

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

POSTAL RATE AND FEE CHANGES, 2006)

Docket No. R2006-1

RESPONSES OF VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

WITNESS ROBERT W. MITCHELL TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE (USPS/VP-T1-1-15)

(October 3, 2006)

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc.

("Valpak") hereby submit responses of witness Robert W. Mitchell to the following interrogatories of the United States Postal Service: USPS/VP-T1-1-15, filed on September 19, 2006. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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**Response of Valpak Witness Mitchell
to Interrogatory of USPS**

USPS/VP-T1-1.

- (a) Please confirm that, under your proposed pricing a Standard Mail Regular automation 5-digit piece-rated letter entered at the DSCF would pay 18.2 cents per piece. If not confirmed, please supply the correct proposed rate.
- (b) Please confirm that, under your proposed pricing a Standard Mail ECR Basic piece-rated letter entered at the DSCF would pay 14.9 cents per piece. If not confirmed, please supply the correct proposed rate.
- (c) Please confirm that the rate difference between the above two letters is 3.3 cents per letter. If not confirmed, please supply the correct difference.
- (d) Is it your view that the rate difference confirmed or supplied in part (c) would be sufficient to cause some letters to migrate from Standard Mail automation to ECR basic if the mail preparation rules are the same as they are today? If you do not agree, please explain fully why you think that no letters would migrate.
- (e) If your response to part (d) is other than an unqualified negative, please explain what the revenue, cost and contribution impacts of this migration would be and describe how you took these impacts into account in preparing your alternative rate proposals.

Response:

- (a) Confirmed.
- (b) Confirmed.
- (c) Confirmed.
- (d-e) Certainly “some” letters would migrate. However, consistent with the testimony of Postal Service witness Tolley in Docket No. MC95-1, the cross elasticity between Regular and ECR is generally considered to be low. This was one of the factors considered when the ECR subclass was created. See the discussion of the Commission in its Opinion in that case, p. V-174, ¶ 5425.

The usual approach is to set rates on defensible bases, typically involving costs and the ratesetting policies of the Act, as developed and applied by the

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Commission, and then to allow mailers to choose what is best for them.

Developing rates with an eye to keeping mailers in one category or another runs counter to the reasoning that should underlie the rates, and is not acceptable practice. See the Commission's discussion of this matter in its Opinion in Docket No. MC95-1, pp. V-161-62, ¶ 5388.

Some pieces once using carrier route rates have undoubtedly migrated to the 5-digit automation category in Regular, due to lower rates there, and some of the same pieces might migrate back, without finding the density requirement to be a hurdle. If sufficient information were available on the number of these pieces and their cost characteristics, I agree that adjustments could be made, as is sometimes done. Short of that, as is also done, the rates are developed based on current billing determinants and the future is allowed to occur. New volumes and estimates of new costs will become available to support realignment later.

In the instant docket, a considerable number of rate and classification adjustments are on the table. Detailed estimates of mailer responses and cost effects are sometimes rough and sometimes unavailable. Some changes will improve the Postal Service's finances and some will not. The net effect can be recognized in the next omnibus case. This reduces somewhat the accuracy of the breakeven estimate for any specific test year, but it is not inconsistent with

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any notion of longer-term breakeven. We should be very careful not to let an interest in this type of accuracy stop progress toward improved rates.

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USPS/VP-T1-2.

- (a) Please confirm that, under your proposed pricing a Standard Mail Regular automation 5-digit piece-rated flat entered at the DSCF would pay 34.5 cents per piece. If not confirmed, please supply the correct proposed rate.
- (b) Please confirm that, under your proposed pricing a Standard Mail ECR Basic piece-rated flat entered at the DSCF would pay 17.2 cents per piece. If not confirmed, please supply the correct proposed rate.
- (c) Please confirm that the rate difference between the above two flats is 17.3 cents per flat. If not confirmed, please supply the correct difference.
- (d) Is it your view that the rate difference confirmed or supplied in part (c) might induce some mailers to migrate the flats from Standard Mail automation to ECR Basic by sending duplicate mail pieces or otherwise padding their mailing lists to qualify for the ECR rates? If you do not agree, please explain fully why you think that no pieces would migrate.
- (e) If your response to part (d) is other than an unqualified negative, please state whether you believe that all migrating flats possess the demand and market characteristics that the Commission had in mind when it recommended ECR as a separate subclass. Please explain your answer.
- (f) If your response to part (d) is other than an unqualified negative, please state whether you believe that expanding the number of small carrier route bundles will increase or reduce Postal Service costs if the Postal Service transitions to automated flat sequencing? Please explain your answer.
- (g) If your response to part (d) is other than an unqualified negative, please explain what the revenue, cost and contribution impacts of this migration would be and describe how you took these impacts into account in preparing your alternative rate proposals.

Response:

- (a) Confirmed.
- (b) Confirmed.
- (c) Confirmed.
- (d) In response to any schedule of rates, mailers can be expected to make adjustments, including the possibility of gaming the system. Some mailers might be in a position to do the latter here. Several things can be said.

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(1) Mailers generally have far more invested in a piece of mail than just the postage. One mailer told me that he had about 70 cents in each mailpiece, making postage a lesser consideration. (2) ECR pieces have line-of-travel requirements. The Postal Service considers now, and would consider in the future, how these requirements are written and applied. It might choose not to allow duplicate pieces to the same address. Also, mailers might have no interest in having recipients receive duplicates. (3) Mailers could seek out addresses not currently on their list. These could be more likely to be undeliverable. In addition, the response rates might be non-existent for such addresses and some mailers might have a preference against non-target recipients receiving their mailpieces. Similarly, some recipients might be averse to receiving such materials. (4) The Postal Service would have to evaluate the profitability of the additional pieces. Usually, firms and organizations are happy to have more business. Whether the Postal Service would assume the migrating pieces have the average costs of their categories, as it has done in some NSAs, is open to question, but the costs available for ECR flats are much lower than the costs for 5-digit automation flats. Another factor would involve the question of elasticities — some of the mailers receiving lower postage could decide to mail even more pieces, resulting in a net gain. In short, the problem may not exist in significant degree, and it could be a good thing instead of a bad one.

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- (e) I agree that the demand and market characteristics, on average, of 5-digit automation flats might be different from the demand and market characteristics, on average, of ECR flats. In fact, they might be *expected* to be different, since they are components of larger categories that are understood to be different. A lack of perfect uniformity always exists, however, in any classification scheme. The fact that it might exist here should not stop otherwise appropriate ratesetting.
- (f) The question of what happens under flats sequencing is an interesting one, but one on which no data and very little analysis are available. See responses of Postal Service witness Coombs to AMZ/USPS-T44-1(c), VP/USPS-T44-4(c), 14, and 18(d), and NAA/USPS-T44-8, 9, 10, and 11. Both costs and preparation requirements would be expected to change, making a great deal of current data inapplicable. I have no assessment to provide.
- (g) Please see my discussion of a similar issue in USPS/VP-T1-1(d-e).

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USPS/VP-T1-3.

- (a) Please confirm that, under your proposed pricing a Standard Mail Regular automation 5-digit piece-rated letter entered at the DSCF would pay 18.2 cents per piece. If not confirmed, please supply the correct proposed rate.
- (b) Please confirm that, under your proposed pricing a Standard Mail ECR Automation Basic piece-rated letter entered at the DSCF would pay 12.9 cents per piece. If not confirmed, please supply the correct proposed rate.
- (c) Please confirm that the rate difference between the above two letters is 5.3 cents per letter. If not confirmed, please supply the correct difference.
- (d) Please confirm that you propose that the Commission recommend that Standard Mail ECR Automation Basic rates be available to otherwise qualified letters addressed to all ZIP Codes and not be restricted to specific destinations as is currently the case.
- (e) Is it your view that the rate difference confirmed or supplied in part (c) would be sufficient to cause some letters to migrate from Standard Mail automation to ECR basic if the mail preparation rules are the same as they are today? If you do not agree, please explain fully why you think that no letters would migrate.
- (f) If your response to part (e) is other than an unqualified negative, please state whether you believe that the volume of migrating letters would be large relative to the current volume of ECR Automation Basic letters? If you did not estimate the volume of letters that would migrate as the result of your alternative rate proposals, explain why not.
- (g) If your response to part (e) is other than an unqualified negative, please explain what the revenue, cost and contribution impacts of this migration would be and describe how you took these impacts into account in preparing your alternative rate proposals.

Response:

- (a) Confirmed.
- (b) Confirmed.
- (c) Confirmed.
- (d) Not confirmed. Please see page 126 of my testimony, VP-T-1, lines 12-21. My suggestion is that the Commission “consider” such a classification, but I do not propose that the Commission recommend it. My hope is that if the Commission

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finds potential merit in such a classification, it will note such, and the Postal

Service will consider it further.

(e, f, and g) Not applicable.

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USPS/VP-T1-4.

Please confirm that your proposed rates produce the percentage rate increases for the sample Standard Mail pieces shown in the table below;

	3 ounce	5 ounce	8 ounce	14 ounce
Standard Mail Regular				
Automation 5-digit, DSCF Letter	5.2%			
Automation 5-digit, DSCF Flat	39.1%	29.8%	19.7%	10.2%
Nonmachinable 3-digit DSCF Parcel	55.9%	49.9%	41.9%	31.9%
Machinable DBMC Parcel—Barcoded			73.4%	62.2%
NFM--3-digit DSCF	169.0%	141.7%	113.0%	85.7%
Standard Mail ECR				
Basic DSCF Letter	-15.8%			
Saturation DSCF Letter	-24.8%			
Basic DSCF Flat	-2.8%	-3.5%	-4.9%	-6.1%
Saturation DSCF Flat (On-piece Addressed)	-14.2%	-12.3%	-11.0%	-9.9%

Response:

With three exceptions, I confirm the data in your table. For saturation 3-ounce flats (with address on piece), I get -14.8 percent. For the line for machinable parcels entered at the DBMC (barcoded), you do not specify the presort level. Under the assumption that the pieces are BMC presorted, are currently paying the basic rate, and are currently paying the residual shape surcharge, I get 53.4 percent for the 8-ounce pieces and 47.9 percent for the 14-ounce pieces.

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USPS/VP-T1-5.

Please refer to page 105 of your testimony.

- (f) Please explain if your use of the term “Stigler’s second definition” of price discrimination is intended to assert that Professor Stigler adopted this definition in his work, or endorsed this definition’s use in preference to “Stigler’s first definition” of price discrimination in some or all applications.
- (g) If you do assert that Professor Stigler adopted or endorsed the second definition in preference to the first for some purposes, please give examples and citations of this preferred use.

Response:

Note: The original question contains a section f and a section g, but no other sections.

Those designations are maintained here.

- (f-g) The reference is to Professor Stigler’s introductory text, *The Theory of Price*.
As part of a discussion of prices differing from costs, he tightens the dialogue somewhat by dropping a footnote, with equations. He says “[o]ur definition of discrimination turns upon the” question of whether the ratios of price to marginal cost (the cost coverages, in postal parlance) are the same. Then, in the same footnote, in what I called his “second definition,” he says “[s]ome economists prefer the slightly different definition that prices are discriminatory if the difference in price is not equal to the difference in marginal cost,” which is the same as the products having the same per-piece contribution. He goes on to point out that the first definition has implications concerning the efficiency of resource allocation, which is an important issue throughout his book.
Otherwise, there is no particular sense in which he “adopts” one definition or

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the other, and he does not specify conditions under which the second one might be more relevant.

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USPS/VP-T1-6.

Please refer to pages 105 and 106 of your testimony. Please confirm that your use of the two definitions of price discrimination described in Professor Stigler's book to apply differentially to shape-based cost differences and worksharing cost differences represents your own opinion and is not based on any explicit or analogous usage of the two definitions by Professor Stigler in published work. If you do not confirm, please supply examples and citations to published work where Professor Stigler used these two definitions to apply as you suggest in your testimony.

Response:

I am not familiar with any published work of Professor Stigler wherein he deals with issues of discrimination in ratesetting. Within a page or so of the two definitions at issue, however, he does discuss the importance of markets having different elasticities if discrimination is to occur and he does discuss the importance of markets being relatively independent, which is an issue of cross elasticity. Applying these notions to postal pricing is, in my opinion, relatively straightforward. (1) Differences in elasticities among subclasses receive a great deal of attention, but there is little discussion about whether the elasticities of categories within subclasses are different. If resources are to be allocated efficiently, another issue Stigler discusses at great length, this leads to equal percentage markups between categories like letters and flats, at least as a default solution. (2) Large potential gains being available on the technical side from having billions of pieces of mail processed in a lower-cost way, issues of worksharing have also received attention, with attendant arguments of significant cross elasticities between workshared and non-workshared mail. Since welfare gains tend to be smaller than these technical gains, and since any bases for discriminating

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among workshare categories are not generally clear, attention has focused on equality of per-piece contributions.

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USPS/VP-T1-7.

Please refer to pages 109, lines 16-17 of your testimony. Do you consider parcels to be a “variant” of flats (or vice-versa) in the same or similar way that automation letters might be considered a variant of machinable letters?

- (a) If your answer to the above question is in the affirmative, please explain why these two shapes should be considered variants of each other.
- (b) If your answer to the above question is in the affirmative, please explain why letters and flats should not be similarly considered variants of each other.

Response:

- (a-b) The relation between automation letters and machinable letters is an intra-shape distinction and is generally considered to be one of worksharing, although I understand that several requirements are involved. The relation among letters, flats, and parcels, however, is more distant, for several reasons. (1) In worksharing, the gains can be very large, as in having substantial portions of mail processed in a lower-cost way. Geometrically speaking, such gains can be thought of as the areas of rectangles, potentially several cents high and billions of pieces wide. Gains of this magnitude, which lead to a focus on cost avoidances, are not at issue in regard to movements between such categories as letters, flats, and parcels. (2) With automation, the processing of letters, flats, and parcels has become increasingly well defined and separate, much as though they were separate products. (3) The cross elasticities between letters, flats, and parcels are generally thought of as rather low. It is easy to conceive of a mailer saying to a mail preparation agency: “You can put a barcode on that flat if you

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want to, but don't you dare convert it into a letter." The reality is that separate markets are involved, again consistent with the notion of separate products.

(4) If the resulting prices or market position of letters, flats, or parcels were found to raise questions, it would be easy to argue that separate subclasses should be considered, in which case questions of different markups would arise immediately, clearly a step beyond thinking in terms of a high passthrough of a cost difference between them. An argument for an automation subclass would be much more difficult to defend.

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USPS/VP-T1-8.

Please refer to page 115, line 3 of your testimony. Please supply the data or studies you relied on to determine that the differences in average weight between commercial Standard Mail Regular Basic nonautomation letters and Basic nonautomation flats will translate easily into “two or more truck-loads of flats for each truckload of letters.”

Response:

My only reference was the billing determinants for Standard mail, contained in USPS-LR-L-77, which show basic non-automation letters to have an average weight of 0.7951 ounces and corresponding flats to have an average weight of 1.9156 ounces, well over twice as much (both figures being on page 2 of section G-1, cells K12 and K19, respectively). Given that trucks loaded with printed matter such as Standard mail generally weigh out before they cube out, it seems intuitive that these differences could translate easily into “two or more truck-loads of flats for each truckload of letters.”

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USPS/VP-T1-9.

Please refer to page 126, lines 12-16 of your testimony.

- (a) If the Commission were to follow your recommendation and establish an unrestricted Automation Basic Letters category in ECR (with the same minimums that now exist for Automation Basic Letters), is it your view that no mail that is currently being entered and processed as Standard Mail Regular 5-digit Automation Letters would migrate to the new ECR category?
- (b) If your answer to the above question is not an unqualified no, please state whether you believe that carrier route sorting, sequencing and bundling of the newly migrated mail will have significant operational value to the Postal Service if the Postal Service continues to delivery point sequence these letters at plants.

Response:

- (a) No. See my response to USPS/VP-T1-3(d).
- (b) Not applicable.

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USPS/VP-T1-10.

Please refer to page 148, line 8 of your testimony. Please explain the basis for describing the proposed NFM rate category as “temporary” as opposed to a permanent rate category to which certain parcels will have temporary rate access.

Response:

The basis for my description was Postal Service witness Kiefer’s use of the term “temporary,” USPS-T-36, page 11, line 6. If I misinterpreted his statement, I would be happy for the record to contain any clarification on this point that the Postal Service wishes to provide. Whether it be temporary or permanent, relative to the Postal Service proposal, I have not proposed any changes in how the rates for the NFM category are developed.

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USPS/VP-T1-11.

Please refer to page 156, lines 4-10 of your testimony. Is it your view that limiting the passthrough of cost differences in order to partially offset the rate change impacts of rate deaveraging is not a legitimate tool in ratemaking?

Response:

No, although I think a significant first step should be taken; otherwise, responses to the decision to deaverage can be minimal and it can take a long time to get to the preferred rate position. Part of the problem here is that other events can occur along the way, and interfere with the best laid of plans. Also, questions should be raised about limiting *established* discounts as part of such an arrangement, since the effects on mailers could be significant and it might be difficult to get those discounts back in place. In any case, the situation needs to be examined.

The categories at issue on page 156 are those of machinable flats. The basic level is proposed to be deaveraged into mixed ADC and ADC, and the 3/5-digit level into 3-digit and 5-digit. In doing this, there is no reason to reduce the passthrough between the MxADC/ADC aggregate and the 3-d/5-d aggregate, as this would disadvantage *both* 3-digit and 5-digit mailers. Under the Postal Service proposal, MxADC mailers see an increase of 18.73 percent while 3-digit mailers see an increase of 24.34 percent. A case could therefore be made for a temporary passthrough of greater than 100 percent between the ADC level and the 3-digit level.

Another problem exists in the rate difference between machinable flats and corresponding automation flats. Under the Postal Service proposal, this difference is larger at

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the 5-digit level than at the MxADC level (4.3 cents at the former and 4.0 cents at the latter).

If anything, the difference at the 5-digit level should be *smaller* than at the MxADC level.

This is because, at the 5-digit level, the Postal Service receives very little benefit from having a barcode applied by the mailer. Therefore, if an “offset” is going to be developed, a number of factors need to be taken into account.

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USPS/VP-T1-12.

Please refer to page 156, lines 11-13 of your testimony where you say, in part, “whenever deaveraging occurs...significant impacts on mailers should be expected, and accepted.”

- (a) Is it your view that the Postal Service and mailers whose rates are pushed up by rate deaveraging should “accept” those impacts, regardless of the size of the impact?
- (b) If your answer to part (a) is not an unqualified yes, please state at what level would deaveraging rate impacts become unacceptable and warrant rate change mitigation.

Response:

- (a-b) Page 156 is part of a section that discusses the deaveraging of basic flats and 3/5-digit flats (machinable, in Regular). It might be better to think of acceptance in terms of whether the bases for the increases are justified and understood. It is true that some mailers would realize effects, usually on a limited portion of their mail, though this would not apply to the Postal Service. In effect, an opportunity to be averaged with some lower-cost mailers is being withdrawn. See also my responses to USPS/VP-T1-19, 23, and 24.

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USPS/VP-T1-13.

Please refer to pages 156-57, subsection 9 of your testimony. If the Commission were to agree with your assertion that the letter-flat cost differential should be more fully reflected in rates, would it be your view that mailers whose rates were pushed up “accept” those impacts, regardless of the size of the impact? Please explain your answer fully.

Response:

In subsection 9, the word “accept” is not used, although it is used in the subsection referenced in USPS/VP-T1-12. Please see my response to that interrogatory.

One could hypothesize a linear relation between the size of a rate increase and the degree of unhappiness. It might be better to think of acceptance in terms of whether the bases for the increases are justified and understood. Consider the following example. Suppose that you (my reader) and I each have a life insurance policy with the same company and that the rates for some years have been the same for smokers and non-smokers. I am a smoker and you are not. With increased knowledge about the health effects of smoking, our company has decided to deaverage the rates and charge me more and you less. The explanation is that the costs have not been reflected in the rates. I could be given the opportunity to talk to the insurance company and explain why my rates should not increase, and I could attempt to make a case that the company is being unfair to me. But I do not get a vote. Unless I give the company a good reason, which I cannot, it will not reduce my rate. The company does, however, provide me with a rational explanation, which would seem a reasonable thing for it to do. The fact that rates have been out of alignment with costs in the past is not relevant.

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Also, to the extent to which you express yourself on the decision to deaverage, I would guess that you would support it and argue that it is fair to all parties.

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USPS/VP-T1-14.

Please refer to page 171, lines 8-18 of your testimony.

- (a) If the Commission were to follow your proposal and recommend rates for the ECR Basic Letters category that were below the rate for Standard Mail Regular 5-digit Automation Letters, is it your view that no mail that is currently being entered and processed as Standard Mail Regular 5-digit Automation Letters would migrate to the ECR Basic Letters category?
- (b) If your answer to the above question is not an unqualified no, please state whether you believe that carrier route sorting, sequencing and bundling of the newly migrated mail will have significant operational value to the Postal Service if the Postal Service continues to delivery point sequence these letters at plants.

Response:

- (a) Please see my response to USPS/VP-T1-1.
- (b) According to sheet 18 of the UDCModel worksheet of USPS-LR-L-67, about 82 percent of Standard letters are DPS'd. I have not found separate figures for 5-digit automation and basic ECR letters. However, my proposal develops rates using the costs that are available, which include a non-machinable component in basic ECR letters. My strength does not lie in describing the details of operations. It is important to note, however, that operations are only one part of any rate difference. The other part relates to the subclasses involved, which goes back in part to whether the market characteristics, on average, are different for ECR mail.

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USPS/VP-T1-15.

Please refer to page 182, lines 16-18 of your testimony. Please state the basis for your opinion that the studies that show the effect of weight on cost of Standard Mail are not reliable. If you relied on your own or other analyses of these studies, please provide those analyses and state which studies were evaluated in each analysis.

Response:

The sentence beginning on line 16 says: “If one takes the position, as I do, that the studies done to date to estimate the effects of weight on the costs of Standard Mail are indicative but not terribly reliable, then no real basis exists for evaluating the pound charges.” The phrase “not terribly reliable” is an expression meaning somewhat reliable, but not as reliable as one would wish. Also, the word “indicative” was meant to be positive.

However, I have reviewed studies of weight over a period of years, in a very general way. Although there is some consistency over time in the results, my recollection is that the graphs of the costs have been far from smooth and well behaved. Also, although I am not an expert on statistical confidence levels and standard errors, I have always been concerned that the estimates we have are very rough. I feel like my concerns were shared by Postal Service witness Daniel in Docket No. R2000-1, who, referring to her own work, said: “The results of the weight analysis presented in this testimony are intended to guide rate design by providing a *general* indication of the effect weight has on total volume variable costs. They are not necessarily intended to be an exact quantification of costs for every individual weight increment.” USPS-T-28, p. 3, ll. 21-24, emphasis in original. Then, after reviewing some factors that made her study complex and difficult, she said: “Thus, while it is possible to

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analyze the data for guidance in rate design, it is difficult, if not impossible, to isolate precisely the impact of weight on costs or identify the exact unit cost of each ounce increment for three of the major classes of mail.” *Id.*, p. 4, ll. 4-7. I interpret these comments as a signal of significant reservations about the reliance that should be put on the results. No study of the effects of weight on costs is available in the instant docket.