

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

POSTAL RATE AND FEE CHANGES, 2006 )

Docket No. R2006-1

VALPAK DIRECT MARKETING SYSTEMS, INC. AND  
VALPAK DEALERS' ASSOCIATION, INC.  
FIRST INTERROGATORIES AND REQUESTS FOR  
PRODUCTION OF DOCUMENTS TO UNITED STATES POSTAL SERVICE  
WITNESS DONALD J. O'HARA (VP/USPS-T31-1)  
(May 18, 2006)

Pursuant to sections 25 and 26 of the Postal Rate Commission rules of practice, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. hereby submit interrogatories and document production requests. If necessary, please redirect any interrogatory and/or request to a more appropriate Postal Service witness.

Respectfully submitted,

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**VP/USPS-T31-1.**

Please refer to page 13 of your testimony (USPS-T-13), at lines 16-19, where you say: “It is also worth noting that as the degree of preparation increases over time, all else equal, the coverage required to obtain the same contribution also increases. This is true for the system as a whole as well as for an individual subclass.” You then go on to provide a numerical, but hypothetical, illustration of this phenomenon.

- a. Have you done any analysis of the absolute or the relative changes in the degrees of worksharing in the various subclasses of mail over time? If so, please present that analysis with its conclusions.
  
- b. The Commission provided a paper entitled, “Pricing Repositionable Notes (RPN) for Use in Postal Delivery Services: An Economic Analysis,” by Professor Frank A. Wolak, dated January 16, 2006. *See* Docket No. MC2004-5, PRC-LR-1 Revised. In it, Professor Wolak looked to measures of consumers surplus for guidance on how RPNs should be priced.

In other situations, the Commission has given weight to notions of efficient component pricing, which focus on getting the lowest-cost provider to do the work. Also, attention has also been given to the effectiveness of signals sent to mailers in rates and to the importance of marginal costs to the efficiency of resource allocation.

Are you aware of any references to economic theory or to the economic literature which point to the efficacy of maintaining “the same contribution [on a per-unit basis]” from a subclass over time, as the costs of that subclass change? If you are, please provide those references.

- c. Please consider the following statement, not taken from any particular source:

Requiring a pre-determined level of contribution from a subclass, either in total or on a per-piece basis, is an exercise akin to the schemes used by practitioners of fully distributed costing. Doing so is anathema to the economic principles of ratesetting, as it is a subtle way of identifying what appears to be responsibility and at the same time of diverting attention from pertinent factors that should guide decision making. It should be rejected on its face.

- (i) Please indicate whether you agree or disagree with this statement, and explain the basis for any disagreement.
- (ii) If you disagree with this statement, please provide references to economic concepts or literature pointing to any benefits you believe would result from adopting such a focus on maintaining contribution.
- d. Please suppose, in period 1, mailers submit mail requiring a wide range of services, including sorting, transporting, and delivering. Assume the Postal Service has adjusted its facilities and equipment to provide the desired services efficiently. Within the framework of this set of facilities and equipment, the

Postal Service estimates its marginal costs, arrives at a level of total volume variable costs, and determines as a residual the level of its institutional costs.

Now, please suppose, in period 2, the only changes are that mailers submit their mail downstream, and that it requires much less sorting and transporting. As would be expected, assume the Postal Service modifies its facilities and equipment to provide the reduced level of services efficiently. Within this modified framework of facilities and equipment, the Postal Service again estimates its marginal costs, arrives at a level of total volume variable costs, and determines as a residual the level of its institutional costs.

- (i) Please provide any bases you have for expecting that the level of institutional costs in the second period would be higher than, would be the same as, or would be lower than the level of institutional costs in the first period.
- (ii) If you do not have any bases for forming expectations, even qualitatively, do you have any bases for ruling out certain outcomes? If so, please explain any such bases and point to any way you believe the outcome would be constrained.

- e. Please suppose a firm in a certain city is providing delivery services in competition with the Postal Service, and the arrangement is that customers prepare their mail in a certain way and bring it to that city. The firm bases its rates on its direct costs and a level of contribution it believes workable. Please suppose also that the Postal Service's competing product is one that has, over the last five years, become highly workshered, due to investments by mailers in preparation activities and downstream entry.

Please explain the extent to which you believe the appropriate competitive posture for the Postal Service in this situation would be to set rates equal to current costs plus a pre-determined contribution rooted in circumstances now five years old.

- f. In Docket No. MC95-1, Postal Service witness McBride, in regard to the then-proposed ECR subclass, said: "As the Postal Service is faced with increasing competition for hard copy delivery, the most likely incursions into the existing customer and volume base will occur in those areas where the unit cost for delivery is less than the average but is not adequately reflect in price, giving competitors an opportunity to price their services to attract the lower cost Postal Service products out of the mailstream." USPS-T-1, p. 29, ll. 16-21.

- (i) Please explain any extent to which you disagree with this quote from witness McBride.
- (ii) It could be suggested that your prescription for developing rates is one of preserving legacy contribution levels and “giving competitors an opportunity to price their services to attract the lower cost Postal Service products out of the mailstream.” Please explain any extent to which you disagree with this suggestion.