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

POSTAL RATE AND FEE CHANGES, 2006	Docket No. R2006–1

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PIFER
TO INTERROGATORIES OF VALPAK. (VP/USPS-T18-1 - 8)
(May 30, 2006)

The United States Postal Service hereby provides the response of witness Pifer to the following interrogatories of ValPak, Inc., filed on May 16, 2006: VP/USPS-T18-1 - 8.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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May 30, 2006

RESPONSE OF POSTAL SERVICE WITNESS PIFER
TO INTERROGATORIES OF VALPAK

VP/USPS-T18-1.
Please refer to your testimony at page 7, lines 25-27, where you discuss a Type 5 cost pool and first state that "in this cost pool [the costs are variable] ... and the variability equals one hundred percent." You then go on to say that "[t]here are non-volume variable costs intrinsic to a product."
a. Please explain how, if all costs in the pool are variable, the pool also can contain non-volume variable costs, regardless of whether they are intrinsic or non-intrinsic.
b. Please give one or two examples of a non-volume variable intrinsic cost in a cost pool where all costs are volume variable.

RESPONSE:

a. and b. It is my understanding of the previous testimony of Prof. Bradley (Direct Testimony of Michael D. Bradley on Behalf of the United States Postal Service, USPS-T-22, Docket No. R2000-1 at 20) that intrinsic costs do not vary at margin, so their existence does not depend upon the measured volume variability:

> For many cost pools, there is more than one product handled, so cost attribution is not so straightforward. In these cost pools, two questions must be answered to determine proper cost attribution. The first question is whether or not there are any intrinsic costs. An intrinsic cost is a variable cost, in the sense that it varies with the level of output, but it does not vary at the margin.[17] By that, I mean that these costs are not increased by additional volume of the product. Nevertheless, they are caused by the provision of the entire volume of the product and are thus incremental to that product. When there are intrinsic costs in a cost pool, then both the volume-related costs and the intrinsic costs are attributed to the product that caused them to arise. Other products in the cost pool will cause volume-related incremental costs but will not generate intrinsic costs.
>
> An example of this type of cost pool is given by the manual Priority Mail cost pool. All costs are labor costs and are variable costs. However, the cost pool arises because of the intrinsic characteristics of

> Priority Mail and would not exist but for that product. If there were no Priority Mail, this cost pool would disappear. The volume variable costs for non-Priority Mail products would not disappear, but both the Priority Mail's volume variable cost and all of the institutional cost would disappear. This latter set of costs are intrinsic to Priority Mail so the incremental cost for Priority Mail in this cost pool is the sum of Priority Mail's volume variable cost and all of the institutional cost. In this instance, the institutional costs are intrinsic costs.
>
> _____
>
> 17 Intrinsic costs would include things like the premium costs associated with an expedited air transportation network.
>
> (Footnote in original)

The only example that I am aware is provided by the old Eagle network. An explanation of the calculation of incremental cost in cost pool with 100 percent variability and intrinsic costs was provided by witness Bradley in Docket No. R2000-1 (Direct Testimony of Michael D. Bradley on Behalf of the United States Postal Service, USPS-T-22, Docket No. R2000-1 at 37):

> The other instance of intrinsic cost is for dedicated air network transportation. In these cost components, the volume variable cost is found by multiplying the amount of the driver (pound-miles) times the (constant) marginal cost of commercial air transportation, (β_j). In the product cost model, the cost function for the dedicated air network is thus given by:
>
> $$C = \alpha_j \bar{D}_j,$$
>
> where the bar on the driver indicates that its amount is fixed with respect to small changes in volume and

α_j represents the cost of a pound mile of dedicated network air transportation.[28] One can express the volume variable cost forExpress Mail as the product of the cost of a pound-mile of commercial air transportation times the number of pound-miles required.[29]

$$VVC_{1j} = \beta_j D_{1j}.$$

The incremental cost of Express Mail in this component adds in the intrinsic cost to the volume variable cost:

$$IC_{1j} = \beta_j D_{1j} + (\alpha_j - \beta_j)\bar{D}_j.$$

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[28] It is my understanding that the air network is sized for a minimum scale and more capacity exists than is required to handle just the Express Mail. Thus marginal increases in Express Mail volume do not affect the capacity of network.

[29] The volume variability of commercial air transportation is one.

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VP/USPS-T18-2.
Please refer to your testimony at page 10, lines 5-7, where it says "[t]hree of the cost pools types identified in section I.C include product specific costs ... and intrinsic costs in type 6 and 7 cost pools." Also, please refer to your testimony at page 8, lines 14-17, in which your description of Type 7 cost pools states that "there are no intrinsic costs." Please reconcile these two seemingly contradictory statements as regards Type 7 cost pools.

RESPONSE:

The description on page 8 of type 7 cost pools is correct. Rather than "type 6 and 7 cost pools," line 7 of page 10 should read "type 5 and 6 cost pools."

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VP/USPS-T18-3.
With respect to any cost pool in which only Priority Mail is handled, would you agree that all non-volume variable costs in any such cost pool would be incremental to the mail processing cost of Priority Mail? If you disagree, please explain fully.

RESPONSE:

Yes, if the cost pool would not exist if Priority Mail were to be eliminated as a product, then all non-volume variable costs would be incremental to Priority Mail.

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VP/USPS-T18-4.
With respect to those cost pools in which only letters are handled (*e.g.*, DBCS), would you agree that all non-volume variable costs in those cost pools are incremental to the mail processing cost of letters? If you disagree, please explain fully.

RESPONSE:

Yes, if the cost pools would not exist if the Postal Service ceased delivering all letter-shaped pieces, although note that this does not imply that the non-volume-variable cost of a letter operation such as DBCS would be incremental to any Postal Service product.

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VP/USPS-T18-5.
With respect to those cost pools in which only flats are handled (*e.g.*, AFSM 100), would you agree that all non-volume variable costs in each of those cost pools are incremental to the mail processing cost of flats? If you disagree, please explain fully.

RESPONSE:

Yes, if the cost pools would not exist if the Postal Service ceased delivering all flat-shaped pieces, although note that this does not imply that the non-volume-variable cost of a flat operation such as AFSM 100 would be incremental to any Postal Service product.

RESPONSE OF POSTAL SERVICE WITNESS PIFER
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VP/USPS-T18-6.
With respect to any cost pool in which only parcels are handled, would you agree that all non-volume variable costs in any such cost pool would be incremental to the mail processing cost of parcels? If you disagree, please explain fully.

RESPONSE:

Yes, if the cost pools would not exist if the Postal Service ceased delivering all parcel-shaped pieces, although note that this does not imply that the non-volume-variable cost of a parcel operation would be incremental to any Postal Service product.

RESPONSE OF POSTAL SERVICE WITNESS PIFER
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VP/USPS-T18-7.
a. Is all mail processing within the collection cost pool restricted to collection mail, or is any other subset of mail also processed within the collection cost pool?
b. If the collection cost pool handles only collection mail, would you agree that all non-volume variable costs in any such cost pool would be incremental to the mail processing cost of collection mail? If you disagree, please explain fully.

RESPONSE:

a. I am not completely sure what you mean by the collection cost pool within mail processing. If you are referring to the Cancellation (1CANCEL) cost pool, I am informed that most collection mail is processed in the Cancellation (010C) operation within mail processing. Please see pages 2-3 of the testimony of witness McCreary (USPS-T-42) for a general discussion of this operation. I am also informed, however, that non-collection mail can also be handled in the Cancellation cost pool. For example, stale dated meter mail might be run through the AFCS to get a proper postmark date on the pieces. Since I am not an Operations expert, further details would have to be elicited from witness McCrery.

b. Not applicable.

RESPONSE OF POSTAL SERVICE WITNESS PIFER
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VP/USPS-T18-8.
Please refer to your testimony at page 18, lines 13-23. At lines 13-14, you state that "[i]ncremental costs for ... Standard ECR mail are ... 2.9% higher than volume variable costs." At lines 18-20, you state that "mail subclasses with a larger share of the driver will have a larger difference between volume variable cost and incremental cost."
a. What is the driver for Standard ECR mail that results in incremental costs being 2.9 percent higher than volume variable cost?
b. Please explain why this driver is not equally applicable to Standard Regular mail.

RESPONSE:

a. Since the 2.9 percent applies to the subclass costs as a whole, rather than any single cost component, there is no single driver that would fully explain that figure, which reflects the net effect of all cost drivers for all cost components.

b. As noted above, there is no single driver that explains the result about which you inquire. But as also suggested at the bottom of the page of my testimony from which you quote, all else equal, subclasses with larger RPW volumes tend to have a larger percentage difference between volume variable and incremental cost. That relationship holds between Standard and ECR, to the extent that Standard has a higher proportion of RPW volumes (31 percent versus 16.5 percent), and a larger difference between volume variable and incremental costs (3.5 percent versus 2.9 percent). Thus, perhaps contrary to the apparent implication of the question, the net effect of the relevant cost drivers does, roughly speaking, appear to be "equally applicable" between Standard and ECR.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with Section 12 of the Rules of Practice and Procedure.

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