

DOCKET SECTION

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

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Postal Rate and Fee Changes, 1997

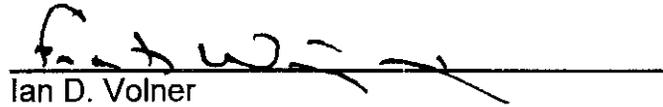
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Docket No. R97-1

RESPONSE OF RECORDING INDUSTRY ASSOCIATION OF
AMERICA, ET AL. WITNESS ANDREW TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE
(USPS/RIAA-T-1-32-33)

The Recording Industry Association of America ("RIAA") hereby provides the responses of witness Gary M. Andrew to the following interrogatories of the United States Postal Service, filed on February 13, 1998: USPS/RIAA-T1-32-33.

The interrogatories are stated verbatim and followed by the responses.

Respectfully submitted,



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February 19, 1998

**RESPONSE OF THE RECORDING INDUSTRY ASSOCIATION
OF AMERICA ET AL. WITNESS ANDREW TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/RIAA et al.-T1-32

Please refer to your response to USPS/RIAA et al.-T1-7. Table 3 in Exhibit K of witness Crum's testimony (USPS-T-28) shows the estimated actual cost per piece for Standard Mail (A) flats and parcels in fiscal year 1996. As repeated on page 11 of USPS-T-28 and referenced in your testimony, the cost difference between parcels and flats is 40.3 cents. To compare costs to revenues, you adjust the cost difference to 33.4 cents. (See page 4, lines 19-20 of your testimony). Your response states that you do not make any similar adjustment to average revenues because "[b]y relying on the actual data from the 1996 Revenue, Pieces and Weight ("RPW") to compute average revenues, the actual mix of dropshipping and presortation and its impact on revenues had been considered."

- a. Please confirm your understanding that the actual mix of dropshipping and presortation is reflected in actual 1996 revenue data. If you cannot confirm, please explain.
- b. Please confirm that the estimated costs used by witness Crum to calculate the 40.3-cent cost difference reflect actual 1996 cost data. If you cannot confirm, please explain.
- c. Please confirm that your rationale for making the adjustment to costs traces back to page 12, lines 9-10 of witness Crum's testimony, where he states: "Standard Mail (A) flats are somewhat more finely presorted and deeply dropshipped than parcels." If you cannot confirm, please explain.
- d. Please confirm that one of the reasons that parcels cost more than flats is that they are less finely presorted and less deeply dropshipped. If you cannot confirm, please explain.

- e. Please confirm that one of the reasons that parcels bring in more revenue than flats is that they are less finely presorted and less deeply dropshipped. If you cannot confirm, please explain.
- f. Please confirm that you make no adjustment to revenues because you believe that the actual mix of dropshipping and presorting is reflected in actual 1996 revenue data, while you do make an adjustment to costs because you believe that the actual mix of dropshipping and presorting and its impact on costs is not reflected in actual 1996 cost data. If you confirm, please explain the logic of making an adjustment to actual costs without making an equivalent adjustment to actual revenue. If you do not confirm, please explain fully.

RESPONSE

- a. Confirmed.
- b. Not confirmed. Actual costs are not recorded by shape across the four subclasses that witness Crum combines. The estimated costs used by witness Crum are modelled costs developed with a series of assumptions and special studies shown in the sidenotes of Table 3 of Exhibit 28K (USPS-28K).
- c. Confirmed. However, if Mr. Crum had not made such an adjustment, I would have done so.
- d. Confirmed to the extent that costs in this question refer to the estimated costs used by witness Crum.
- e-f. Not confirmed. I do not have the information available and the Postal Service has not provided the information to demonstrate to what extent, if any, the additional revenue per piece generated by parcels (above flats) is due to less, or less deep,

dropshipping and less, or less, fine presortation. The interactions between the significant weight differences of parcels and flats and the complex rate structures in Standard (A) Mail can easily cause the revenue differences between flats and parcels to behave in counter intuitive directions. For example, flats that are more deeply dropshipped can actually generate higher revenue than a less deeply dropshipped mix, depending on the weight distribution.

USPS/RIAA et al.-T1-33

Please refer to your response to USPS-RIAA et al.-T1-24 and the response of witness Bradley to OCA/USPS-T14-1, Tr. 11/5357 referenced in that question. Your response states that witness Bradley's "procedure simply applies the system average of variability for MODS offices to all non-MODS cost pools." You criticize this approach for "mask[ing] any mix differences in the use of resources with differing variabilities."

- a. Please confirm that witness Bradley's interrogatory response breaks the non-MODS activities down by cost pool and applies the cost-pool specific variabilities from the MODS analysis. If you cannot confirm, please explain.
- b. Please refer to witness Bradley's response cited above and confirm that when the volume variable costs for the non-MODS offices are combined, one gets virtually the same result as the MODS system variability. (77.9% vs. 78.6%). If you cannot confirm, please explain.
- c. Please confirm that this negates the notion that the mix of costs in the non-MODS offices are different from MODS offices and thus the relative magnitude of the cost pools are different. If you cannot confirm, please explain fully.
- d. In light of the additional analysis presented by witness Bradley in the cited interrogatory response, please explain fully why the "system" variability from MODS offices cannot be accurately be (sic) applied to the non-MODS offices.

RESPONSE

a. Confirmed.

b. Confirmed.

c-d. Not confirmed. There are two fundamental problems with application of the system average volume variability developed in the MODS cost pool to the non-MODS cost pools. Witness Bradley's response to OCA/USPS-T14-1 does not address either problem.

First, there is an implicit assumption made "that variabilities from activities in MODS offices would serve as good proxies for the variabilities for similar activities in the non-MODS offices." (OCA/USPS-T14-1, page 2) This assumption is based on witness Moden's non-quantitative descriptions of the similarity between non-MODS and MODS offices. However, there are no additional data to support the proposition that the "similar activities" necessarily have similar variabilities. Furthermore, there are additional assumptions required before the calculations proposed by witness Bradley can be made. (OCA/USPS-T14-1, page 3)

Second, the method used in LR-H-146 to implement witness Bradley's variability was not the method used in the response to OCA/USPS-T14-1. As documented in my testimony (pages 14 and 15, including footnote 8) the MODS system average variability is applied in LR-H-146 to each of the non-MODS cost pools. Different types of mail use

different mixes of resources from these cost pools and the use of the system average variability at the cost pool level creates significant distortions.

The example in the attached table illustrates the nature and source of this distortion. Consider a system of two cost pools and two shapes (products) as shown in lines 1 and 2 of the table. Only one unit of each shape is produced. Line 1 represents a manual cost pool in MODS with accrued costs of \$1,000 of which 30% (or \$300) are volume variable. The distribution key for the manual related volume variable cost distributes 30% of these costs to Shape A and 70% of these costs to Shape B.

Line 2 of the attached table represents a machine cost pool with accrued costs of \$500 of which 90% (or \$450) are volume variable. The distribution key for the machine related volume variable costs distributes 65% of these costs to Shape A and 35% of these costs to Shape B.

Line 3 of the table shows the total accrued, volume variable, and distributed costs for the MODS cost pools. Line 4 of the table computes the MODS system average volume variability of 50% ($\$750/\$1,500$). Line 5 of the table shows the difference in volume variable cost per unit between Shape A and Shape B. Shape A costs \$15.00 more than Shape B when the specific cost pool volume variability is used at each respective cost pool.

The bottom half of the attached table demonstrates what occurs if system average volume variability percentages are used in each cost pool and all other conditions are held constant. This charge is recognized by adjusting Column (3), Line 6 and Line 7 to reflect the overall system average variability of 50% (Line 4, Column (3)). The difference between Shape A and Shape B has changed to Shape A being \$125 less than Shape B (Line 10, Column (7)) versus the prior calculation that Shape A costs more than Shape B.

This demonstrates the critical point that was overlooked in the implementation in LR-H-146 where witness Bradley's MODS system average variability was applied to each non-MODS cost pool. The impact of the interaction between individual cost pool variabilities and distribution key can distort the differences between shapes. Therefore, the non-MODS component of volume variable costs should not be permitted to contribute to the difference in costs between parcels and flats.

**Illustrative Example of Distortion Caused by
the Use of MODS System Average Variability
in Non-MODS Cost Pools**

MODS Costs with Pool Level Variabilities

Cost Pools (1)	Accrued Costs (2)	Volume Variability		Distribution of Volume Variable Costs			
		(percent)	(dollars)	Keys (percent)		Costs (dollars)	
		(3)	(4)	Shape A (5)	Shape B (6)	Shape A (7)	Shape B (8)
1. Manual	\$ 1,000	30%	\$ 300	30%	70%	\$ 90.0	\$ 210.0
2. Machine	\$ 500	90%	\$ 450	65%	35%	\$ 292.5	\$ 157.5
3. MODS Total	\$ 1,500		\$ 750			\$ 382.5	\$ 367.5
4. MODS System Average		50%					
5.	Cost Difference (Shape B - Shape A)					\$ (15.00)	

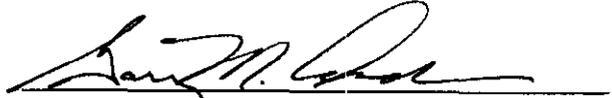
Non-MODS Costs with MODS System Average Variabilities

Cost Pools (1)	Accrued Costs (2)	Volume Variability		Distribution of Volume Variable Costs			
		(percent)	(dollars)	Keys (percent)		Costs (dollars)	
		(3)	(4)	Shape A (5)	Shape B (6)	Shape A (7)	Shape B (8)
6. Manual	\$ 1,000	50%	\$ 500	30%	70%	\$ 150.0	\$ 350.0
7. Machine	\$ 500	50%	\$ 250	65%	35%	\$ 162.5	\$ 87.5
8. Non-MODS Total	\$ 1,500		\$ 750			\$ 312.5	\$ 437.5
9. Non-MODS System Average		50%					
10.	Cost Difference (Shape B - Shape A)					\$ 125.00	

[For ease of illustration 1) All characteristics of the MODS and the Non-MODS Cost Pools were held constant except the Volume Variability at the Cost Pool level and
2) Only one unit of each shape is considered.]

DECLARATION

I, Gary M. Andrew, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.


GARY M. ANDREW

Dated: 2-18-98

CERTIFICATE OF SERVICE

I hereby certify that I have on this date served this document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


N. Frank Wiggins

DATE: February 19, 1998

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