

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

POSTAL RATE AND FEE CHANGES
PURSUANT TO PUBLIC LAW 108-18

Docket No. R2005-1

RESPONSES OF UNITED STATES POSTAL SERVICE WITNESS TAUFIQUE TO
INTERROGATORIES OF VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
(VP/USPS-T28-1-3, 6(f), 7(b)(v), 8(f), 9(b, g-h), 10-13, 16, 17(a-c), 18(c-g), 19)

The United States Postal Service hereby files the responses of witness Taufique to the above-listed interrogatories of the Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc., filed on April 20, 2005. Interrogatory VP/USPS-T28-4 has been redirected to witness Kelley. Interrogatories VP/USPS-T28-5, 6(a-e, g), and 7(a-b(iv)) have been redirected to witness Miller. Interrogatories VP/USPS-T28-8(a-e, g), 9(a, c-f, i), and 14-15 have been redirected to witness Abdirahman. Interrogatories VP/USPS-T28-17(d) and 18(a-b) have been redirected to witness Robinson.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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VP/USPS-T28-1. Please refer to library reference USPS-LR-K-115, file USPST28Aspreadsheets.xls. The sheet "ECR-15 Rate Adjustments" shows 15 special adjustments to ECR commercial rates, all of them positive. You indicate that these adjustments are "to remove irregularities in rate differentials caused by rounding."

- a. Referencing the statistical expectation that normal rounding procedures involve both rounding up and sometimes down, please explain how it is that all 15 of the adjustments have a positive effect on the rates.
- b. For each of the 15 adjustments, individually, please identify and specify the "irregularity" that you saw in the rates, which caused you to make the adjustment, and explain how your adjustment fixed the anomaly.

Response:

a&b. Since neither the rate anomalies nor the remedy for the anomalies were the result of a statistically random process, there should be no *a priori* expectation that the adjustments would not have all the same sign.

The adjustments were made to ensure that current consistency in discounting practices was maintained. For instance, the DSCF discount would be the same (0.5 cents off the DBMC rates) for all shapes and presort levels, and similarly, Origin-DBMC and DSCF-DDU discounts were kept uniform across shape and presort levels. For Saturation parcels (piece rated pieces) and Basic parcels (pound rated pieces), the adjustments were designed to ensure that the RSS was uniform for all presort levels.

These anomalies can be seen by comparing the unadjusted drop-ship rate differentials (and RSS values for parcels) across shape and presort levels. That the adjustments fixed the anomalies can be seen by making the same comparisons using the adjusted ECR rates.

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VP/USPS-T28-2. Please refer to your testimony, USPS-T-28, page 11 (ll. 17-18), where you say that, under the Postal Service proposal, Standard Mail ECR receives a rate increase of 5.6 percent, while Standard Mail Nonprofit ECR receives a rate increase of 5.9 percent. Please refer also to your statement on page 11 (ll. 21-26) that Public Law 106-384 requires the per-piece revenue of Nonprofit to be equal as nearly as practical to 60 percent of the per-piece revenue of the corresponding commercial category, and that your proportion is 56 percent. On page 12 (ll. 2-4 and ll. 9-12) you say that honoring the 60-percent proportion stipulated in Public Law 106-384 would require a rate increase for Nonprofit “on the order of 13 percent,” and that, “under the unique circumstances of this uniform across-the-board rate increase request,” your 56 percent is as close to 60 percent as is practical.

- a. Within the framework of an across-the-board preference of 5.4 percent and an increase of 5.6 percent for commercial ECR, please explain how the issue of practicality led you to lower the rate increase for Nonprofit ECR from 13 percent to 5.9 percent.
- b. Aside from a stated preference by Postal Service witness Potter (USPS-T-1), as explained in his testimony, please identify and discuss the circumstances in this case that caused you to give (i) little weight to the requirement imposed by law (as witnessed by your 5.9 percent increase being considerably below the 13 percent mandated by the statute), and (ii) substantial weight to the preference of a 5.4 percent increase (as witnessed to by 5.9 percent being just moderately above 5.4 percent).
- c. On page 29 (ll. 8-9) of your testimony, you say that the “average proposed fee increase for registered mail is in the range of 70 percent, in order to cover costs.” As applied to your work and the rates which you recommend, please explain your understanding of the difference between (i) the legal requirement that rates cover costs, which causes you to raise the rate increase for registered mail from 5.4 percent up to 70 percent, and (ii) the legal requirement that the per-piece revenue of Nonprofit ECR be 60 percent of the corresponding figure for the commercial category, which causes you to take the rate increase for Nonprofit ECR from 5.4 percent up to 5.9 percent, but not up to 13 percent.
- d. Public Law 103-123 (Revenue Forgone Reform Act of 1993) requires that Within County Periodicals have a markup that is one-half the markup of the corresponding commercial category of Periodicals. Because of this, as explained on page 14 of your testimony, you propose a rate **decrease** for Within County of 5.4 percent. As applied to your work, please explain your understanding of the difference between (i) the legal requirement in Public Law 103-123 relating to the markup on Within County, which causes you to take the rate increase for Within County from a positive 5.4 percent down to a negative 5.4 percent, a spread of 10.8 percentage points, and (ii) the legal requirement in Public Law 106-384 that the per-piece revenue of Nonprofit ECR be 60 percent of the corresponding figure for the commercial category, which causes you to take the rate increase

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for Nonprofit ECR from 5.4 percent up to 5.9 percent, but not up to 13 percent, the latter being a spread of 7.6 percentage points.

- e. In your opinion, does an average nonprofit per-piece revenue equal to 56 percent of the corresponding category complies with Public Law 106-384? If not, please explain your recommendation.
- f. Is it your interpretation of Public Law 106-384 that nonprofit per-piece revenue may be measurably less than 60 percent of the corresponding commercial category, but not measurably more than 60 percent of it? If not, please explain.
- g. Are you advocating that the Postal Rate Commission recommend an average nonprofit per-piece revenue equal to only 56 percent of the corresponding category, regardless of whether it complies with Public Law 106-384? If not, please explain.
- h. (i) Please confirm that one lawful way to satisfy a guideline pointing to increases of 5.4 percent and to satisfy as well the legal requirement on the perpiece revenue of Nonprofit would be to specify an increase for Nonprofit ECR of 5.4 percent and to reduce the rate increase for commercial ECR so that the 60-percent law is satisfied. This approach would avoid taking the preferred category of Nonprofit ECR, which has always received special rate consideration, above the 5.4 percent guideline. (ii) Please explain why this approach is inferior to the approach you have taken. (iii) If you do not believe it to be lawful, please explain why you did not take such an approach.
- i. Please assume that in **this** case the Nonprofit ECR increase were 7.4 percentage points above the increase for commercial ECR, but you held it to a difference of 0.3 percentage points, and in the **next** rate case the Nonprofit ECR increase were 14.8 percentage points above the corresponding increase for commercial ECR. Please explain whether in the next rate case you believe that the effect on mailers would be too large, the law should be neglected, and a smaller increase (with an attendant loss of revenue to the Postal Service) should be adopted.

Response:

- a. As can be seen in the workpapers, a targeted uniform 5.4% increase was applied to both commercial and nonprofit ECR rates. The resulting 5.9% increase in the average revenue per piece for NECR is therefore the result of applying the uniform rate change policy, along with adhering to rounding constraints and maintaining discounting consistency, as described in my response to question 1, to both ECR and NECR rates, and not an after-the-fact decision to lower the NECR increase from 13% to 5.9%.

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- b. I disagree with the assertion that little weight was paid to the pricing requirement for Standard Mail NECR contained in PL 106-384. That law requires the prices to be set so that the average revenue per piece for nonprofit mail is "as nearly as practicable" to 60 percent of the average revenue per piece for commercial mail. The statute does not specify an absolute tolerance around the 60 percent figure that must be achieved. Rather, it specifies that the target be achieved within "practicable" bounds. The Postal Service interprets this language to permit deviation from the 60 percent target when the total circumstances of the case make it not practicable to achieve the 60 percent target more closely. Therefore I disagree with the assertion implicit in the question that a 13 percent increase is "mandated by the statute." The policy reasons stated in witness Potter's testimony (USPS -T-1) were the basis for the Postal Service's judgment that a higher rate increase for Standard Mail NECR was not practicable in this case.
- c. Please see my response to VP/USPS-T28-2b. The statutory requirement to cover costs is, in the view of the Postal Service, a more specific standard than the standard applied to Standard Mail Nonprofit and Standard Mail NECR rates.
- d. Please see my response to VP/USPS-T28-2b. The statutory requirement for pricing Within-County Periodicals is, in the view of the Postal Service, a more specific standard than the standard applied to Standard Mail Nonprofit and Standard Mail NECR rates.
- e. I believe that the proposed rates meet the requirements of the statute for the reasons set forth in my response to VP/USPS-T28-2b. The bands around the statute's 60 percent target that it is practicable to reach will depend on the

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circumstances of the particular case. In another case, a closer approach than 56 percent may be practicable, and therefore required, by the statute.

- f. The deviation from 60 percent permitted by the practicability standard can be either above or below the 60 percent target.
- g. No. In this case, the proposed rates comply with PL 106-384. See my response to VP/USPS-T28-2b.
- h.
 - (i) I am advised that this approach would be lawful.
 - (ii) This approach would, *ceteris paribus*, leave the Postal Service far short of its revenue requirement.
 - (iii) See my response to part (i).
- i. In the next omnibus rate case the Postal Service will attempt to meet the 60 percent target, again, as nearly as practicable. The Postal Service always takes into account the effect of its proposed changes on mailers when setting rates, and will do so in the next rate case as well. Without more complete and detailed information regarding the conditions that would hold at the time the next rate case is filed, and until such time that I am charged with the responsibility of formally proposing rates in the next rate case, commenting on specific rate change values would be speculative and unwise.

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VP/USPS-T28-3. Please refer to Exhibit USPS-28A, page 16, Table 5, where you propose a "Presorted Basic" rate of \$0.282 for Standard Regular letters and a "Presorted Basic" rate of \$0.363 for Standard Regular non-letters, which is a letter/non-letter differential of 8.1 cents. This interrogatory relates to the justification for the corresponding letter/non-letter differential in the current rates of 7.6 cents, which is increased to the 8.1-cent figure by application of an across-the-board proportion.

- a. Please confirm that the 7.6-cent difference in current rates is developed, after rounding, by applying a 73 percent passthrough to a cost difference of 10.366 cents, as shown in cells E18 through G18 on the "PRE DIS" sheet of file USPSLR-J-WP1.xls in library reference USPS-LR-J-132 of Docket No. R2001-1. If you do not confirm without reservation, please explain the origin and development of the 7.6-cent letter/flat rate differential in current rates, and also explain the use made of the cells referenced herein.
- b. Please confirm that the cost differential of 10.366 cents, discussed in preceding part a, is the difference between a unit cost for Basic presort flats of 28.041 cents (equal to the sum of 8.312 cents for delivery and 19.729 cents for mail processing) and a unit cost for Basic presort letters of 17.675 cents (equal to the sum of 4.201 cents for delivery and 13.474 cents for mail processing), as shown on the "COST" sheet in the file and library reference cited in preceding part a. If you do not confirm without reservation, please explain the origin, development and components of the 10.366-cent cost differential.

Response:

- a. I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. I can confirm that the 7.6 cent difference was developed as described in the first sentence of the question.
- b. I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. I can confirm that the 10.366 cent cost differential was developed as described in the first sentence of the question.

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VP/USPS-T28-4. Please refer to the 8.312-cent cost for delivery of Standard Regular Basic presort flats referenced in VP/USPS-T28-3, part b.

- a. Does this reflect the bottom-up cost for delivery, or have adjustments been made? If the latter, what are the adjustments?
- b. Is this delivery cost the same for Standard Regular nonprofit and for-profit mail? If so, are there no differences in delivery cost incurrence between these two categories?
- c. Does this delivery cost include both in-office costs and street costs?
- d. Is this delivery cost a marginal cost? If not, please explain what type of cost it is.
- e. Does this delivery cost recognize differences between city routes and rural routes?
- f. Please confirm that the updated figure for the 8.312-cent cost for delivery of Basic presort flats is 9.795 cents, 17.7 percent higher than the Docket No. R2001-1 figure (found on the first sheet of file LR-K-101.xls in library reference USPS-LR-K-101). If you do not confirm, please provide the appropriate updated figure.

Response:

a-f. Redirected to witness Kelley, USPS-T-16.

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VP/USPS-T28-5.

- a. Please refer to VP/USPS-T28-3. For the 19.729-cent mail processing cost for Standard Regular Basic presort flats, referenced therein, please confirm that the source is the "CRA ADJ UNIT COSTS" sheet of the file STANDARD.XLS in library reference USPS-LR-J-61 of Docket No. 2001-1, and that it is the sum of (i) a "Non Worksharing Unit Cost" of 4.003 cents and (ii) a "Worksharing Related Unit Cost" of 15.726 cents. If you do not confirm, please provide the appropriate figure and give the source.
- b. Please confirm that the updated figure for the 19.729-cent mail processing cost for Standard Regular Basic presort flats, referenced in preceding part a, is 26.468 cents, **34.2 percent higher than the current cost**, and is found on the first sheet in file STANDARD FLATS PRC.xls of library reference USPS-LRK-102. If you do not confirm, please provide the appropriate updated figure and give the source.

Response:

a&b. Redirected to witness Miller, USPS-T-19.

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VP/USPS-T28-6. Regarding the 4.003-cent non-worksharing unit cost of processing Standard Regular Basic presort flats in VP/USPS-T28-5, part b:

- a. Please describe the nature of what that cost measures.
- b. Please explain why the 4.003-cent cost is not related to worksharing.
- c. Assume that the rate for basic, non-prebarcoded, minimum-per-piece flats, which is currently 34.4 cents, were to be reduced and resulted in a volume increase in line with the appropriate elasticity. Please state whether you would expect the cost of each additional unit of volume to reflect any part of this 4.003 cents, and explain why you come to the conclusion you do.
- d. Please explain whether the 4.003-cent cost figure is designed to be a marginal cost. If it is not, please explain the nature of the costing concept which it embodies.
- e. Please explain what worksharing the 4.003-cent figure is not sensitive to, describing the specific nature of the work that may (or may not) be shared.
- f. Please explain the extent to which you view it as important whether any worksharing-type work that you identify is provided by the lowest-cost provider.
- g. Please explain whether mailing a flat, as opposed to an identically prepared and entered letter, causes the Postal Service to do work that could have been done by the mailer.

Response:

- a. Redirected to witness Miller, USPS-T-19
- b. Redirected to witness Miller, USPS-T-19.
- c. Redirected to witness Miller, USPS-T-19.
- d. Redirected to witness Miller, USPS-T-19.
- e. Redirected to witness Miller, USPS-T-19.
- f. Generally speaking and putting aside the extraordinary circumstances of the current case, it is important for the Postal Service to provide accurate and consistent signals to the mailers regarding worksharing. The accuracy of these signals is based on the cost savings that accrue to the Postal Service when the work in question is performed by the mailers. Examples of such worksharing are finer presorting, barcoding or dropshipping of mail. Who actually performs the

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work is not relevant to this exercise. Mailers can do the work themselves or contract it out to a third party, based on their analysis of their own cost structure and that of their contractors. One would expect that this worksharing will be provided by a low-cost provider but, from the perspective of the Postal Service, what is important is that mailers are provided the appropriate signals based on the Postal Service's cost savings.

- g. Redirected to witness Miller, USPS-T-19.

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VP/USPS-T28-7.

- a. For the 15.726-cent worksharing-related unit cost referenced in VP/USPS-T28-5, part a, please confirm that, according to library reference USPS-LR-J-61 in Docket No. 2001-1, it is equal to a model unit cost of 15.329 cents times a Cost and Revenue Analysis ("CRA") adjustment factor of 1.023 plus a worksharing related fixed cost of 0.047 cents. If you do not confirm, please provide the appropriate figure and give the source.
- b. For the model unit cost of 15.329 cents referenced in preceding part a, please provide a narrative description of the nature of this cost and answer the following questions.
 - i. Is this 15.726-cent worksharing-related unit cost an estimate of a marginal cost? If not, please explain the costing concept that guides this estimate.
 - ii. Is this 15.726-cent worksharing-related unit cost constrained or limited in any way? If yes, please explain each constraint and the reason for it.
 - iii. If the associated rate for basic, non-prebarcoded, minimum-per-piece flats, which is now 34.4 cents, were to be reduced and the volume were to increase in line with the elasticity, please explain whether you would expect the 15.726-cent figure to increase on a per-additional-unit basis.
 - iv. Is this 15.726-cent worksharing-related unit cost specifically designed or estimated to relate to any particular concept of worksharing? If so, please specify the piece of work that may or may not be shared.
 - v. If this cost is related to any concept of worksharing, please describe the nature of the signal in the rates that determines whether the piece of work involved is or is not done by the lowest-cost provider.

Response:

- a. Redirected to witness Miller, USPS-T-19.
- b. Except b. v, Redirected to witness Miller, USPS-T-19.
 - v. Please see my response to your interrogatory VP/USPS-T28-6 subpart f.

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VP/USPS-T28-8. Please refer to VP/USPS-T28-3, part b. For the 4.201-cent unit cost for delivery of Standard Regular Basic presort letters referenced therein, please provide a narrative description of its nature. In your response, please include answers to the following questions.

- a. Is it in effect a bottom-up cost for delivery, or have adjustments been made? If the latter, please provide a description of all adjustments.
- b. Is this cost the same for nonprofit as for the commercial category? If so, does it therefore recognize no differences in cost incurrence between these two categories?
- c. Does it include both in-office costs and street costs?
- d. Is it designed to be a marginal cost? If not, please explain the theory that guides its development.
- e. Does it recognize both city routes and rural routes? How are these different?
- f. Why is this cost contained under the heading, "Alternative Costs for Specific Rate Design Purposes"? In your response, please state clearly what these purposes are and what effect these purposes had on the cost.
- g. Please confirm that the updated figure for this cost is 4.591 cents, 9.3 percent higher than the current figure, found in file LR-K-101STDLTRS.xls of library reference USPS-LR-K-101. If you do not confirm, please provide the correct updated figure and identify its source.

Response:

a to g except f redirected to witness Abdirahman, USPS-T-21.

- f. I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. The following represents my understanding of this section of the workpapers. The costs shown in the section of the workpaper entitled "Alternative Costs for Specific Rate Design Purposes" represent average mail processing and delivery costs for the specific mail categories shown in the section. The cost item referenced in this interrogatory, 4.201 cents, represents the average delivery cost for a Basic Presort letter. It is included in this section to calculate the average mail processing plus delivery costs for the purposes of calculating the letter-flat cost differential. The mail

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processing costs for Basic Presort letters in this section of the workpaper (though not the delivery costs) differ from the corresponding costs for Basic Presort letters shown above this section of the workpaper due to different mail mix assumptions. In other words, to calculate a true letter-flat differential it is necessary to adjust the presort mix of letters within the Basic Letters category to match the average mix for flats. Otherwise the cost differential would reflect not only the letter-flat differential, but also the difference in presort between the averages for flats and for letters.

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VP/USPS-T28-9.

- a. Please refer to VP/USPS-T28-3, part b. For the 13.474-cent unit cost for mail processing of Standard Regular Basic presort letters referenced therein, please confirm that the source of this unit cost is cell C13 of the "LETTERS SUMMARY" sheet in file STANDARD.XLS file of library reference USPSLR-J-60 in Docket No. 2001-1, and that it is a weighted average of the more disaggregated unit costs in cells C14 through C17. If you do not confirm, please provide the appropriate updated figure and give the source.
- b. On the "COST" sheet in file USPS-LR-J-132-WP1.xls of library reference USPS-LR-J-132 in Docket No. 2001-1, cell F28, please explain why this 13.474-cent cost for mail processing of Standard Regular Basic presort letters is contained under the heading, "Alternative Costs for Specific Rate Design Purposes." Please provide an explicit statement concerning what such rate change purposes are and what effect these purposes had on the cost.
- c. Please provide a narrative description of the nature of this mail processing cost of 13.474 cent referenced in preceding parts a and b.
- d. Is this 13.474-cent unit cost an estimate of a marginal cost? If not, please explain the costing concept it measures.
- e. Is this 13.474-cent unit cost constrained or limited in any way? If yes, please explain each constraint and the reason for it.
- f. If the rate for Standard Regular Basic non-prebarcoded presort letters, which is now 26.8 cents, were to be reduced and there were to be an associated volume increase, in line with the appropriate elasticity, please explain whether you would expect the costs behind the 13.474-cent figure to increase on a peradditional-unit basis.
- g. Is this 13.474-cent cost specifically designed or estimated to relate to any particular concept of worksharing? If so, please specify the piece of work that may or may not be shared.
- h. If this 13.474-cent cost is related to any concept of worksharing, please describe the nature of the signal in the rates that determines whether the piece of work involved is or is not done by the lowest-cost provider.
- i. Please confirm that the updated unit cost for Standard Regular Basic presort letters is 17.303 cents, 28.4 percent higher than the level in Docket No. 2001-1, found the file LR-K-110.xls of library reference USPS-LR-K-110. If you do not confirm, please provide the correct figure and its source.

Response:

Subparts a, c-e, f & i redirected to witness Abdirahman, USPS-T21.

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- b. I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. Please see my response to VP/USPS-T28-8f.
- g. I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. If the question is meant to elicit whether the 13.474-cent figure represents the difference in cost between a workshared piece of mail and a non-workshared piece of mail, the answer is no. Please see my response to VP/USPS-T28-8f.
- h. Please see my response to VP/USPS-T28-9g.

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VP/USPS-T28-10.

- a. Please refer to Docket No. R2000-1, library reference PRC-LR-15, file WP1-PRC-Hybrid.xls, sheet "RATE DESIGN SHEET," cell DK25, which shows a passthrough of 73 percent for the letter/flat differential, and please explain the extent to which this Commission-recommended passthrough was the basis for the 73 percent passthrough proposed in Docket No. R2001-1 by the Postal Service, referenced in VP/USPS-T28-3, part a.
- b. Please refer to Docket No. R2000-1, *Opinion and Recommended Decision*, page 339, ¶ 5382, where the Commission says, "with respect to the letter/nonletter differential, the Commission believes it is appropriate to recognize more of the reported cost difference, where this can be achieved without undue impact." Please explain the extent to which the Postal Service's proposal to pass through only 73 percent of the letter/nonletter differential in Docket No. R2001-1 was responsive to the Commission's opinion that "it is appropriate to recognize more of the reported cost difference."
- c. Please explain whether it is the Postal Service's position that it is fair, equitable and appropriate to continue the passthrough of 73 percent by virtue of the across-the-board nature of the proposal in this case, losing this opportunity to take a step in a direction that the Commission has explained is "appropriate."
- d. Please explain whether the letter/nonletter cost differential is related to worksharing (*i.e.*, is related to a piece of work which could be done by either the Postal Service or the mailer). If so, please identify the specific type of worksharing.
- e. Please explain whether it is the Postal Service's position that the passthrough of the letter/nonletter cost differential into rates should be limited to 100 percent. If so, please explain the basis for this limit, drawing where appropriate on notions of fairness, lowest combined cost, and efficient component pricing.
- f. Please refer to Docket No. R90-1, where the letter/flat rate differential was first recommended (*Op. & Rec. Dec.*, p. V-230, ¶ 5941). The Commission referred to establishing a new discount, "especially one based primarily on physical characteristics of the mail and not on traditional worksharing concepts." Please explain the Postal Service's position concerning the extent to which letters and flats should be viewed essentially as separate products, in separate but related markets, with cross elasticities similar to those for other separate-but-related products, and with costs and production facilities that are essentially separate or at least different in character.

Response:

- a. I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. I have examined the relevant portion of the testimony of witness Moeller (USPS-T-32), who sponsored the

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workpapers from Docket No. R2001-1 cited in the question. Based on the materials I have examined, I can confirm that in both instances the passthrough was 73 percent. These documents do not describe the extent to which the recommended passthrough in Docket No. R2000-1 was the basis for the proposed passthrough in Docket No. R2001-1.

- b. In proposing a passthrough percentage, many factors are taken into account. The opinion expressed by the Commission in the prior rate case is given serious consideration and weight in developing the Postal Service's proposal. In giving the Commission's opinion its due weight, the opinion is interpreted within the context of factors that existed when the opinion was given, rather than as an absolute directive, binding under all circumstances. In general, the Postal Service attempts to respond to the Commission's opinions in light of the totality of conditions and circumstances that are present at the time the Postal Service makes its decisions. I was not involved, either directly or indirectly, in developing the specified passthrough percentage in Docket No. R2001-1 and I do not know all of the factors, circumstances and considerations that went into the selection of the proposed passthrough percentage (see my response to VP/USPS-T28-10a). Therefore I am unable to characterize the degree to which the proposal in Docket No. R2001-1 responded to the Commission's opinion in Docket No. R2000-1.
- c. Yes, but I would disagree with the characterization of this rate request as a lost opportunity. Witness Potter (USPS-T-1) has stated that, absent the statutory escrow requirement, the Postal Service would not have filed any general rate case at this time. The Postal Service intends to consider necessary and

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appropriate changes in classification and rate relationships when it files its next omnibus case.

- d. The cost differential is intended to reflect the mail processing cost differences between letters and flats, rather than worksharing as the term is normally understood.
- e. If the question refers to an absolute limit that cannot be breached in either direction, regardless of circumstances, the answer is no.
- f. The Postal Service views letters and flats as different shapes, and supports different rate treatment when appropriate, based on identifiable mail processing and delivery cost differences and other relevant factors. The Postal Service has not taken the position that letters and flats should necessarily be viewed as different products, since they often share close, if not identical, market characteristics, despite the fact that they may be treated for mail processing purposes as separate mail streams.

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VP/USPS-T28-11. Please refer to Docket No. R2000-1, *Opinion and Recommended Decision*, page 390, ¶ 5533, where the Commission states:

The Commission begins the rate design process assuming equal implicit markups. This is a neutral starting position which seems to be implied by § 3622(b)(1), a fair and equitable schedule. It is consistent with the Commission's general policies that the rates for each rate category be above cost; that rates reflect the costs developed in the record; and that rate design results in identifiable relationships between rate categories. Equal implicit markups, however, are only a starting place, and often may not be practicable or appropriate. The Commission frequently has good reason to depart from them in actual practice.

- a. Please explain whether you believe that the rate design for letters and flats should begin with equal implicit markups, and "depart" only for good reason.
- b. Please explain why it is fair and equitable to depart from equal implicit markups for letters and flats and limit the passthrough to 73 percent.
- c. Please explain whether it is appropriate to view the deliberate selection of a passthrough for the letter/flat differential that is below the cost coverage of the subclass and/or that is below 100 percent as elevating the rates for letters so that the rates for flats can be lower.
- d. Please explain how elevating the rate for a letter above the rate that the Commission says it "begins with" helps set appropriate rates for letters.

Response:

- a. The Postal Service believes that the requirement to maintain a fair and equitable schedule of rates is a requirement that pertains to the final rates themselves and not to the process used to arrive at the rates. In general the Postal Service's view is that it is appropriate to begin with the existing rates, since those rates have already been determined to be fair and equitable by the Commission.
- b. Please see my response to VP/USPS-T28-11a.
- c. Not necessarily. To take this view, one would have to assume that if the passthrough percentage were set at 100 percent or at the cost coverage of the subclass, the rates for letters would be lower, and vice-versa. This assumption

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cannot be made without specifying a host of other assumptions. It would not be reasonable to make these assumptions unless provided with all the detailed circumstances pertinent to the rate case in question.

- d. Please see my response to VP/USPS-T28-11a.

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VP/USPS-T28-12.

Please consider the case of the letter/nonletter rate differential, which was first established with a passthrough of 50 percent in Docket No. R90-1 (Op. & Rec. Dec., p. V-230, ¶ 5941), which the Commission stated it does not view as a worksharing differential, and which the Commission subsequently stated should have a passthrough greater than 73 percent. Please note that in recommending a letter/nonletter differential that went from zero percent to 50 percent in one step, the Commission said that this “adjustment mitigate[d] the rate increase for required flats.” In view of the Commission’s stated position, as cited above, please explain:

- a. How many years should it take to get this differential up to a level of at least 100 percent?
- b. How should the maximum size of each step toward that goal be determined?
- c. Does the Postal Service believe that the rationale for the notion of an across-the-board increase should override these considerations and put off once again an opportunity to take further steps that would increase this passthrough?

Response:

- a. This question cannot be answered in the absolute. Each time it proposes Standard Mail rates, the Postal Service evaluates the proposed letter-flat rate differential in light of many factors, including the previous rate relationship, rate of change in rates, and other factors, as well as the cost differential. The Postal Service does not believe that a rigid timetable, or predetermined set of steps, best serves the interests of all its customers.
- b. Please see my response to VP/USPS-T28-12a.
- c. The Postal Service believes that its rationale for the proposed across-the-board rate increase is justified and most appropriate under the unique circumstances of this case. See the testimony of witness Potter (USPS-T-1). The Postal Service intends to address the letter-flat differential, along with other pertinent rate relationships when it files its next omnibus rate case.

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VP/USPS-T28-13. Please refer to Exhibit USPS-28A, page 16, Table 5, where you propose for Standard Regular letters a presorted Basic rate of \$0.282 and a 3/5-digit rate of \$0.261. The current Standard Regular 3/5-digit discount of 2.0 cents would be increased to 2.1 cents under the Postal Service's proposal.

- a. Please confirm that the rate differential of 2.0 cents between Presorted Basic and Presorted 3/5 is developed, after rounding, by applying a passthrough of 158 percent to a cost difference of 1.238 cents, as shown in cells E21 through G21 on the "PRE DIS" sheet of file USPS-LR-J-WP1.xls in library reference USPSLR-J-132 of Docket No. R2001-1. If you do not confirm without reservation, please explain the origin and the development of the current 2.0-cent figure and also explain the use made of the above-referenced cells.
- b. Please confirm that the 1.238-cent cost differential is the difference between a cost for Basic letters of 13.913 cents (equal to the sum of 4.201 cents for delivery and 9.712 cents for mail processing) and a cost for 3/5-digit presort letters of 12.675 cents (equal to the sum of 4.418 cents for delivery and 8.257 cents for mail processing), as shown on the 'COST' sheet of the file and library reference cited above. If you do not confirm without reservation, please explain the origin and the development and the components of the 1.238-cent cost differential.

Response:

- a. I did not prepare the Docket No. R2001-1 workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. I can confirm the calculation described in the question.
- b. I did not prepare the Docket No. R2001-1 workpapers cited in the question, nor were they prepared under my supervision, but I have examined them. I can confirm the calculation described in the question.

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VP/USPS-T28-16.

Please consider the following hypothetical. Suppose that: (i) a subclass has two categories of equal volume; (ii) the average unit cost of the subclass is 10 cents; (iii) the identified cost difference between the two categories is 4 cents (meaning that cost differences not studied by the Postal Service could exist and, if recognized, would make the known cost difference greater than 4 cents); and (iv) the cost difference of 4 cents is to be used on a defensible basis to de-average and institute separate rates for each of the two categories.

- a. Would you agree that the information known about the two categories suggests an **implied** unit cost for the higher-rated category of 12 cents and an **implied** unit cost for the lower-rated category of 8 cents? That is, 8 cents and 12 cents are **implicit** unit costs for each category, **implied** by what is known about the average cost, the difference in cost between the two categories, and the volume of each category. If you do not agree, please state all reasons for disagreement and explain why the **implicit** unit cost for each category cannot be developed in the manner described.
- b. For any rate categories of ECR and/or Standard Regular mail, has the Postal Service developed any estimates of **implicit** unit costs, based on estimates of cost differences or cost avoidances, along with any identified and understood set of assumptions, either on a basis similar to that described in preceding part a or on any other basis? If the answer is yes, please provide them. If the answer is no, please explain why such a seemingly relevant figure has not been developed.
- c. Please suppose that a cost coverage of 100 percent were to be selected for a subclass, and all passthroughs associated with discounts, as well as any other rate differences based on cost differences, were set at 100 percent. Would you agree that the result would be a set of at-cost rates, taking "at-cost rates" to mean that the rates are equal to costs, with no markups? If you do not agree, please state all reasons for disagreeing and identify any difficulties that, in your opinion, cannot be dealt with by making plausible assumptions and then stating that the results are contingent on those assumptions.
- d. Has the Postal Service developed such an at-cost set of rates for any categories of ECR or Regular Standard mail, possibly including stated assumptions about how to set at-cost pound rates and how at-cost Nonprofit rates should be developed? If the answer is yes, please provide them. If the answer is no, please explain why such a seemingly relevant figure has not been developed.

Response:

- a&b. The Postal Service has proposed and the Commission has recommended de-averaging between rate categories and established new subclasses based on

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market characteristic and cost differences in the past, and are expected to do so when circumstances warrant. The purpose of this particular filing is not to enter into a discussion on the merits of rate design and classification changes. As stated in witness Potter's testimony, the focus of this case is narrowly defined, i.e., to generate enough revenue to fulfill the mandated escrow requirements.

Further, even if this rate proposal did not involve the special circumstances explained by witnesses Potter (USPS-T-1) and Robinson (USPS-T-28), rate design does not require the determination of implicit costs by rate category within a subclass. The Postal Service has not developed costs in the manner described. Regarding the hypothetical example provided in your question I would like to offer a few observations.

Our data systems develop reasonably reliable marginal (and incremental) costs for the subclasses. Workshare cost savings are estimated using special cost models isolating specific workshare parameters such as finer presort, automation compatibility (barcodes and machinability) and dropshipment of mail closer to destination. These studies allow the Postal Service to recognize the efforts of mailers to make mail cheaper for the Postal Service to process, transport, and deliver.

Second, average cost differences are not always due to cost avoidances. Cost differences can accrue due to valid cost avoidances caused by the additional work performed by the mailers or they could occur because of the

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inherent characteristics of the two categories being compared. For instance, savings due to a certain worksharing parameter, e.g., presence of the barcode on a mail piece, could be estimated to be a negative number if the mail mix is not held constant in order to estimate the savings. In other words, barcoded mail as a group could cost more to process than non-barcoded mail. This is obviously an extreme example but one within my range of experience.

Third, the premise set forth in item (iii) of the question is flawed. Identified cost differences are just that: cost differences that can be identified. If the cost differences that could be identified amounted to four cents, then we should be unable to say a priori whether other unidentified cost differences would serve to augment the identified cost differences (as assumed in (iii)) or diminish them. Because of this limitation, the concept of implicit unit costs based, as it is, on 'identified' cost differences can only have a limited use for the purposes of developing pricing.

- c. No, the rates would not all necessarily be at 100 percent of total costs, by category, unless the hypothetical situation is defined as knowing that all of the remaining cost grouping (beyond the subset that has the 4-cent differential) are equal for all rate categories.
- d. The Postal Service has not developed such a set of at-cost rates. Given that Standard Mail is required to make a significant contribution to the Postal Service's institutional costs (over \$9 billion, according to witness Robinson

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(USPS-T-27)), developing a set of rates that would yield absolutely no contribution would be pointless.

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VP/USPS-T28-17. Please address the following questions relating to costs, economic efficiency, and competition:

- a. Does the Postal Service agree that, laws permitting, competitors are more likely to compete for categories of mail that are priced substantially above cost than for categories of mail that are only moderately above cost, *i.e.*, the distance above cost, however expressed, is related to the likelihood and the intensity of competition? If not, please explain your reasons.
- b. Does the Postal Service agree that the costs underlying rate categories, particularly if they are estimates of marginal costs, are the appropriate links of the rates to the efficiency of resource allocation and to notions of economic efficiency in rates, and that this fact adds substantially to the importance of costs. If not, please provide all reasons for disagreeing and explain how interests in such efficiency and efficiency-related notions should be examined.
- c. Does the Postal Service agree that, except for consideration of externalities, it would be most economically efficient to set rates **equal** to marginal costs, even though that may not be a permissible option under current law? If not, please provide references to the economic literature showing that economic efficiency requires that rates be set at some other level.
- d. Please assume that there are no cross elasticities and that all own-price elasticities are at the same non-zero level. Now consider two markup measures: Measure **A** is the per-piece (unit) markup, as in the rate being 6 cents above cost, and Measure **B** is the percentage markup, as in rates being 30 percent above cost (implying a cost coverage of 130 percent).
 - (i) If one were interested in improving the efficiency of resource allocation and in reducing losses in economic efficiency, please explain which of the two measures would be most useful in gauging the distance of the rates from their costs, *i.e.*, which measure of distance-above-costs is indicative of the efficiency loss associated with the rate?
 - (ii) Under the elasticity assumptions of this question, would you agree that all rates should have the same percentage markup, but not the same per-piece markup. If you do not agree, provide references to the economic literature supporting your position.
 - (iii) Please explain whether you agree that, even if the elasticity assumptions are relaxed and the efficiency formulas become more complex, it is still measure **B** and not measure **A** that has a reasonably simple and straightforward relation to notions of economic efficiency.
 - (iv) Please explain whether you agree that under notions of economic efficiency, absent externalities and cross elasticities, one could say that the more elastic products would have a lower measure **B** (cost coverage) but one could not say whether the more elastic products would have a lower measure **A** (per-piece (unit) markup).

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Response:

- a. If the costs in question are the Postal Service's costs, the answer is not necessarily. The relevant price-cost margins to a competitor would be (i) the margin between the prices and the competitor's own costs and, (ii) the margin between the prices and other competitors' costs. If the costs in question are those of the competitors themselves, it is reasonable to assume that, over some range, higher prices would stimulate competition, *ceteris paribus*.
- b. The Postal Service agrees that the relationship of marginal costs to rates is a fundamental relationship in determining whether pricing will promote efficient resource allocation. This important role underlines the importance of accurately determining the relevant costs, particularly marginal costs.
- c. Not necessarily. It is well known that for businesses where marginal costs are below average costs (typical of network-based firms like the Postal Service), setting prices equal to marginal costs would not generate enough revenue to cover the firm's total costs. To continue to operate over the long term, a subsidy would be necessary. The funds for the subsidy would have to be raised by taxes, which themselves (except for the lump-sum tax) impose their own economic inefficiencies and distortions. It is an open question whether marginal cost pricing requiring subsidies would be the most economically efficient pricing scheme for a network-based business.

The problems of marginal cost pricing for firms with falling average costs are well understood in Economics and are presented in undergraduate textbooks. See, for example, the introductory Economics textbook, Economics by Paul Samuelson and William Nordhaus, McGraw-Hill, 1989, Chapters 24 and 33.

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- d. Redirected to witness Robinson, USPS-T-27.

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VP/USPS-T28-18.

Please refer to the following statement from the Commission's *Opinion and Recommended Decision* in Docket No. MC95-1, pages V-161-62, ¶ 5388, in reference to a separate automation subclass of Standard Mail:

The alternative of creating separate subclasses and considering the issue of lowest combined cost when selecting the associated markups is not a rational alternative. Selecting the markups in such a constrained way provides rates that are no different from those that result from offering worksharing discounts through rate categories.... One has to question the logic of creating subclasses and then constraining the outcome in accordance with a result that would be obtained without creating the subclasses.

- a. Please explain whether the cost coverages of the current ECR and Regular Standard subclasses, whose relative levels are being perpetuated by the across-the-board proposal, are or should be constrained in any way to achieve "a result that would be obtained without creating the subclasses."
- b. Has the Postal Service done any analysis to determine whether the proposed ECR rates differ from those that would likely exist if ECR had **not** been made into a separate subclass? If so, please provide that analysis.
- c. Suppose it were shown convincingly that the current ECR rates are higher than the rates for equivalent rate categories would be if a separate subclass had not been created. How would you view such a finding, and what should be done about it? Please provide all reasons for the view taken.
- d. If an ECR subclass had not been created, and the category passthroughs were 100 percent in line with oft expressed Postal Service and Commission preferences for mature subclasses, do you believe that the per-piece (unit) markups for the various categories would be approximately equal? If you disagree, please state all reasons for disagreeing. (For purposes of this question, the per-piece (unit) markup of a category is the revenue of the category minus the implicit cost of the category. The implicit cost of the category is the cost implied by the cost of the parent subclass and the cost differences to which the passthroughs are applied. For example, if a subclass costing 10 cents were composed of two equal-size categories with a cost difference to be used for ratesetting purposes of 4 cents, it would be implied that the cost of one category is 8 cents and the cost of the other category is 12 cents. See *also* Op. & Rec. Dec., Docket No. R2000-1, p. 390, ¶ 5534.)
- e. Has the Postal Service done any analysis comparing the implicit per-piece (unit) markups for the rate categories within **ECR** mail? If so, please present that analysis.
- f. Has the Postal Service done any analysis comparing the implicit per-piece (unit) markups for the rate categories within **Standard Regular** mail? If so, please present that analysis.

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- g. For the proposed rates, please provide a table showing the implicit per-piece (unit) markups for each rate category within ECR and Regular Standard mail.

Response:

- a&b. Redirected to witness Robinson, USPS-T-27.
- c. The Postal Service believes that pricing, though guided by general overarching principles, must address the contemporaneous needs of the Postal Service and its customers. The Postal Service finds itself in a different world today than when the ECR subclass was created, and its pricing proposals since then have responded to the situations as they presented themselves over time. It is impossible to say with any reasonable certainty what the appropriate rates for mail that currently uses the ECR (or any other) subclass would have been today had no separate subclass been developed. Since the premise of the question is impossible to verify, the question itself becomes purely speculative and unanswerable.
- d. Please see my response to VP/USPS-T28-18c. The question is purely counterfactual and does not specify all the factors and information the Postal Service takes into account when it makes its pricing proposals. Without complete information, any specific response would be impossible.
- e. No.
- f. No.
- g. The Postal Service has not produced such a table.

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VP/USPS-T28-19. Please refer to spreadsheets "COST" and "NCOST" in files USPS-LR-J-131-WP1.xls and USPS-LR-J-131-WP2.xls, respectively, of library reference USPS-LR-131 in Docket No. R-2001-1, which provide cost information behind the current commercial ECR and Nonprofit ECR rates that are proposed to be increased by any an approximately equal across-the-board percentage amount in this docket. Column G in each or the two above-referenced spreadsheets shows delivery costs. Please provide a specific source for each delivery-cost cell in both sheets; *i.e.*, one for commercial ECR and the other for Nonprofit ECR. Note that the source for these delivery cost data shown on the each respective spreadsheet may not be correct. Note also that library reference USPS-J-LR-117 in Docket No. 2001-1 is a candidate source, but does not appear to show separate costs for commercial ECR and Nonprofit ECR.

RESPONSE:

I did not prepare the workpapers cited in the question, nor were they prepared under my supervision, but I have reviewed the spreadsheets cited in the question. I have also noted that these spreadsheets were replaced by updated versions during the course of Docket No. R2001-1. The updated versions of the spreadsheets are available on the Commission's website for Docket No. R2001-1, in the Library References section under USPS-LR-J-131, by accessing the link entitled Notice of Filing Errata to USPS-LR-J-131, dated 1/3/2002. The updated spreadsheets give identical delivery costs for ECR and NECR and show the specific sources for the data in Footnote (2) on each spreadsheet. The sources cited in those footnotes are: USPS-LR-J-58, Workbook LR-J-58.xls, Summary and USPS-LR-J-117.xls, Table 1. I do not know the source of the previous, erroneous data.