline by as much as 29.5 percentage points for zone 8, so that, again, the suggestion in your question is probably correct that the coverage on the advertising piece is both higher than the coverage on the editorial piece and greater than 100 percent.

As can be seen from this analysis, the benefit being received by the editorial piece, relative to the cost coverage of the subclass, may be rather small. Also, back to the context of my testimony, the editorial piece is in a position where it could be printed at a distant location, for little or no increase in postage, and thus be carried back by the Postal Service virtually free. On the other hand, the advertising piece is not as likely to print at a distant location, because its rates do increase, although not as much as the Postal Service's costs. Accordingly, it seems more likely that the printing of the pieces in your question would fall the other way, the editorial printed far and the advertising printed close.