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Before the

POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

UNITED STATES POSTAL RATE COMMISSION

In the Matter of: POSTAL RATE AND FEE CHANGES

Docket No. R97-1

VOLUME 34

DATE: Wednesday, March 18, 1998

PLACE: Washington, D.C.

PAGES: 18179 - 18546

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1

BEFORE THE

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POSTAL RATE COMMISSION

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In the Matter of: :

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POSTAL RATE AND FEE CHANGES : Docket No. R97-1

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- - - - - X

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Third Floor Hearing Room

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Postal Rate Commission

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1333 H Street, N.W.

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Washington, D.C. 20268

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Volume 34

14

Wednesday, March 18, 1998

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The above-entitled matter came on for hearing,

17

pursuant to notice, at 9:30 a.m.

18

19

BEFORE:

20

HON. EDWARD J. GLEIMAN, CHAIRMAN

21

HON. W. H. "TREY" LeBLANC, III, COMMISSIONER

22

HON. GEORGE W. HALEY, COMMISSIONER

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HON. GEORGE A. OMAS, COMMISSIONER

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1	C O N T E N T S				
2	WITNESS	DIRECT	CROSS	REDIRECT	RECROSS
3	LAURTIS R. CHRISTENSEN				
4	BY MR. KOETTING	18210			
5	BY MR. BAKER		18247		
6	BY MR. McKEEVER		18254		
7	BY MR. McLAUGHLIN		18273		
8	BY MR. BAKER		18276		
9	BY MR. McKEEVER		18287/18290		
10	BY MR. KOETTING			18291	
11	BY MR. McKEEVER				18294
12	ANTOINETTE CROWDER				
13	BY MR. McLAUGHLIN	18298			
14	BY MS. BLAIR		18368		
15	BY MR. WELLS		18379		
16	BY MR. BAKER		18380		
17	BY MR. COOPER		18421		
18	BY MR. McLAUGHLIN			18435	
19	JOHN C. PANZAR				
20	BY MR. COOPER	18440			
21	BY MR. WELLS		18465		
22	BY MR. BAKER		18467		
23	BY MR. McKEEVER		18473		
24	BY MR. TODD		18480		
25	BY MR. McKEEVER		18484		

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1 C O N T E N T S [continued]

2	WITNESS	DIRECT	CROSS	REDIRECT	RECROSS
3	JOHN C. PANZAR [continued]				
4	BY MR. TODD		18486		
5	BY MR. BAKER		18492		
6	BY MR. COOPER			18499	
7	BY MR. McKEEVER				18504
8	BY MR. COOPER			18505	
9	ALTAF H. TAUGIQUE				
10	BY MR. COOPER	18507			
11	BY MR. BAKER		18526		
12	BY MR. COOPER			18544	
13	BY MR. BAKER				18545
14					
15	DOCUMENTS TRANSCRIBED INTO THE RECORD:				PAGE
16	Rebuttal Testimony and Exhibits of Guy Wendler,				
17	ABP-RT-1				18202
18	Rebuttal Testimony and Exhibits of Laurantis R.				
19	Christensen, USPS-RT-7				18212
20	Rebuttal Testimony and Exhibits of Antoinette				
21	Crowder, Advo-RT-1				18301
22	NAA Cross-Examination Exhibit Number 1				18419
23	Rebuttal Testimony and Exhibits of John C. Panzar,				
24	USPS-RT-13				18442
25					

1 DOCUMENTS TRANSCRIBED INTO THE RECORD: [continued] PAGE
2 Rebuttal Testimony and Exhibits of Altaf H. Taufique,
3 USPS-RT-21 18509
4

E X H I B I T S

6	EXHIBITS AND/OR TESTIMONY	IDENTIFIED	RECEIVED
7	Rebuttal Testimony and Exhibits of		
8	Guy Wendler, ABP-RT-1	18201	18201
9	Rebuttal Testimony and Exhibits of		
10	Laurtis R. Christensen, USPS-RT-7	18211	18211
11	Rebuttal Testimony and Exhibits of		
12	Antoinette Crowder, Advo-RT-1	18300	18300
13	Cross-Examination Exhibit No. NAA-XE-1	18418	18418
14	Rebuttal Testimony and Exhibits of		
15	John C. Panzar, USPS-RT-13	18441	18441
16	Rebuttal Testimony and Exhibits of		
17	Altaf H. Taufique, USPS-RT-21	18508	18508

P R O C E E D I N G S

[9:30 a.m.]

CHAIRMAN GLEIMAN: Good morning. Today we continue hearings to receive testimony in rebuttal to the direct case of participants other than the Postal Service. We are scheduled to receive testimony of American Business Press witness Wendler; Postal Service witnesses Panzar, Christensen, Taufique, and Advo witness Crowder.

I have been informed by the Postal Service that Dr. Panzar has been ill this week, and consequently is flying in just this morning, so I am going to modify the schedule of appearance, the order of appearance of witnesses today. We will hear from witness Wendler first, or not, as the case may be, and then we will move on to witnesses Christensen, Crowder, Panzar and Taufique.

In order to expedite this final phase of our hearing, yesterday I undertook to provide all rulings on outstanding motions concerning the admissibility of rebuttal testimony, and I see counsel is responding to this initiative by providing additional motions; not unexpectedly, I might add.

Last night the Alliance of Non-Profit Mailers filed a motion to compel production of mail acceptance logs underlying USPS-RT-22 or, in the alternative, to strike portions of that testimony. RT-22 is sponsored by witness

1 Schenk who is scheduled to appear for cross examination on
2 Friday.

3 It is my understanding that a copy of this motion
4 was faxed to the Postal Service counsel last night. Ms.
5 Duchek, I will direct that a response to the motion be
6 submitted by noon tomorrow, Thursday the 19th. If the
7 Postal Service cannot meet that deadline, could you please
8 let me know by the lunch break today?

9 MS. DUCHEK: Yes, I will.

10 CHAIRMAN GLEIMAN: Or at least after the lunch
11 break.

12 Yesterday morning the Postal Service provided its
13 expedited response to the motion to strike portions of the
14 rebuttal testimony of Postal Service witness Degen, filed by
15 eight participants, concerning the rates for periodicals,
16 and I appreciate the Postal Service's prompt response. It
17 makes our life a little bit easier around here when we do
18 get that kind of cooperation.

19 The Postal Service incorporated in its pleadings a
20 request that if a motion to strike Degen testimony is
21 granted that a portion of the rebuttal testimony of Magazine
22 Publishers of America witness Cohen also be stricken.

23 Is counsel representing any of the eight moving
24 parties -- ah, Mr. Cregan, I'll ask you during the break how
25 the pass that I gave you worked last night.

1 MR. CREGAN: During the break, not on the record.

2 CHAIRMAN GLEIMAN: Yesterday was St. Patrick's
3 Day. The general counsel of the Rate Commission found a way
4 to schedule almost every Irish surname witness that would
5 appear before us during the rebuttal phase for yesterday,
6 and most of them, along with their Irish surname counsel,
7 were here until shortly after 10:00 last night.

8 MR. CREGAN: I would point out for the record that
9 my colleague, Mr. McKeever, who took a lot of grief from the
10 rest of us yesterday for not wearing green, does have his
11 shamrock tie on today.

12 [Laughter.]

13 MR. CREGAN: Better late than never. UPS is never
14 late, of course.

15 [Laughter.]

16 CHAIRMAN GLEIMAN: I understand they operate at
17 the speed of business.

18 MR. McKEEVER: I might point out, Mr. Chairman,
19 since I didn't bring it with me, I had it sent UPS next-day
20 air and it arrived early A.M. this morning.

21 [Laughter.]

22 CHAIRMAN GLEIMAN: Yes. Where was I?

23 MR. CREGAN: Dueling motions to strike.

24 CHAIRMAN GLEIMAN: So one of the eight moving
25 parties' counsels is in the hearing room this morning. I

1 wanted to let you know that I have reviewed the legal
2 pleadings carefully and I will grant the motion to strike a
3 portion of the rebuttal testimony of Postal Service witness
4 Degen, specifically the material found at page 31, lines 12
5 through page 32, line 9, and Table 5 at page 33. That was
6 page 31, line 12 through page 32, line 9, and Table on page
7 33.

8 I will also grant the Postal Service request for a
9 waiver of Special Rule C and consider its motion to strike a
10 portion of the testimony of witness Cohen. I will not rule
11 on the Postal Service motion to strike witness Cohen's
12 testimony at this time since participants have not had an
13 opportunity to respond to that motion.

14 If the joint parties could, I would appreciate
15 hearing from responses -- hearing responses on the Postal
16 Service motion by noon tomorrow, the 19th.

17 MR. CREGAN: We will do that, Mr. Chairman.

18 CHAIRMAN GLEIMAN: Thank you, sir.

19 MR. CREGAN: If not sooner.

20 CHAIRMAN GLEIMAN: We appreciate it, Mr. Cregan.

21 The motion to strike portions of the testimony of
22 witness Degen offered two grounds for relief:

23 First, it claims that material provided by witness
24 Degen is properly part of the direct case of the Postal
25 Service and may not be offered as rebuttal. It contends

1 that witness Degen is sponsoring a new analysis which
2 purports to explain the cost behavior of periodicals in
3 issue which has been in controversy in each of the cases
4 since I've been here, and I understand preceded me to the
5 Commission. It argues that this issue should have been
6 explored in the Postal Service's direct case.

7 Second, the motion also characterizes in some
8 detail the method used to develop witness Degen's analysis
9 and explains why it is impossible for parties or the
10 Commission to actually analyze that data or test its
11 validity.

12 In particular, it alleges that witness Degen does
13 not provide certain data sets, claiming that they contain
14 sensitive publication-specific information, quote, close
15 quote, and that programs appear to be run in proprietary
16 software in a specialized computer environment.

17 In its response the Postal Service characterizes
18 witness Degen's testimony as proper rebuttal to testimony
19 characterizing the reported cost of processing periodical
20 mail submitted by witnesses Stralberg and Cohen.

21 The Service contends that it could not know the
22 nature of the testimony participants concerned with
23 periodical rates might offer and that Witness Degen's
24 presentation is proper rebuttal to the Stralberg and Cohen
25 testimony.

1 The Postal Service distinguishes Commission action
2 in docket number R80-1, which granted a motion to strike a
3 portion of Postal Service rebuttal testimony that was
4 essentially a second separate study supporting a contention
5 made as part of the Postal Service direct case.

6 I find this aspect of the Postal Service argument
7 persuasive. The issue of whether periodicals are exhibiting
8 counter-intuitive cost characteristics is one that was
9 raised by participant testimony. Witness Degen's attempt to
10 rebut that proposition are distinct from issues addressed in
11 the Postal Service's request, in its direct case, that is.

12 However, the Postal Service has failed to meet the
13 second argument offered in the motion to strike. It does
14 not counter the contention that it would be impossible for
15 participants or the Commission to analyze particular
16 challenge portions of the witness' presentation.

17 In particular, it is not appropriate for the
18 Postal Service to make that -- to make information that it
19 characterizes as sensitive publication-specific data
20 available to its own outside consultants but not to
21 consultants and employees of mailers and the Commission.

22 Now, I'm not suggesting that Witness Degen or any
23 other Postal Service consultants are not trustworthy,
24 although I do have some questions in my mind as to whether
25 the Postal Service should be treating itself as exempt from

1 privacy and confidentiality considerations that it
2 apparently would apply to everyone else in the world, but I
3 feel quite certain that the Postal Service cannot offer an
4 analysis and simultaneously contend that no one else should
5 be allowed to review the underlying data in order to
6 evaluate the reported results.

7 This is particularly so in the instant situation
8 where the witness presents conclusions based on his personal
9 knowledge of mailing habits of individual publishers that
10 are supposedly reflected in his results.

11 The Postal Service notes that several mailers
12 complained about responding to discovery on their
13 work-sharing practices.

14 It is worth noting that the information sought by
15 the Postal Service in those discovery requests is not used
16 by Witness Degen nor would it have provided any information
17 on Postal Service processing costs.

18 I should also mention that the motion to strike
19 challenges a Postal Service failure to provide the
20 explanatory material called for in Rule 31.

21 It argues that Witness Degen failed to provide
22 sufficient information on programs and methods used in
23 developing the particular analysis that is subject to the
24 motion to strike.

25 The Postal Service does not contradict this

1 contention.

2 This problem also might have justified granting
3 the motion to strike. However, because the motion is
4 justified on other grounds, it's unnecessary to fully
5 evaluate the extent and impact of the Service's failure to
6 comply with Rule 31.

7 Now, returning for a moment to the motion to
8 strike the testimony of Witness Cohen, let me comment that
9 footnote 25 does not seem to fully explain the development
10 of Table 1 on page 13, and my ruling may largely hinge on
11 whether the Postal Service will have had a fair opportunity
12 to explore the validity of the development of that table by
13 the conclusion of Friday's hearing.

14 Does anyone else have a procedural matter that
15 they'd like to raise before we begin today? I hope not.
16 I'm all procedural mattered out at this point.

17 One participant filed a timely request to conduct
18 oral cross examination of American Business Press Witness
19 Wendler. United Parcel Service has since indicated,
20 however, that it does not have oral cross examination for
21 that witness.

22 Therefore, as has been our practice in the past,
23 it is my intention to allow the testimony of Witness Wendler
24 to be received into evidence at this point, accompanied by a
25 statement of authenticity.

1 Ms. Blair, are you prepared to move Witness
2 Wendler's testimony into evidence at this point?

3 MS. BLAIR: Yes, Mr. Chairman. I'm going to hand
4 the reporter two copies of Mr. Wendler's testimony. I'd ask
5 that it be copied into the record and received into
6 evidence.

7 His declaration is in transit. I don't know what
8 form of delivery is being used, but we expect it this
9 morning, and we will deliver it later today.

10 CHAIRMAN GLEIMAN: Thank you, Ms. Blair.

11 In light of that, we will move the testimony and
12 exhibits of Witness Guy Wendler into evidence and direct
13 that they be transcribed into the record at this point, and
14 we will incorporate the statement of authenticity when it
15 arrives.

16 [Rebuttal Testimony and Exhibits of
17 Guy Wendler, ABP-RT-1, was received
18 into evidence and transcribed into
19 the record.]

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

POSTAL RATE AND FEE CHANGES, 1997

)
) Docket No. R97-1
)

REBUTTAL TESTIMONY
OF
GUY WENDLER
ON BEHALF OF
AMERICAN BUSINESS PRESS
AND THE MCGRAW-HILL COMPANIES, INC.

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Attorney for American Business Press

March 9, 1998

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

POSTAL RATE AND FEE CHANGES, 1997

) Docket No. R97-1
)

**REBUTTAL TESTIMONY OF GUY WENDLER
ON BEHALF OF AMERICAN BUSINESS PRESS
AND THE MCGRAW-HILL COMPANIES, INC.**

1 My name is Guy Wendler, and I am the President of Stamats Communications
2 in Cedar Rapids, Iowa. Stamats publishes two business-to-business periodicals that are
3 members of the American Business Press: Buildings, with a circulation of 56,640 and
4 Meetings in the West, with a circulation of 20,055. In addition, Stamats provides
5 research, consulting and marketing communications services to institutions of higher
6 learning, produces award-winning special interest video programming for public
7 television, and publishes three periodical newsletters for the higher education market
8 and two annual directories of meeting facilities and residential real estate firms.

9
10 I am testifying for the limited purpose of rebutting United Parcel Service
11 witness Stephen Henderson, who proposes that Periodicals rates be increased by 25%.
12 Needless to say, an average increase of this magnitude, with some individual increases
13 still larger, would have a severely adverse impact on periodical mailers.

14

15 I would like to start with a bit of history and background. Because of the threat
16 that the reclassification case posed to publishers of small-circulation magazines such as
17 those we produce, I testified on behalf of ABP in that proceeding. There, as I recall, the
18 Postal Service had proposed rate increases averaging 17% for smaller circulation
19 publications, and such increases would have been devastating. Fortunately in my
20 opinion, the Commission rejected the proposed changes, but it did adjust rates in a
21 way that produced much more modest but still significant increases for most
22 periodicals that cannot be presorted to carrier route (which is most periodicals).

23

24 In the aftermath of that mid-1996 increase, we at Stamats were relieved at the
25 first news that the Postal Service's proposal in this case would raise regular rate
26 Periodicals postage an average of less than 4%, in line with the increases for most other
27 subclasses of mail. Our relief was soon tempered by the analyses we received that
28 showed that the claimed costs of processing periodicals continued to rise rapidly, and
29 that the modest increase proposed was possible only because the Postal Service had
30 selected a low markup over attributable costs for periodicals. Our concern deepened
31 still further when we learned that the Postal Service in this case is proposing to change
32 the way it distributes mail processing costs to subclasses of mail in a way that
33 increases the cost responsibility of Periodicals.

34

35 Although I am certainly not an expert on postal ratemaking, I do know that this
36 change in methodology, combined with the supposedly skyrocketing costs of handling

1 periodicals, caused a great deal of concern within the publishing industry, leading to its
2 unprecedented unity in this case. I also know that there was a special concern among
3 the industry's experts that if only a portion of the Postal Service's new method were to
4 be adopted by the Commission, a much larger increase than the 3.5% proposed would
5 be possible, especially if the relatively low markup proposed by the Postal Service were
6 to be increased.

7
8 I must admit, however, that, even though I was warned, I viewed that outcome
9 as theoretically possible but probably not a real threat from a practical standpoint,
10 because no one, I believed, would seriously suggest that Periodical rates should increase
11 20% or more.

12
13 I now realize that the threat is far more real than I imagined, for United Parcel
14 Service witness Henderson, supported by the testimony of other UPS witnesses,
15 proposes that Periodicals rates be increased by more than 25%. Although I would hope
16 that an increase of this magnitude would be viewed by the Commission as totally out
17 of line, the UPS proposal is one that we must take seriously.

18
19 Fortunately, when it is carefully considered, witness Henderson's proposal is
20 revealed as an unsupported appendage to the transparently self-serving effort of UPS to
21 obtain large rate increases for those types of mail with which it competes. Periodicals
22 are just the innocent bystanders.

1

2 I understand that the UPS approach is to do exactly as we feared—accept only
3 the portion of the Postal Service's new methodology that hurts periodicals, which raises
4 the costs for which periodicals are directly responsible, and then assign the same cost
5 markups as the Commission used in the 1994 case, on the theory that there is no
6 reason to use any other markups. Witnesses for ABP and the other publishers have
7 submitted direct testimony on the cost methodology issues, and I understand that
8 there will be expert rebuttal testimony on these issues as well. I would like to address
9 the second point, the cost markup, especially because Mr. Henderson seems to have
10 ignored the statutory obligation of the Commission to consider the impact of increased
11 rates on mailers.

12

13 As I understand his testimony on this issue, Henderson did not perform an
14 independent analysis of impact or any of the other statutory criteria. Rather, as he
15 explains at page 8 of his testimony, he concluded that because Postal Service witness
16 O'Hara "does not indicate any change in circumstances since Docket No. R94-1 that
17 would require a change in the previously approved markup relationships," the
18 previously approved markups should be used.

19

20 Mr. Henderson thus implies that even the Postal Service agrees that the
21 markup for periodicals in this case should be the same as in the 1994 case, but the best
22 evidence of the Postal Service's analysis of all of the present circumstances is the actual
23 markups it has proposed. In this regard, the Postal Service has, to its credit, recognized

1 that the situation of periodicals is different from the situation of 1994. It has reacted
2 to the fact that costs purportedly continue to rise sharply in the face of additional
3 mailer worksharing and has considered the 1996 rate increases resulting from
4 reclassification, and it has proposed a markup reduction to 7%. It is obvious, therefore,
5 that the Postal Service has in fact perceived a change warranting, in Mr. Henderson's
6 words, "a major revision in markup relationships."

7

8 The Postal Service has recognized what Mr. Henderson has not, which is that
9 one cannot possibly separate the impact and fairness criteria, at least, from the specific
10 rate increases at issue. That is, in its R94-1 decision, the Postal Rate Commission
11 believed that a 16% markup for periodicals producing a 13.9% rate increase was
12 appropriate in 1994 in the context of an average double-digit increase for all classes and
13 following four years of rate stability. It is wrong to conclude without any analysis that
14 a 25% periodicals increase in the context of a 3.5% average increase, with most
15 periodical rates having increased less than two years ago, and with four more years of
16 very large reported cost increases, represents the same factual situation justifying the
17 same cost coverage. Such an increase, I submit, would not be fair and equitable and
18 would not take into consideration the impact on publishers, as required by the Postal
19 Reorganization Act.

20

21 Let me be a bit more specific, using Buildings magazine as an example. The rate
22 adjustments in 1996, in what was a "revenue neutral" case, raised our postage bill
23 about 3%. I understand that other ABP members, especially those who cannot obtain

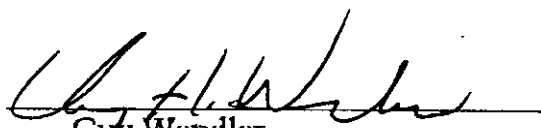
1 barcode discounts, suffered even greater increases. The 25% increase proposed by
2 United Parcel Service here would mean that our costs would have increased by 29% in
3 two years, after having increased by 13% in 1995. That large an increase in a major
4 cost like postage would be terrible for our company, and I'm sure many others. In the
5 face of these facts, one cannot and should not do what Mr. Henderson has done, which
6 is simply to apply 1994 markups and claim to comply with the ratemaking criteria of
7 the Postal Reorganization Act.

8

9 The Postal Rate Commission's Recommended Decision in the reclassification
10 case considered the adverse impact of the proposed 17% increase to be an important
11 factor in rejecting that result (for example at paragraphs 5134 and 5201), just as it
12 there questioned the "troublesome cost increases in second class." Paragraph 5137.
13 Irrespective of what action the Commission takes on the cost methodology issues
14 being addressed by the technical witnesses, these same factors argue for a cost coverage
15 here much lower than that recommended in 1994. Mr. Henderson is wrong.

DECLARATION

I, Guy Wendler, declare under penalty of perjury that the rebuttal testimony presented by me in this proceeding is true and correct to the best of my knowledge, information and belief.


Guy Wendler

3-17-98
Date

1 MS. BLAIR: Thank you, Mr. Chairman.

2 CHAIRMAN GLEIMAN: Thank you.

3 Mr. Koetting, if you would identify your witness
4 so that I can swear him in.

5 MR. KOETTING: Thank you, Mr. Chairman. The
6 Postal Service calls as its next witness Dr. Christensen.

7 CHAIRMAN GLEIMAN: Dr. Christensen, if I could get
8 you to raise your right hand.

9 Whereupon,

10 LAURTIS R. CHRISTENSEN,
11 a rebuttal witness, was called for examination by counsel
12 for the United States Postal Service and, having first been
13 duly sworn, was examined and testified as follows:

14 CHAIRMAN GLEIMAN: Please be seated.

15 Counsel, you can proceed when you're ready.

16 DIRECT EXAMINATION

17 BY MR. KOETTING:

18 Q Could you please state your full name and title
19 for the record?

20 A Yes. I am Lurtis R. Christensen. I am Chairman
21 of Christensen Associates.

22 Q Dr. Christensen, I'm handing you a copy of a
23 document entitled "Rebuttal Testimony of Lurtis R.
24 Christensen on Behalf of the United States Postal Service,"
25 which has been designated as USPS-RT-7. Are you familiar

1 with this document?

2 A Yes, I am.

3 Q Was it prepared by you or under your supervision?

4 A Yes, it was.

5 Q Does the copy that I've handed you contain the
6 revisions filed on March 12th to footnote 6 on the bottom of
7 page 7?

8 A Yes, it does.

9 Q With that revision, if you were to testify orally
10 today, would this be your testimony?

11 A Yes, it would.

12 MR. KOETTING: Mr. Chairman, I'm moving on behalf
13 of the Postal Service, requesting to be accepted into
14 evidence the rebuttal testimony of Lurtis R. Christensen,
15 designated as USPS-RT-7.

16 CHAIRMAN GLEIMAN: Are there any objections?

17 [No response.]

18 CHAIRMAN GLEIMAN: Hearing none, Dr. Christensen's
19 testimony and exhibits are received into evidence, and I
20 direct that they be transcribed into the record at this
21 point.

22 [Rebuttal Testimony and Exhibits of
23 Lurtis R. Christensen, USPS-RT-7,
24 was received in evidence and
25 transcribed into the record.]

USPS-RT-7

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

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

REBUTTAL TESTIMONY
OF
LAURITS R. CHRISTENSEN
ON BEHALF OF THE
UNITED STATES POSTAL SERVICE

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1 Rebuttal Testimony
2 Of
3 Laurits R. Christensen

4 AUTOBIOGRAPHICAL SKETCH

5 My name is Laurits R. Christensen. I am a founder and the chairman of
6 Christensen Associates, which is an economic research and consulting firm
7 located in Madison, Wisconsin. My education includes a BA in economics from
8 Cornell University, an MS in statistics and PhD in economics from the University
9 of California-Berkeley. For twenty years I was on the economics faculty at the
10 University of Wisconsin-Madison and was a visiting associate professor at the
11 University of British Columbia (1973). I have also worked as a full-time
12 consultant to the Bureau of Labor Statistics, Office of Prices (1972-1973) and the
13 U. S. Treasury, Office of Tax Analysis (1971-1972).

14 My career as an economist has been devoted to the measurement of
15 economic phenomena. In particular, I have done considerable research
16 regarding the measurement of relationships between outputs and inputs. I was
17 one of the developers of the translog functional form and many of my 66
18 published articles rely on it and its underlying principles. Regulatory commissions
19 in the railroad, telecommunications, electricity, and cable television industries
20 have relied on my work. I have also provided testimony to the United States
21 Congress on regulatory matters.

22 In 1976 I co-founded Christensen Associates to do research and
23 consulting in regulated industries. Since 1981, Christensen Associates has done

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1 a substantial amount of work for the U. S. Postal Service. The Commission is, I
2 am sure, very familiar with our development of the Postal Service's measure of
3 Total Factor Productivity, a methodology the Commission has audited and
4 accepted.

5 This is the first time I will be giving testimony before the Postal Rate
6 Commission.

1 **PURPOSE AND SCOPE OF TESTIMONY**

2 The purpose of my testimony in this docket is to make clear that the new
3 mail processing costing methodology being proposed by the Postal Service is an
4 integrated system of variability and distribution that produces estimates of
5 economic marginal costs. The underlying theory of the new method was set
6 forth by Dr. Panzar in his direct testimony. Deviations from Dr. Panzar's
7 approach will result in estimated product costs that are not necessarily marginal
8 costs, and may not be appropriate for rate making. My testimony will also
9 include rebuttal of several incorrect points made by intervenor witnesses.

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1 **I. The mail processing volume variability and cost distribution methods**
2 **must be closely linked in order to produce economically meaningful costs**
3 **by product category.**

4 Since nearly a quarter of the Postal Service's Base Year 1996 costs are
5 accrued in the mail processing cost component, it is highly desirable to use the
6 best available technique to estimate marginal mail processing costs. The Postal
7 Service has traditionally estimated "volume-variable cost" by mail subclass
8 which, when expressed per unit of mail volume, provide estimates of economic
9 marginal costs. The testimony of Postal Service witness Panzar (USPS-T-11)
10 demonstrates the equivalence of unit volume-variable cost and the marginal cost
11 of a subclass of mail or special service. In this docket, the Postal Service has
12 presented an improved analysis of the costs associated with mail processing
13 activities that is consistent with the econometric approach to volume variability
14 applied to other cost components.

15 Historically, the Postal Service has assumed unit elasticities between
16 most categories of mail processing costs and the corresponding "cost drivers,"
17 which are handlings of single pieces, containers, or other units of mail. This is
18 the "100 percent variability" assumption from the old Postal Service
19 methodology. As a consequence of this assumption, essentially all mail
20 processing costs were distributed to the subclasses of mail and special services
21 (USPS-LR-H-1, section 3.1). The cost distribution was performed by a series of
22 computer programs known as LIOCAT, which used data from the In-Office Cost
23 System (IOCS) to identify the small portion of mail processing cost classified as

1 non-volume-variable and distribute the remainder to subclasses of mail and
2 special services (USPS-T-12 at 3-4).

3 Both the 100 percent variability assumption and the traditional distribution
4 methodology have been controversial. In Docket No. R94-1, witness Stralberg
5 argued that certain costs he alleged to be overstated in the Postal Service's cost
6 methodology might be reclassified as "institutional" costs (Docket No. R94-1, Tr.
7 25/11845). In effect, Stralberg was suggesting that the Postal Service's old
8 100% variability assumption overstated the volume variability of mail processing
9 costs. However, while the IOCS data can identify the proportion of mail
10 processing workhours spent on various activities, it cannot identify the underlying
11 causal relationships needed to establish volume variability. Given the available
12 data, the Commission rightly declined to alter its variability assumptions in that
13 docket.¹

14 The LIOCATT cost distribution system was also the object of considerable
15 criticism from intervenors in Docket No. R94-1. LIOCATT assumed that the
16 costs associated with the handling of mail of specific subclasses ("direct" costs)
17 could be assigned directly to those subclasses, and distributed the remaining
18 costs in proportion to certain "direct" costs in a complicated way. LIOCATT was
19 criticized for incorporating erroneous assumptions regarding the subclass
20 composition of "mixed-mail" observations and, more generally, for distributing
21 costs inconsistently with operational realities (Docket No. R94-1, TW-T-1 at

¹ Docket No. R94-1, Opinion and Recommended Decision (November 30, 1994), at III-13.

1 13-16).

2 In response to these criticisms, the Postal Service has developed a large
3 set of operating data with which witness Bradley has estimated volume variability
4 factors. Witness Bradley's results strongly indicate that past mail processing
5 variability assumptions are incorrect. Witness Bradley's analysis identifies the
6 pool of volume-variable cost, but requires a consistent distribution method to
7 produce economically meaningful cost by subclass (USPS-LR-H-1, appendix H).
8 Witness Degen has developed a new cost distribution system to accurately
9 represent the subclass distributions of the cost drivers specified in witness
10 Bradley's analytical framework. The old LIOCATT cost distribution method is not
11 satisfactory for this purpose because it is inconsistent with the relationships
12 between mail processing costs and cost drivers estimated by witness Bradley.
13 The Postal Service's new distribution method developed by witness Degen
14 generally distributes a cost pool's volume-variable costs based upon the
15 subclass distribution of IOCS tallies associated with that cost pool in which the
16 sampled employee was observed handling mail.²

17 Intervenor witnesses such as Stralberg who contend that the new cost
18 distribution method ignores all cross-pool causality relationships (Tr. 26/13957)
19 have, at a minimum, oversimplified the new cost distribution methodology. For a
20 number of operations, witness Bradley specifies cross-pool relationships, and the

² The new Postal Service method employs alternate distribution procedures for certain cost pools, such as mail processing support operations, where the cost driver specified by witness Bradley is the workload in some specified group of (supported) operations (USPS-LR-H-146, pages II-11 to II-12). In these cases, the new cost distribution approach is effectively a hybrid of the "distribution key" method and the "piggyback" method (USPS-LR-H-1, Appendix H, page H-).

1 distribution method takes this into account (see Footnote 2). Witness Stralberg's
2 criticism is, therefore, unfounded.

3

4 **II. By recommending that the portions of the mail processing cost**
5 **methodology presented by witnesses Bradley and Degen be divorced,**
6 **intervenor witnesses advocate economically non-meaningful mail**
7 **processing costs.**

8 In this docket, several witnesses argue that the Commission should adopt
9 part of the Postal Service's mail processing cost analysis and reject the other.
10 Witnesses Cohen (MPA-T-2), Shew (DJ-T-1) and Stralberg (TW-T-1) argue that
11 witness Bradley's analysis of mail processing variability improves on the past
12 assumption of the Postal Service, but witnesses Buc (DMA-T-1), Cohen, and
13 Stralberg favor a cost distribution method resembling the old LIOCATT method.³
14 Witness Sellick (UPS-T-2) argues that witness Degen's cost distribution method
15 improves significantly on past Postal Service method, while witness Neels (UPS-
16 T-1) argues in favor of retaining the past variability assumptions of the Postal
17 Service.

18 The intervenor recommendations assume that the proposed variability
19 analysis and the proposed distribution method can be easily separated. Witness
20 Cohen states this explicitly, claiming that witnesses Bradley and Degen
21 "undertake fundamentally different analyses" (Tr. 26/14039). Obviously,
22 witnesses Bradley and Degen use different techniques for their respective

³ Witness Buc describes Bradley's analysis as "sophisticated", but he does not otherwise address Bradley's analysis on its merits (Tr. 28/ 15367). Witness Buc recommends that the Commission continue to employ the LIOCATT cost distribution method without modification.

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1 components of the Postal Service's mail processing cost analysis. However, the
2 analytical framework of the variability analysis and the cost distribution method
3 cannot be separated and still be expected to produce economically meaningful
4 costs.

5

6 **A. If mail handlings within an operation are the cost driver for an**
7 **operation, then the subclass distribution of mail handlings within that**
8 **operation should be the distribution key.**

9 For cost pools related to piece sorting, witness Bradley specifies TPH, a
10 measure of mail handling defined in MODS, as the cost driver.⁴ This approach is
11 consistent with long-standing treatment of mail processing, which has regarded
12 handling of "piece[s] of mail, mail container[s], or unit[s] of mail volume" as the
13 relevant cost drivers in mail processing and distribution operations (USPS-LR-H-
14 1, section 3.1). Witness Bradley's regression models produce estimates of the
15 elasticity of workhours with respect to TPH in each of these operations. The
16 theoretically appropriate distribution key is, then, the subclass distribution of the
17 recorded TPH. This is the component of the analysis described by witness
18 Degen. However, the TPH data from MODS are not available by subclass of
19 mail. Thus, to form a distribution key for each activity, witness Degen employs
20 the IOCS data, which provide estimates of the proportion of time spent handling
21 mail of various subclasses (and other characteristics). The subclass distribution

⁴ There are ten such cost pools, with associated costs of \$4.75 billion (USPS-T-12, Table 4).

1 of time spent handling mail is equal to the productivity-weighted subclass
 2 distribution of TPH.⁵

3 **B. Witness Neels' criticism of witness Bradley's use of TPH instead**
 4 **of mail "volume" is unfounded because it fails to take into account the**
 5 **critical connection between Bradley and Degen.**

6 UPS witness Neels criticizes witness Bradley for his use of TPH as cost
 7 driver. Witness Neels contends that mail volumes must be used as the cost
 8 driver in order to properly compute volume-variable costs. Witness Neels
 9 correctly observes that the elasticity of cost with respect to a cost driver such as
 10 TPH is not necessarily the same as the elasticity of cost with respect to mail
 11 volume. However, the premise of his critique, that the Postal Service ignores
 12 this distinction, is simply wrong. This is because application of the chain rule
 13 allows the elasticity of cost with respect to mail volume to be decomposed as:
 14
$$d \ln C / d \ln M = (d \ln C / d \ln D) \cdot (d \ln D / d \ln M),$$

 15 where C is cost, M is mail volume, and D is the cost driver. It is, therefore,
 16 sufficient for witness Bradley to estimate the elasticity of cost with respect to
 17 TPH, $d \ln C / d \ln D$, as long as someone else estimates the elasticities
 18 $d \ln D / d \ln M$. Witness Neels does not seem to realize that it is actually witness
 19 Degen, not witness Bradley, who provides estimates of the elasticities
 20 $d \ln D / d \ln M$. This is because witness Degen's distribution keys represent the
 21 proportions of mail handlings by subclass for each activity, and the proportions of

⁵ If the average work content of a piece of mail does not vary by subclass, the time distribution is equal to the unweighted TPH distribution.

1 mail handlings themselves serve as estimates of $d \ln D / d \ln M$.⁶ In other words,
 2 the elasticity of the cost driver with respect to volume is equal to the ratio of
 3 handlings of subclass j in cost pool i (D_{ij}) to the total handlings in cost pool i (D_i).
 4 It follows that the appropriate distribution key for a distribution cost pool is the
 5 subclass distribution of the mail handlings in that cost pool.

6 The requirement that the distribution keys provide estimates of the
 7 variabilities of mail volumes with respect to the cost drivers exposes the error
 8 witnesses Buc, Cohen and Stralberg make by adopting witness Bradley's
 9 elasticities while proposing unrelated cost distribution methods. A fundamental
 10 assumption of their alternative mail processing cost distribution proposals is that
 11 it is inappropriate to construct mail processing distribution keys at the cost pool
 12 level. This is contrary to the theory set forth by witness Panzar linking unit
 13 volume-variable costs and economic marginal costs.

⁶ Consider a typical mailpiece of subclass j , that requires a_{ij} TPH in distribution activity i . Mathematically, this may be written as:

$$D_{ij} = a_{ij} M_j.$$

Total handlings in the activity are

$$D_i = \sum_j D_{ij} = \sum_j a_{ij} M_j.$$

So, for any subclass j ,

$$\partial D_i / \partial M_j = a_{ij}.$$

Also note that we can write:

$$\partial \ln D_i / \partial \ln M_j = (M_j / D_i) \cdot (\partial D_i / \partial M_j).$$

Combining results,

$$\begin{aligned} \partial \ln D_i / \partial \ln M_j &= (M_j / D_i) \cdot (\partial D_i / \partial M_j) \\ &= (M_j / D_i) \cdot a_{ij} \\ &= a_{ij} M_j / D_i \\ &= D_{ij} / D_i. \end{aligned}$$

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1 A conceptual problem also arises for witness Sellick's alternative.
2 Witness Sellick's use of the Postal Service's proposed cost distribution
3 methodology in conjunction with the old assumption of 100 percent volume
4 variability factors assumes that witness Bradley's basic analytical framework—
5 i.e., specification of cost drivers—is sound, but that Bradley's numerical results
6 are not. However, witness Sellick relies on witness Neels for variability
7 assumptions (Tr. 26/14162). Witness Neels argues not only that witness
8 Bradley's results are wrong, but also that the analytical framework underlying
9 those results is wrong as well. By disagreeing with witness Bradley's analytical
10 framework, witness Neels undercuts the basis for witness Sellick's use of the
11 new Postal Service cost distribution method.

12

13 **C. The presence of multiple cost drivers and/or cross-operation cost**
14 **relationships does not imply that LIOCATT or a similar distribution method**
15 **is appropriate.**

16 Witness Stralberg suggests that the costs of an activity could depend on
17 the mail handlings not only in that activity, but also in other activities (Tr.
18 26/13956). Indeed, the original version of witness Stralberg's "automation
19 refugee" hypothesis requires that workhours in manual distribution operations be
20 causally related to volumes of mail handled in automated letter distribution
21 operations. However, he offers no evidence to support this contention, and I am
22 aware of no such evidence presented by anyone else.

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1 Even if some of the interconnections between automated and manual
 2 distribution operations hypothesized by witness Stralberg were shown to exist,
 3 the LIOCATT and the Cohen/Stralberg cost distribution methods would still be
 4 wrong. Suppose that workhours in the manual flats operation did, in fact,
 5 depend on both the handlings in the operation and on handlings in letter
 6 automation operations. The correct procedure in this case would be to
 7 separately identify pools of volume-variable cost associated with each cost
 8 driver, and then to distribute each pool of volume-variable cost in proportion to
 9 the subclass distribution of the respective cost driver.⁷ If, as one would expect,
 10 the "own workload" elasticity is large relative to workload elasticity with respect to
 11 other cost drivers, then the resulting cost distribution would be approximately
 12 equal to witness Degen's. In this light, the cost distribution method proposed by
 13 witnesses Stralberg and Cohen is fatally flawed. Their method assumes no
 14 cross-operation causality relationships for "direct" costs (such costs are assigned
 15 directly to the subclasses of the associated IOCS tallies), while it indiscriminately
 16 applies cross-operation distributions for "mixed-mail" and "not handling" costs.
 17 Their method has no provision at all to weight the cost distributions they apply for
 18 any actual cross-operation patterns of cost causality that may exist. To do so

⁷ Then, the factor requirement equation for manual flats would have the form:

$$H_{\text{manf}} \approx f(D_{\text{manf}}, D_{\text{auto}}).$$

The total volume-variable cost, then, would be:

$$VVC_{\text{manf}} = (\varepsilon_{\text{manf}} + \varepsilon_{\text{auto}}) \cdot C_{\text{manf}}$$

And the volume-variable cost of subclass j should be calculated as:

$$VVC_{\text{manf},j} = (C_{\text{manf}} \cdot \varepsilon_{\text{manf}} \cdot (D_{\text{manf},j} / D_{\text{manf}})) + (C_{\text{manf}} \cdot \varepsilon_{\text{auto}} \cdot (D_{\text{auto},j} / D_{\text{auto}})).$$

Dividing $VVC_{\text{manf},j}$ by the volume of subclass j yields economic marginal costs under the same conditions as the distribution key method under the single cost driver case.

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1 would require that they compute subclass distributions of mail handlings by cost
2 pool—exactly what witness Degen has already done.

3 For the LDC 17 “allied labor” operations, witness Bradley has specified an
4 index of piece handlings in several distribution operations as a proxy cost driver.⁸
5 It could be argued that the cost distribution method for the multiple cost driver
6 case should be applied to these operations. To do so, however, would ignore
7 the critical distinction between the proxy and the actual cost drivers. Witness
8 Stralberg acknowledges that the “true” allied labor workload includes processing
9 mail that bypasses piece sorting to some extent—that is, presorted mail—as well
10 as support of sorting operations (Tr. 26/13916). Taking the proxy cost driver
11 literally for distribution purposes would understate costs of presorted mail
12 categories by ignoring their contribution to workload in allied operations.

13 *The Postal Service’s proposed allied labor distribution method recognizes*
14 *that the cost drivers from the econometric allied labor equations are proxies.*
15 This proposal method basically takes the approach that regardless of whether
16 the “ultimate” cause of a unit of allied labor workload is a distribution operation or
17 not, the “immediate” cost drivers are still handlings of mail. As I understand it, in

⁸ Note that witnesses Buc, Cohen and Stralberg have no complaints about the allied labor variability analysis.

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1 allied operations these handlings will tend to be things like container movement
2 rather than piece sorting, but they are handlings nonetheless. So, again, the
3 general exercise is still to construct a subclass distribution for mail handlings. It
4 is just the type of mail handling that has changed. The challenge, as Degen
5 discusses in his direct and rebuttal testimonies, is simply to get an accurate
6 subclass distribution of the mail handlings.

7 **D. Witnesses Cohen and Stralberg have no economic basis for**
8 **reclassifying any volume-variable costs as institutional costs.**

9 Witnesses Cohen and Stralberg both suggest, witness Bradley's analysis
10 notwithstanding, that the Postal Service overestimates volume-variable mail
11 processing cost. While their underlying concerns regarding attribution principles
12 are relevant, witness Bradley's analysis squarely addresses them. Witness
13 Bradley's analysis demonstrates, and witness Degen's method implements, the
14 result that some portion of each cost pool's cost is non-volume-variable. In this
15 regard, I agree with witnesses Cohen and Stralberg that not all mail processing
16 costs should be considered volume-variable. For non-volume-variable costs, it
17 would be economically meaningless to distribute those costs to subclasses of
18 mail. However, for volume-variable costs, economic theory, in conjunction with
19 witness Bradley's empirical results, points clearly to the correct cost distribution
20 approach.

21 As described above, volume-variable costs should be distributed to
22 subclasses in proportion to the corresponding subclass distributions of mail
23 handlings. Thus, the claims by witnesses Cohen and Stralberg that there is

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1 insufficient evidence to causally link volume-variable costs to the subclasses of
2 mail are wrong. The variability analysis, linking mail handlings to cost pool costs,
3 and the distribution analysis together contain the relevant information on cost
4 causality. In contrast, characteristics of particular IOCS tallies do not indicate
5 whether the associated costs are volume-variable. To take a portion of the
6 volume-variable cost and reclassify it as institutional cost is by definition
7 inappropriate. Therefore, the Commission should reject the proposals to
8 reclassify these costs.

9 **III. Meaningful comparisons of Postal Service productivity to other**
10 **industries do not indicate any inefficiency that would support the treatment**
11 **of additional costs as institutional.**

12 A major theme of the testimonies of witnesses Buc, Cohen, and Stralberg
13 is the assertion that inefficiencies in certain postal operations lead to
14 overstatement of costs for certain subclasses of mail. Witness Buc attempts to
15 support this argument by comparing total factor productivity (TFP) growth for the
16 Postal Service with manufacturing sector multifactor productivity⁹ growth and with
17 railroad total factor productivity growth (Tr. 28/15420-15423). Such comparisons
18 are incorrect and misleading.

19 Witness Buc claims to have conducted an analysis "showing [that] the
20 inefficiency and low levels of productivity of the Postal Service indicate that there
21 is excess mail processing labor" (Tr. 28/15420). I find witness Buc's

⁹ Multifactor productivity is conceptually the same as total factor productivity.

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1 comparisons to be poorly motivated, but even if they were meaningful, none are
2 specific to mail processing. Under cross-examination, witness Buc conceded
3 that the Postal Service TFP statistics he presents cannot be used to determine
4 mail processing productivity growth (Tr. 28/15459).

5 Comparisons of the entire Postal Service to the manufacturing sector or to
6 the railroad industry are misleading. The Postal Service provides retail services,
7 processes the mail, transports the mail, and delivers the mail. Of these
8 functions, only the portion of mail processing that is performed in the Postal
9 Service's large plants bears any resemblance to a manufacturing operation¹⁰
10 and this portion of mail processing is responsible for only a fraction of Postal
11 Service inputs. In 1997, only 34 percent of wages and salaries were booked to
12 "Function 1" mail processing operations.¹¹ Transportation is also a relatively
13 minor part of Postal Service resource usage. In 1997, transportation expense
14 amounted to only 7 percent of the Postal Service's total operating expense.¹²
15 Given the variety of activities that the Postal Service performs, it is more
16 appropriate to compare it to a much broader sector of the economy, for example
17 the private nonfarm business sector. The Bureau of Labor Statistics publishes a
18 multifactor productivity index for the private nonfarm business sector.

19 Witness Buc implies that a comparison between Postal Service TFP and
20 private nonfarm business multifactor productivity would liken the Postal Service

¹⁰ For that matter, among manufacturing operations, it is hardly clear that mail processing plants resemble steel mills very much, as witness Buc suggests (Tr. 28/15460). They would be more likely to be comparable to printing and publishing, which have had very slow productivity growth.

¹¹ Source: National Workhours Reporting System, (Function 1 Dollars/Total Dollars).

¹² Source: United States Postal Service Annual Report, page 45.

1 to "law firms and consulting firms and accounting firms, and traditional services"
2 (Tr. 28/15461). Buc's statement is inaccurate. The private nonfarm business
3 sector is made up of a diverse collection of industries, of which manufacturing
4 and transportation constitute a significant fraction. I believe the wide range of
5 activities encompassed by the private nonfarm business sector makes it
6 comparable to the Postal Service as a whole. Table 1 compares multifactor
7 productivity for the private nonfarm business sector with Postal Service TFP.
8 From the table, one can see that their rates of growth have been quite similar—
9 indeed, Postal Service productivity growth has exceeded the productivity growth
10 of the private nonfarm business sector on average.

11 It would also be incorrect to draw any conclusions regarding Postal
12 Service productivity performance based upon labor productivity growth. Labor
13 productivity growth is a partial measure of productivity. Labor productivity growth
14 can be achieved by increases in non-labor inputs, relative to labor. To the extent
15 that labor productivity growth is due to increases in non-labor inputs, it does not
16 measure increases in efficiency. Total factor productivity growth measures the
17 increase in outputs relative to all inputs, and therefore is a better measure of
18 efficiency.
19

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Table 1

Comparison of USPS and Private Non-Farm Business
Total Factor/Multifactor Productivity Indexes

Year	Total Factor/Multifactor Productivity	
	USPS (1972=1)	Private Non-Farm Business (1972=1)
1971	0.9883	0.9717
1972	1.0000	1.0000
1973	1.0420	1.0294
1974	1.0230	0.9937
1975	1.0141	0.9958
1976	1.0092	1.0325
1977	1.0299	1.0514
1978	1.0658	1.0609
1979	1.0440	1.0483
1980	1.0493	1.0252
1981	1.0557	1.0210
1982	1.0414	0.9874
1983	1.0355	1.0147
1984	1.0384	1.0410
1985	1.0369	1.0399
1986	1.0587	1.0493
1987	1.0630	1.0493
1988	1.0666	1.0546
1989	1.0600	1.0483
1990	1.0916	1.0430
1991	1.0736	1.0336
1992	1.0792	1.0451
1993	1.1200	1.0514
1994	1.1169	1.0567
1995	1.0995	N/A
1996	1.0838	N/A

1

2 **IV. Witness Chown's "weighted attributable cost" is arbitrary and has**
3 **no economic meaning**

4 NAA witness Chown proposes that a new metric, "weighted attributable
5 cost," be used in the determination of institutional cost assignments to
6 subclasses of mail. The "weighting", according to witness Chown, accounts for
7 the "different mix of functions used by each subclass of mail and the different
8 amounts of institutional costs incurred to provide these functions" (Tr. 25/13274).
9 The result of witness Chown's "accounting" is that "weighted attributable costs"
10 correspond neither to volume-variable costs nor to incremental costs. So,
11 although witness Chown's stated goal is to provide "better information"
12 (Tr. 25/13422) for institutional cost assignment, "weighted attributable costs" are
13 inconsistent with the economic basis for the Postal Service cost estimates on
14 which it is based.

15 **A. Past Commission analysis of institutional cost assignment is**
16 **appropriate.**

17 In its past decisions, the Postal Rate Commission has recognized that,
18 consistent with economic principles, institutional costs cannot be causally
19 attributed to individual subclasses or services. Instead, the Commission has
20 emphasized that careful consideration and balancing of all of the nine statutory
21 criteria from Section 3622(b) of the Postal Reorganization Act is important for
22 determining institutional cost allocations and Postal Service rates.

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1 Consistent with their conclusion that all nine statutory criteria are
2 important for setting rates, the Commission also emphasized that noncost factors
3 were important in determining institutional cost coverage in its Docket No. R90-1
4 Opinion and Recommended Decision (January 4, 1991):

5 "The analysis of the statutory public policy factors in order to allocate
6 institutional costs involves balancing many conflicting considerations. All
7 categories of mailers can provide valid reasons why increases in their
8 postage rates should be restrained." (para 4009)
9

10 "... we are not prepared to abandon our practice of basing rates on an
11 evaluation of how noncost factors of the Act apply to the various
12 subclasses of mail." (para 4029)
13

14 My understanding is that the Commission has allocated institutional costs
15 according to its statutory obligations, not relying on any single factor for
16 allocating institutional costs. In this respect, the Commission's position is
17 consistent with economic principles. As described below, institutional costs are
18 not causally related to any particular service or product. Given that they are not
19 caused by any particular service or product, the determination of institutional cost
20 coverage is not a question of what product or service is causally responsible for
21 these costs. Rather, coverage of institutional costs depends on other noncost
22 considerations, such as customers' willingness to pay, the value of service to
23 customers, and fairness (USPS-T-30, at 2-3).

24 The institutional costs of the Postal Service are more generally referred to
25 as "shared," or "joint and common" costs in the economics literature. For
26 simplicity, I will generically refer to such costs as "shared costs." The

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1 distinguishing feature of shared costs is that they are not causally related to any
2 service produced by a multiproduct firm. Rather, they are incurred by the firm as
3 a whole, and their levels do not vary with the level of production of any individual
4 service.¹³ Stated another way, shared costs are not avoidable with respect to
5 individual products or services—i.e., reducing or eliminating the quantity
6 produced of individual services does not allow the company to avoid incurring
7 shared costs. Shared costs are only avoidable at the company-wide level—i.e.,
8 the firm must cease production of all of its services to completely avoid incurring
9 shared costs.

10 Because shared costs are not causally attributable to individual services,
11 there is no unique method for assigning these costs to individual services for the
12 purpose of cost recovery. In economic terms, the allocation of shared costs to
13 individual services is arbitrary. Given the arbitrary nature of shared cost
14 allocations, there is no unique set of prices that will recover shared costs.

15 Baumol, Koehn, and Willig have succinctly stated the problem with shared
16 cost allocations as it related to allocating shared investment to calculate rates of

¹³ There may be various levels of shared costs incurred by a firm—ranging from those costs that are shared by all services produced by the firm (as discussed above), to costs that are shared by some subset of the firm's services. In this last instance, costs are said to be shared by a "service family." However, regardless of the level of shared costs, the distinguishing economic feature of shared costs is that they are not causally attributable to the provision of any particular product or service—i.e., the level of shared costs does not vary as the level of production of individual services changes.

1 return for individual activities. (These criticisms also apply to allocating shared
2 costs for purposes of determining individual rates for services):¹⁴

3 "Where the activities of a firm benefit from substantial common
4 investments of substantial common outlays (or both), there is no way to
5 calculate a rate of return for any or all of the company's individual
6 activities, one by one. Indeed, the difficulty is not that we cannot
7 determine these numbers, but that such numbers themselves are
8 necessarily figments of the imagination."
9

10 "If regulatory rules nevertheless require the undefinable to be defined, the
11 only option open to those who must comply with the rules is to adopt
12 some arbitrary device, usually dressed up to give it an appearance of
13 reasonableness—an arbitrary rule that divides up indivisible investments
14 and costs. This, of course, is what full allocation means."
15

16 "But an arbitrary division criterion produces just the sort of results the term
17 "arbitrary" implies. Depending upon the conventional criterion chosen for
18 the division of investments and costs, one will obtain widely different
19 results from the calculation. It is generally acknowledged that the result
20 will be affected by this choice. But there seems to be an impression that
21 any such calculation, if carried out with sufficient care, will yield a
22 reasonable approximation to some underlying true figure. That
23 impression is totally unfounded. ... changes in the basis of allocation can
24 make an enormous difference to the results that emerge, ... In other
25 words, one can have absolutely no confidence in the results obtained from
26 any such calculation. Moreover, the numbers that emerge readily lend
27 themselves to manipulation by any interested party through selective
28 choice of basis of allocation."

29 Baumol, Koehn and Willig conclude that, because of their arbitrary nature,
30 shared cost allocation methods produce economically meaningless results.

¹⁴ William J. Baumol, Michael F. Koehn, and Robert D. Willig, "How Arbitrary is 'Arbitrary?' – or, Toward the Deserved Demise of Full Cost Allocation, Public Utilities Fortnightly, September 3, 1987, p 17.

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1 More than anything, cost allocation methods produce the desired outcomes of
2 their advocates:¹⁵

3 "Fully allocated cost figures and the corresponding rate of return numbers
4 simply have zero economic content. They cannot pretend to constitute
5 approximations to *anything*. The "reasonableness" of the basis of
6 allocation selected makes absolutely no difference except to the success
7 of the advocates of the figures in deluding others (and perhaps
8 themselves) about the defensibility of the numbers. There just can be no
9 excuse for continued use of such an essentially random or, rather, fully
10 manipulable calculation process as a basis for vital economic decisions by
11 regulators."

12 In this context, witness Chown's "weighted attributable cost" proposal for
13 assigning institutional costs not only runs counter to the Commission's
14 established rate making principles, but is also an arbitrary cost allocation
15 procedure that has no economic basis.

16 **B. Witness Chown's suggestion that institutional costs be assigned**
17 **on the basis of cost factors is unfounded.**

18 Witness Chown acknowledges that institutional costs of the Postal Service
19 have the property that they are not causally attributable to any particular
20 subclass of mail:

21 "By definition, institutional costs are costs that are not causally related to
22 any particular subclass" (Tr. 25/13263).

23
24 In the next sentence, however, she asserts that institutional costs can be
25 "related" to particular functions of the Postal Service:

26 "However, institutional costs can be related to the provision of a particular
27 function of the Postal Service" (Id.).

¹⁵ Id., p. 21.

1 Witness Chown then proceeds to use cost allocation methods employed
2 by the Commission to determine how institutional costs can be "related" to
3 particular functions of the Postal Service. As discussed above, the Postal
4 Service properly recognizes that institutional costs are not directly incurred by
5 any particular subclass or function of the Postal Service.¹⁶ Institutional costs are
6 allocated across subclasses based on the nine criteria of Section 3622(b). The
7 process of institutional cost allocation does not depend on cost causality.
8 However, witness Chown mistakes these allocations for a causal relationship;
9 she infers causality where there is none. This is evident in some of the
10 statements she makes in her direct testimony:

11 "... even if the provision of these functions causes the Postal Service to
12 incur substantial institutional costs." (Tr. 25/13265, underline added)

13 "... the proportion of institutional costs incurred to provide each function"
14 (Tr. 25/13272, underline added)

15 "This method explicitly recognized the mix of functions used by each
16 subclass of mail and the proportion of institutional costs incurred to
17 provide each of the functions ..." (Tr. 25/13272, underline added)

18 "... subclasses which use mostly the delivery function can receive a lower
19 institutional cost assignment, even though a large share of institutional
20 costs are incurred to provide the delivery function." (Tr. 25/13275,
21 underline added)

¹⁶Even if there was a causal relationship between institutional costs and the Postal Service functions defined by Chown, the assignment of institutional costs to using those functions subclasses of mail would still require some type of allocation method that was not based on a causal relationship.

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1 Witness Chown's cost allocation proposal is essentially the same as her
2 proposal in Docket No. R90-1. In that docket, the Commission recognized that
3 her proposal did not meet the statutory obligation of the Commission:

4 "... Chown suggests that the Commission separately apply cost
5 coverages to four functional categories of costs. We have chosen not to
6 change our methodology for distributing institutional costs in this case."
7 (para 4033)

8 "Witness Chown offers her proposal in order to preserve, or improve, our
9 ability to allocate institutional cost burdens fairly. She identifies
10 "unbundling" of rates as a postal pricing trend which, while salutary in
11 many respects, tends to make the equitable division of institutional costs
12 more difficult." (para 4034)

13 "We find a serious deficiency in the Chown method to be its mechanistic
14 application of coverage factors to attributable cost pools. Such a method
15 tends to eliminate the essential role judgement must play in assuring fair
16 and equitable application of the statutory factors." (para 4047)

17 In her current testimony, witness Chown refers to her proposal in Docket
18 R90-1 and notes that the Commission acknowledged she focused attention on
19 the impact of unbundling costs and how worksharing discounts can affect the
20 apportionment of institutional costs to categories of mailers (Tr. 25/13273).

21 However, in the next paragraph of its decision in Docket No. R90-1, the
22 Commission concluded:

23 " we are convinced that the method we use for the allocation of
24 institutional burdens among the classes and subclasses, as we described
25 it in our Docket R87-1 Opinion, and further clarify it in this Section, is more
26 fair in application and result than the method proposed by witness
27 Chown." (para 4044)

28 The Commission went on to state that witness Chown's proposal did not address
29 the criteria for the fair distribution of institutional costs:

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1 "We consider it unfortunate however, that witness Chown does not
2 address whether her methodology is likely to meet the goals for fairly
3 distributing institutional costs we set out in Docket R87-1, particularly the
4 benefits of predictable relationships between classes and subclasses."
5 (para 4046)

6 In her current testimony, witness Chown also notes that in its R90-1
7 decision, the Commission agreed with her that total attributable costs are not a
8 completely accurate measure of how much various subclasses benefit from
9 institutional effort (Tr. 25/13273). However, in the same paragraph in its R90-1
10 decision referenced by witness Chown, the Commission stated:

11 "... we cannot accept Chown's proposal, which is simply to break
12 systemwide attributable costs into pieces, as a solution for the problem
13 she describes." (para 4049)

14 "Just as systemwide attributable cost is not a measure of responsibility for
15 systemwide institutional cost, we do not consider attributable
16 transportation cost a usable measure of responsibility for institutional
17 transportation costs. ("Responsibility" is used here as shorthand for the
18 appropriateness of the share of institutional costs we assign, and not in
19 the causal sense.) For example, there is no reason why a subclass which
20 is a heavy user of attributable ground transportation should be more
21 responsible for recovery of institutional costs related to air transportation
22 than a subclass which causes little attributable transportation cost of any
23 kind." (para 4050)

24 "Chown has tried to attack this problem with a more elaborate formula, but
25 we think it calls not for more complex mechanical solutions but for the
26 focused exercise of rational judgement." (para 4051)

27 In summary, witness Chown develops a concept, "identifiable" institutional
28 costs, that purportedly identifies the institutional costs associated with each of
29 her four functions. Moreover, she seems to claim that this identification is a
30 causal relationship. She also defines a residual category of institutional costs
31 that are not identified with any particular function as "system-wide" institutional

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1 costs. However, Chown's identifiable institutional cost concept defies economic
2 logic and is inconsistent with established Commission practices.

3 **V. Witness Henderson's proposal is based on a misunderstanding of**
4 **incremental costs, and is neither necessary nor sufficient to address his**
5 **concerns regarding cost coverage.**

6 UPS witness Henderson proposes that the estimates of incremental costs
7 presented by the Postal Service be used as the basis for markups. He claims
8 this is necessary to satisfy the Section 3622(b)(3) requirement that postal rates
9 cover "attributable" costs plus a portion of non-attributable costs. Additionally,
10 witness Henderson claims that markups over incremental cost are necessary to
11 prevent inefficiencies related to cost measurement errors, as well as to reflect
12 the correct economic cost concept. Witness Henderson's concern that the
13 Section 3622(b)(3) requirement be satisfied is relevant, but any rates that pass
14 an incremental cost test meet this criterion equally well. The type of
15 inefficiencies resulting from measurement error that Henderson identifies would
16 not be remedied by his proposal. Finally, witness Henderson's arguments in
17 favor of long-run incremental cost as the appropriate cost concept for rate
18 making are self-contradicting and involve fundamental misunderstanding of the
19 economic content of Postal Service cost estimates. For these reasons, the
20 Commission should reject witness Henderson's proposal.

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1 **A. Both the Postal Service and the Henderson proposals constitute**
2 **a departure from past practice; both meet the section 3622(b)(3) cost floor**
3 **requirements equally well in principle.**

4 The main argument witness Henderson offers in support of his proposal to
5 mark up incremental costs is that such a procedure is needed to meet the
6 Section 3622(b)(3) requirement that postal rates cover "attributable" costs plus a
7 portion of non-attributable costs. Witness Henderson notes that the Postal
8 Service has provided incremental cost estimates for the subclasses of mail. He
9 further argues that the incremental cost of a subclass of mail is, by definition,
10 attributable to the subclass. Finally, he observes that the rates proposed by the
11 Postal Service are based on markups over volume-variable costs, with
12 incremental cost tests applied as a check against cross-subsidy (Tr. 25/13557-
13 13558). This is a departure from prior Postal Service practice, in which the cost
14 floor for rates was based on attributable costs (as defined in USPS-LR-H-1).

15 Witness Henderson then complains that the new Postal Service approach
16 is "contrary to the Commission's prior application of the statute" (Tr. 25/13558).
17 Note that witness Henderson's own approach is subject to this critique, since
18 incremental costs and attributable costs are distinct cost concepts (see USPS-
19 LR-H-1, Appendix H). However, witness Henderson's complaint is ultimately
20 empty since both the Postal Service and witness Henderson employ the same
21 cost floor—a floor based upon incremental costs. The methods differ only in the
22 mechanism by which the cost floor is imposed. The Postal Service method
23 imposes incremental cost floors via incremental cost tests. Witness Henderson

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1 acknowledges that products that pass the incremental cost test will make a
2 contribution to institutional costs (Tr. 25/13624). Thus, postal rates that pass
3 incremental cost tests satisfy the cost floor requirement of Section 3622(b)(3).

4 Witness Henderson observes that some rates could be below actual (as
5 opposed to estimated) average incremental cost if certain subclasses only just
6 pass the incremental cost test. Postal Service witness O'Hara has already
7 shown in his direct testimony (USPS-T-30) that the Postal Service's proposed
8 rates generate estimated TYAR revenue strictly greater than TYAR incremental
9 costs for every non-preferred subclass of mail. Witness Henderson's argument
10 that cost measurement errors could lead to economic inefficiencies is unfounded.
11 Rational competitors will take the uncertainty of the Postal Service's cost
12 estimates into account in making entry decisions. Rational decisionmaking
13 under uncertainty does not lead to inefficiencies except when measured against
14 an unattainable ideal world in which every relevant datum is known without error.

15 **B. Long-run incremental costs are unlikely to reflect the actual costs**
16 **of either the Postal Service or its competitors, and are therefore an**
17 **inappropriate basis for rate making.**

18 Witness Henderson asserts that the relevant costs for determining postal
19 rates are "longer-run" costs. He claims that "longer-run" costs correspond to the
20 time span between postal rate cases.¹⁷ There are three fundamental problems
21 with witness Henderson's analysis. First, he is not consistent in his definition or

¹⁷ Witness Henderson: "Accordingly, the relevant costs for pricing purposes are longer run, not short run costs. Most (if not all) of the specific fixed costs identified by the Postal Service are avoidable in the time span between postal rate cases" (Tr. 25/13560).

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1 application of the economic concept of the "long-run." He equates the economic
2 long-run with a calendar period of time (2 to 4 years) between postal rate cases.
3 However, as he admits, and as any basic course in economics stresses, the
4 long-run cannot be measured by a particular calendar period of time; it is
5 measured with respect to factor variability.¹⁸ As an example of factor variability,
6 witness Henderson noted that advertising costs can be adjusted in his 2 to 4
7 year "long-run." However, he ignores other costs, largely associated with mail
8 processing capacity, that are not completely variable in this 2 to 4 year period
9 such as sorting equipment. Therefore, witness Henderson's concept of the
10 "long-run" does not comport with the economic concept of the long-run.

11 Second, even if witness Henderson's discussion had accurately reflected
12 the economic principles of the long-run, the long-run costs of economic theory
13 are not likely to reflect the long-run costs of an actual firm. An on-going firm
14 never finds itself in the "true" theoretical long-run with complete factor variability.
15 Real firms are always dealing with some type of constraint. To assume that all
16 inputs are totally variable in a 2 to 4 year period—or, indeed, any given period of
17 calendar time—is not realistic, nor will it provide an adequate estimate of the
18 costs the Postal Service will actually incur. This is equivalent to assuming that
19 the entire postal network and all of its facilities can be built from scratch in this
20 time period (an even more extreme interpretation is that this occurs
21 instantaneously). Furthermore, this interpretation of the long-run assumes that
22 all older technologies in use in the mail processing system will be completely

¹⁸ Henderson acknowledges the economic long run permits all productive inputs to be varied.

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1 replaced by the latest least-cost technologies. In reality, the most efficient actual
2 firm will use a mix of technologies as it adopts to new technologies.

3 As witness Panzar has stated, the Postal Service is subject to a number
4 of operating constraints that may not allow it to achieve the most efficient
5 operation. Moreover, as witness Panzar demonstrates, it is not necessary to
6 assume perfect cost efficiency to determine Postal Service marginal and
7 incremental costs.¹⁹ Therefore, long-run costs that assume instantaneous
8 adoption of least-cost technologies and most efficient operation will not
9 accurately reflect costs of the Postal Service operating under its various
10 constraints.

11 The third fundamental problem with witness Henderson's analysis of long-
12 run costs is his incorrect presumption that long-run costs are always greater than
13 short-run costs because long-run costs are simply short-run variable costs plus

¹⁹ "Clearly, the Postal Service cost function I have defined, $C(M,w)$ will coincide with the *minimum* cost function of economic theory if the operating plan always specifies the most cost efficient possible way of providing service for the given mail volumes. However, it is important to emphasize that it is not necessary to assume perfect cost efficiency to apply the methodology being developed here to the calculation of Postal Service marginal costs. Nor is it necessary to assume that the Postal Service is perfectly cost efficient for the pricing analysis to be meaningful" (USPS-T-11, p. 16).

"...when performing an analysis of postal pricing it must be recognized that the analysis is subject to the institutional constraint that Postal Service is going to produce the mail service in question using its established practices and procedures: what I have dubbed its operating plan. How close these practices and procedures come to achieving economic cost minimization is undoubtedly an important determinant of the efficiency of the Postal Service. And, of course, the closer to the operating plan comes to true cost minimization, the greater will be the maximized level of social surplus resulting from optimal pricing. However, the efficiency of the Postal Service operating plan is not an issue for the analyst. *As long as it is given that postal services will be produced following Postal Service practices and procedures, the relevant marginal and incremental costs for pricing purposes are those calculated based on the Postal Service operating plan*" (USPS-T-11, p. 17).

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1 some amount of fixed costs.²⁰ This problem is, again, due to the fact that
 2 Henderson makes the fundamental mistake of confusing the economic definition
 3 of the long-run (i.e., complete factor variability) with some calendar period of
 4 time. The fact is short-run costs can be less than, greater than, or equal to long-
 5 run costs. The true difference between short-run and long-run costs is that, in a
 6 short-run situation (which could be equivalent to any calendar period of time), not
 7 all options are available to the firm, while in the long-run, the firm faces fewer
 8 constraints on its decisions. Therefore, the key difference between the long-run
 9 and the short-run is the ability to have greater degrees of freedom in making
 10 decisions and deploying resources. In fact, it is often the case that it is more
 11 costly to expand output when a relatively greater number of inputs are fixed than
 12 when more inputs can be chosen optimally. Therefore, it is often true that short-
 13 run costs will be greater than long-run costs.

²⁰ In response to interrogatory USPS/UPS-T3-3, witness Henderson states that "As a general matter, in the absence of decreasing returns to scale long run incremental costs will always be at least as great as short run incremental costs. This is true because in the long run the Postal Service would be able to eliminate more costs than it would be able to eliminate in the short run." (Tr. 25/13626). Henderson's assertion is incorrect. Recall that the incremental cost for a service, which we can call IC, is the difference between the total costs of the Postal Service with the service, say $C(w)$, and the total costs of the Postal Service without the service, say $C(w/o)$. Thus, $IC = C(w) - C(w/o)$. Witness Henderson's mistake is focusing on the fact that as the Postal Service avails itself of opportunities to optimize its operations, the "longer run" costs $C(w/o)'$ should be less than the "shorter run" costs $C(w/o)$. Henderson's assertion is that the "longer run" incremental costs are $IC' = C(w) - C(w/o)' > IC$. The flaw in Henderson's logic is that the Postal Service will have the same opportunities to reduce $C(w)$ to $C(w)'$ in the longer run as it did to reduce $C(w/o)$ to $C(w/o)'$. So, the correct formula for the "longer run" incremental cost is $IC' = C(w)' - C(w/o)'$. There is no economic basis to assert a priori that IC' is greater than IC .

USPS-RT-7

1 **C. Long-run incremental costs may not satisfy statutory cost floor**
2 **requirements.**

Estimates of long-run incremental cost based on the assumption of a firm that instantaneously adopts all the latest technologies and operates most efficiently with these technologies will likely understate the costs of an actual firm that adapts its inputs over time and has a blend of new and old technologies. If, in fact, long-run incremental cost estimates are less than the actual costs incurred by the Postal Service, then long-run incremental cost would not be an appropriate cost concept to meet the cost floor requirement of Section 3622(b)(3). *Witness Panzar is correct in stating that it is appropriate to use estimates of actual marginal and incremental costs in rate making.*

1 CHAIRMAN GLEIMAN: Three participants requested
2 oral cross examination of the witness -- Florida Gift Fruit
3 Shippers, Newspaper Association of America, and United
4 Parcel Service.

5 Does any other participant wish to cross examine
6 this witness?

7 [No response.]

8 CHAIRMAN GLEIMAN: If not, Mr. Wells, you can
9 begin when you are ready.

10 MR. WELLS: Mr. Chairman, we have no questions
11 right at this time, but we may have follow-up.

12 CHAIRMAN GLEIMAN: Thank you, Mr. Wells.
13 The Newspaper Association of America, Mr. Baker.

14 MR. BAKER: Thank you, Mr. Chairman.

15 CROSS EXAMINATION

16 BY MR. BAKER:

17 Q Good morning, Dr. Christensen.

18 A Good morning.

19 Q My name is Bill Baker, I'm counsel for the
20 Newspaper Association of America, and my questions this
21 morning will address the portions of your rebuttal testimony
22 that are directed towards the testimony of my Witness Chown.

23 You are, I believe, the founder or co-founder of
24 Christensen Associates? Is that correct?

25 A That's correct.

1 Q And I seem to have seen the name of your firm
2 around these parts a lot. Is it correct that your firm does
3 a lot of postal consulting?

4 A Yes, that is correct.

5 Q If you could turn to page 17 of your testimony.

6 A Yes.

7 Q And I would direct your attention to lines 17 and
8 18 on page 17, where you state that institutional costs are
9 not causally-related to any particular service and product.
10 Do you see that?

11 A Yes, I do.

12 Q By the phrase service and -- excuse me. By the
13 phrase service or product, do you mean to refer to what we
14 know as first class and periodicals and standard mail?

15 A The usage here is generic, intended to include any
16 service or product, so insofar as those are considered to be
17 products or services, although what I hear you saying is
18 very broad categories of products or services, I believe
19 that is correct, yes.

20 Q Is it your understanding that Witness Chown
21 discussed what I will refer to as postal functions, such as
22 delivery and transportation and mail processing and window
23 service?

24 A I don't recall specifically what terminology she
25 was using.

1 Q Okay. Would you regard delivery and
2 transportation ^{and} ~~in~~ mail processing ^{and} ~~in~~ window service as a
3 service or a product in the sense that you use it here on
4 page 17 of your testimony?

5 A What the categories that you --

6 Q Delivery, transportation, mail processing, and
7 window service.

8 A No, I think for the most part as an economist I
9 would characterize those as intermediate products rather
10 than final products or services.

11 Q So then looking back at page 17 when you state
12 that institutional costs are not causally related to any
13 particular service or product, then this testimony is not
14 referring to say delivery function as a service or product
15 in the sense you use it in that sentence; is that correct?

16 A Perhaps, but the whole point of the sentence is
17 that institutional costs are not causally related to
18 anything. I mean that's my understanding of what
19 institutional costs are and therefore I don't know that it's
20 an important distinction as to whether we are looking at
21 final products or intermediate products because
22 institutional costs, my understanding is, by definition are
23 not related causally to any of them.

24 Q Are you generally familiar with the Postal
25 Service's cost accounting systems?

1 A Generally familiar, yes.

2 Q Are you familiar with the concept of cost
3 segments?

4 A Generally.

5 Q Okay. You are aware, for example, that cost
6 segment 3 holds various accounts for mail processing costs?

7 A Yes, I am aware of that.

8 Q And ^{do} you have any reason to doubt that the costs
9 that are accrued in these accounts over the course of time
10 are properly there?

11 A I'm not sure what you mean by that question.

12 Q Well, costs get accrued to these accounts during
13 the normal course of Postal Service operation; is that
14 correct?

15 A That is my understanding, yes.

16 Q And as a general matter, you have no reason to
17 question the appropriateness of costs being put in cost
18 segment 3 as opposed to cost segment 4 or cost segment 7, do
19 you?

20 A No, I have no reason to believe otherwise.

21 Q And are you aware that when the accrued costs in
22 these cost segments get attributed for ratemaking purposes
23 that the attribution methodologies that the Postal Service
24 and Rate Commission employ typically do not attribute 100
25 percent of the costs into these cost segments?

1 A Yes, that is my understanding.

2 Q And is it your understanding that what is left
3 over in a particular cost segment is considered an
4 institutional cost?

5 A That indeed is my understanding.

6 Q Do you agree that those unattributed costs within
7 cost segment 3, for example, arise from the provision of the
8 particular postal function whose costs are collected in cost
9 segment 3?

10 A Sorry, could I have the question again, please?

11 Q I asked if you were -- could agree that the
12 institutional costs, that is the unattributed costs within
13 cost segment 3 do arise from the provision of the postal
14 function whose costs are collected in cost segment 3?

15 A I'm not sure what you mean by arise from.

16 Q Well, they are accrued to cost segment 3; is ~~that~~ *that*
17 correct?

18 A That is correct. In that sense I would agree with
19 it, but I think only in that sense.

20 Q Let's take an extreme hypothetical and assume that
21 the Postal Service stopped providing transportation service,
22 that all the mail was taken -- all the transport functions
23 provided by the Postal Service were done by mailers. I
24 understand it's an extreme hypothetical, but I want you to
25 consider that hypothetical situation.

1 In theory, if that were done, would the Postal
2 Service's accrued transportation costs disappear?

3 A I don't know. It depends on your hypothetical. I
4 mean you're providing the hypothetical. If they
5 disappeared, they would disappear.

6 Q By definition.

7 A Yes, exactly.

8 Q And that would include all of the accrued costs
9 for transportation -- is that correct? -- under the
10 hypothetical.

11 A Well, you tell me. It's your hypothetical.

12 Q That was the assumption, that transportation
13 entirely goes away.

14 A Okay. If they go away, they go away.

15 Q That would include whatever transportation costs
16 were attributed and those that were not attributed, wouldn't
17 it?

18 A If we're doing a hypothetical, I think you can
19 assume what you want to assume.

20 Q I'd like you to turn the page to page 18 of your
21 testimony, and in here, you were generally discussing the
22 allocation of shared costs.

23 Can you describe for me your understanding of how
24 the Postal Service and the Rate Commission now -- have,
25 until now, decided how institutional costs are recovered?

1 A It's my understanding that this Commission has
2 broad authority to use their judgement in recovering those
3 costs. I do not have specific knowledge as to how they have
4 implementing that authority in recent years.

5 Q Well, maybe in a simpler way of looking at it,
6 does the Postal Service propose and the Commission set rates
7 that are designed to recover all of the costs of the Postal
8 Service, both the directly attributable and all the common
9 shared costs?

10 A My understanding is that that is, indeed, the
11 exercise.

12 Q And in doing that, the Commission both attributes
13 to sub-classes certain costs and also assigns to them the
14 responsibility, if you will, of a share of institutional
15 costs that the rates are set to recover. Is that correct?

16 A Sure. I'm not quite sure about the word
17 "responsibility," but they do, indeed, assign costs.

18 Q Does this current approach that we've discussed
19 fully allocate the shared costs to the sub-classes to be
20 recovered through rates?

21 A It's my understanding that it does.

22 Q And is it also your testimony that Ms. Chown's
23 proposal would allocate shared costs?

24 A Yes.

25 Q Does she do so in any sense that the Postal

1 Service does not under the current process?

2 A Yes, in the sense that my understanding is that
3 she is putting forth a methodology which she seems to seek
4 to portray as having economic content, whereas my reading of
5 her proposal is that it, indeed, does not have any economic
6 content.

7 Q Do you recall whether Ms. Chown's metric of
8 weighted attributable costs, when summed across all of the
9 sub-classes, equals the actual attributable costs proposed
10 by the Postal Service?

11 A I don't recall.

12 MR. BAKER: Okay. I have no more questions, Mr.
13 Chairman.

14 CHAIRMAN GLEIMAN: Mr. McKeever.

15 MR. McKEEVER: Thank you, Mr. Chairman.

16 CROSS EXAMINATION

17 BY MR. McKEEVER:

18 Q Dr. Christensen.

19 A Good morning, Mr. McKeever.

20 Q How are you?

21 A Fine, thank you.

22 Q Good.

23 Could you please turn to the page iv of your
24 testimony, which is entitled Purpose and Scope of Testimony?

25 A Could I have a page for that, please?

1 Q Page iv.

2 A Oh, iv. Sorry. Thank you.

3 Yes.

4 Q There you refer to estimates of economic marginal
5 costs. Do you see that?

6 A Yes.

7 Q Now I take it that that term "economic marginal
8 costs" that you use there is meant to mean the marginal
9 costs that economists say are the appropriate basis for
10 setting economically efficient rates.

11 A Yes, that's the intention.

12 Q Okay. And one of the main points in your
13 testimony I take it is that in order to obtain accurate
14 estimates of those economic marginal costs one must accept
15 both Dr. Bradley's variability analysis and Mr. Degen's cost
16 distributions methods.

17 A Yes, I believe that's fair.

18 Q In other words, you can't take one without the
19 other if you want to estimate the marginal costs which
20 economists say are the proper basis for determining
21 economically efficient rates.

22 A Yes. I would put it slightly differently. I
23 would say that together Dr. Bradley's methodology and Mr.
24 Degen's methodology form a coherent integrated system for
25 estimating economic marginal costs that follows the economic

1 theory laid out by Dr. Panzar in his testimony.

2 Q Okay. Now on page 1 of your testimony at lines 15
3 to 17 you state that historically the Postal Service has
4 assumed unit elasticities between most categories of mail
5 processing costs and the corresponding cost drivers. Do you
6 see that?

7 A Yes, I do.

8 Q The corresponding cost drivers, you're referring
9 there to their -- does that include handlings -- piece
10 handlings of mail?

11 A Yes, it does.

12 Q In other words, that's Dr. Bradley's total piece
13 handlings.

14 A That's correct.

15 Q Dr. Christensen, have you done any empirical
16 analysis to determine the actual relationship between mail
17 volume and the number of piece handlings?

18 A No, I have not.

19 Q Is it your understanding that Mr. Degen did an
20 analysis to determine the actual relationship between mail
21 volume and the number of piece handlings?

22 A I do not have knowledge of the specifics of what
23 Mr. Degen did.

24 Q So you don't know one way or the other.

25 A That's correct.

1 Q Okay. Could I ask you to turn to page 7 of your
2 testimony, please?

3 And in particular to footnote 6.

4 A Yes.

5 Q Am I correct that there you explicitly model a
6 relationship between piece handlings and mail volume that is
7 constant?

8 A Well, I wouldn't say I've done a modeling exercise
9 here. What I've -- what I have in this footnote is showing
10 the mathematical relationships that lead to this
11 distribution key approach relating cost drivers to the
12 handlings within particular cost pools.

13 Q And that mathematical relationship -- and I'm
14 focusing now in particular to the third equation in the
15 footnote -- that mathematical relationship treats the
16 relationship between piece handlings and mail volume as a
17 constant; is that correct?

18 A Are you referring to the a_{ij} ?

19 Q Yes.

20 A Well, I don't know if a_{ij} necessarily by
21 definition is constant, but I would say under certain
22 circumstances it could be treated as such.

23 Q Well, in your equation there, is it a constant?

24 A Well, it's not anything. It's a letter. I mean,
25 it's showing a relationship, and under certain

1 specifications that could be constant. Under other
2 specifications, it could be variable depending upon certain
3 characteristics.

4 Q So your expression there doesn't treat it one way
5 or the other?

6 A That's correct.

7 Q Okay. Let me ask you to assume, Dr. Christensen,
8 another hypothetical here. Let me ask you to assume that
9 the results of Dr. Bradley's analysis was that mail
10 processing costs are in fact 100 percent volume variable.
11 He did his analysis exactly the way he did it, and the
12 result turned out that there was 99.9 or 100 percent volume
13 variability. Could you then still use Mr. Degen's cost
14 distribution methods to arrive at economic marginal costs
15 under that assumption?

16 A Yes.

17 Q Could I ask you to turn to page 6 of your
18 testimony, please? And in particular, lines 12 to 15.

19 There you set forth another equation; is that
20 correct?

21 A Yes.

22 Q Now is the first component on the right-hand side
23 of the equation, the first term in parentheses, is that the
24 partial derivative of cost with respect to the partial
25 derivative of total piece handlings?

1 A Not exactly. What -- if I might explain in my own
2 words what that is --

3 Q Sure.

4 A It's the -- it's the elasticity -- the logarithmic
5 derivative, if you like -- of cost with respect to a cost
6 driver.

7 Q Okay. So if I were to restate it to say that the
8 right-hand side of the equation is the elasticity of cost
9 with respect to the elasticity -- with respect to total
10 piece handlings, you would agree?

11 A Not necessarily. Whatever the cost driver would
12 be in cases where the cost driver is indeed piece handlings,
13 then I would agree. But there may be cases where the cost
14 driver is not piece handlings.

15 Q Okay. Well, let's just talk, so we have something
16 concrete to talk about, as if the cost driver were piece
17 handlings.

18 A Fine.

19 Q Now, does that relationship exhibit scale
20 economies?

21 A It doesn't say anything one way or the other about
22 scale economies.

23 Q Okay. This is just a general equation.

24 A That's correct.

25 Q And it may exhibit scale economies, it may not, in

1 actual fact.

2 A You mean in an actual real-life situation that
3 corresponds with this may or may not have scale economies?

4 Q Yes. That's your testimony?

5 A Yes.

6 Q Okay. Now the second component on the right-hand
7 side of the equation, the second term in parentheses, is
8 that the elasticity of total piece handlings with respect to
9 mail volume?

10 A Yes, more generally whatever the cost driver would
11 happen to be, but since you ask me to assume that the cost
12 driver is piece handlings, that is indeed the elasticity of
13 piece handlings with respect to mail volume.

14 Q Okay. Now you state at the bottom of page 6,
15 beginning on line 21, and continuing to the top of page 7,
16 line 1, that, quote, the proportions of mail handlings
17 themselves serve as estimates of that second component. Is
18 that correct?

19 A Yes.

20 Q Are you saying there that total piece handlings is
21 used as a proxy for volume? Is that another way to say
22 that?

23 A No.

24 Q Are you saying there that the proportions of mail
25 handlings themselves represent the proportions of volumes of

1 types of mail?

2 A No, I'm saying that the proportions of mail
3 handlings serve as estimates of this elasticity between the
4 cost driver and mail volume.

5 Q In other words, you're saying there that in our
6 discussion and in the Postal Service's approach where piece
7 handlings is a cost driver it is using piece handlings as
8 estimates of that second component of the equation?

9 A Yes, that is correct.

10 Q It is using them as estimates of mail volume?

11 A No, it's using them as estimates of the elasticity
12 of piece handlings with respect to mail volume.

13 Q Okay. Do you know if the relationship is a
14 directly proportional one?

15 A I do not know.

16 Q You do not know.

17 Dr. Christensen, could you turn to page 8, please?

18 There you state at lines 1 to 6 that the
19 conceptual problem in Mr. Sellick's alternative is that his
20 use of the Postal Service's proposed distribution
21 methodology -- and I'm skipping down to your second point
22 here -- assumes that Bradley's numerical results are not
23 sound.

24 Do you see that?

25 Witness Sellick's --

1 A I think you're misrepresenting what it says here.

2 Q Well, I apologize. I don't intend to. Let me
3 start over again. Maybe I tried to truncate too much. You
4 do say in the first line that there is a conceptual problem
5 with Witness Sellick's alternative; is that correct?

6 A Yes.

7 Q Okay. And that you say that conceptual problem, I
8 take it, is his use of the Postal Service's cost
9 distribution methodology in conjunction with 100-percent
10 volume variability. Is that correct?

11 A Yes.

12 Q And you say that assumes that Bradley's numerical
13 results are not sound. Is that correct? Do I read that
14 right? Or maybe I misunderstand your sentence.

15 A Well, let me see if I can put the sentence --
16 interpret this sentence for you. Maybe this will help.

17 The problem is, as I'm identifying in this
18 paragraph, that Mr. Sellick says he is relying on two things
19 that are incompatible. He's relying upon the testimony of
20 Dr. Neels for the variability assumptions, but in fact
21 Witness Neels as I understand it has rejected the framework
22 put forth by Dr. Bradley of relating -- of looking at
23 variability in terms of piece handlings by cost pools. So I
24 have trouble with Mr. Sellick saying that he's relying on
25 Mr. Neels and thereby Dr. Bradley when in fact Dr. Neels has

1 explicitly rejected the conceptual framework of Dr. Bradley.

2 Q Maybe my problem is we're not clear -- I'm not
3 clear in my mind on what you meant by the conceptual
4 framework. Do you mean that Dr. Bradley's method measures
5 marginal costs?

6 A No. No. By the conceptual method I mean the
7 estimation of the elasticity of costs with respect to cost
8 drivers by looking at total piece handlings within cost
9 pool.

10 Q The use of total piece handlings is part of the
11 conceptual framework?

12 A Piece handlings by cost pool; yes.

13 Q Okay. Dr. Christensen, could you turn to page 5
14 of your testimony, please?

15 A Yes.

16 Q And I'd like to specifically direct your attention
17 to lines 18 and 19, where you state, "However, the TPH,
18 total piece handling, data from MODS are not available by
19 subclass of mail."

20 Do you see that?

21 A Yes.

22 Q Are you saying there that total piece handlings
23 are not, that there is not an actual measure of total piece
24 handlings for each subclass of mail for each activity?

25 A That is indeed what I am saying -- at least from

1 MODS, as it says here.

2 Q Okay, so that Mr. Degen's distribution keys are
3 not actual measures of total piece handlings for each
4 subclass of mail for each activity? Is that correct?

5 A That is not what it says here. It just says that
6 TPH from MODS are not available by subclass. It doesn't say
7 that Mr. Degen -- I think you are extending the words beyond
8 what's here.

9 Q Well, Mr. Degen does come up with distribution
10 keys for each subclass of mail, doesn't he?

11 A He does indeed.

12 Q And he obviously can't do it using TPH data from
13 MODS by subclass because MODS doesn't have TPH data by
14 subclass, is that correct?

15 A That is correct.

16 Q And that is why you say in your next sentence that
17 "Thus to form a distribution key for each activity, since he
18 couldn't do it directly from MODS by subclass, he employs
19 the IOCS data." Is that correct?

20 A That is indeed correct.

21 Q Okay -- so that since the TPH data from MODS are
22 not available by subclass of mail Mr. Degen uses IOCS
23 estimates of the proportion of time spent handling each
24 subclass in each activity as his distribution keys. Is that
25 right?

1 A That is my understanding, yes.

2 Q Okay. Do you agree that the proportion of time
3 spent handling each of the various subclasses of mail
4 reflects the costs of handling each of those subclasses?

5 A I don't have specific knowledge on that question.
6 I would defer to Mr. Degen on that.

7 Q You don't have a view on whether the time spent
8 handling each of the various subclasses reflects the cost of
9 handing those subclasses?

10 A I have not studied that issue.

11 Q Time is money, isn't it?

12 A I think so.

13 Q Okay. Dr. Christensen, I would like to ask you to
14 turn to pages 17 and 18 of your testimony, where you explain
15 the concept of shared costs.

16 Now again I want to make sure I understand that
17 testimony. The way I understand it, you explained there
18 that shared costs are costs that do not disappear or go away
19 when only one product or service is eliminated, but rather
20 go away only when all products and services are
21 discontinued, is that right?

22 A Sorry, I don't see where you are reading from.

23 Q I wasn't quoting. I was paraphrasing, so let me
24 try it again.

25 A Can you tell me which lines of my testimony you

1 are paraphrasing?

2 Q Sure. In particular, page 18, lines 4 through 7.

3 A Page 18?

4 Q Yes.

5 A Page 18, lines 4 through 7.

6 Q Are you there?

7 A May I have time to read that?

8 Q Sure. I was going to read it but you read it to
9 yourself.

10 A Please do.

11 Q There you state, quote, "Stated another way,
12 shared costs are not avoidable with respect to individual
13 products or services" -- and then you have a dash -- "that
14 is, reducing or eliminating the quantity produced of
15 individual services does not allow the company to avoid
16 incurring shared costs."

17 Is that right?

18 A Yes.

19 Q And then you ^{go} ~~to~~ on and say in the next sentence,
20 "Shared costs are only avoidable at the company-wide level.
21 That is, the firm must cease production of all of its
22 services to completely avoid incurring shared costs." Is
23 that right?

24 A Yes.

25 Q I take it then that shared costs are different

1 from incremental costs because incremental costs do go away
2 when one service is eliminated. Is that correct?

3 A That is correct.

4 Q Okay. And turning back to page 17 of your
5 testimony at lines 24 and 25, you say that the institutional
6 costs of the Postal Service are more generally referred to
7 as shared costs in the economics literature; is that right?

8 A Shared or joint and common costs; that's correct.

9 Q Right. Are you reading shared and joint and
10 common to be the same thing?

11 A Yes, I am.

12 Q Okay. So just to make sure I'm clear, the
13 institutional costs to the Postal Service correspond to the
14 notion of shared costs in the economics literature. Is that
15 what you're saying there?

16 A That is my opinion; yes.

17 Q Thank you.

18 Dr. Christensen, I'd like to ask you to turn to
19 pages 25 and 26 of your testimony.

20 At the bottom of 25 you state, quote, Witness
21 Henderson -- and then turning over to page 26 --
22 acknowledges that products that pass the incremental cost
23 test will make a contribution to institutional costs. Is
24 that correct?

25 A Yes.

1 Q Now, let's just suppose that revenues for a
2 service just equal incremental costs, right on the nose.
3 Does that satisfy section 3622(b)(3) of the statute under
4 your understanding of the statute?

5 A My understanding is that that indeed would fall
6 within the range specified by section 3622(b)(3).

7 Q So it would satisfy the statute?

8 A Yes.

9 Q Okay. Can I ask you to turn to page -- well,
10 we're on page 26. Stay at page 26 of your testimony. At
11 lines 6 to 9 you state that Dr. O'Hara shows in his direct
12 testimony that, quote, and I'm starting here on line 7, that
13 the Postal Service's proposed rates generated estimated test
14 year after rate revenue strictly greater than test year
15 after rates incremental costs for every nonpreferred
16 subclass of mail. Is that correct?

17 A That is my -- well, that's what it says here, and
18 that is my understanding. That's true.

19 Q Okay. Now you use the word "estimated test
20 year" -- or the phrase "estimated test year after rates
21 revenue." You didn't use the word "estimated" when you used
22 the phrase "test year after rates incremental cost," but I
23 take it you did mean to and your intent was test year after
24 rates estimated incremental costs. Am I correct?

25 A Yes.

1 Q Okay. Why did you use the word "strictly" there
2 when you said strictly greater?

3 A My recollection is that it wasn't -- there weren't
4 any examples of the case that you put forward where it was
5 exactly equal. That the incremental cost test was passed
6 without any room to spare, so to speak.

7 Q Okay. Can you turn to page 27 of your testimony?
8 And I'd like to direct your attention in particular to lines
9 15 through 18.

10 There you state, quote, to assume that all inputs
11 are totally variable in a two- to four-year period, or
12 indeed any given period of calendar time, is not realistic,
13 nor will it provide an adequate estimate of the cost the
14 Postal Service will actually incur. Do you see that?

15 A Yes.

16 Q Is it your understanding that Dr. Henderson
17 assumed in his testimony that all inputs are totally
18 variable in a 2- to 4-year period?

19 A I don't recall specifically what he assumed or
20 what he specified.

21 Q You did read his testimony, though, right?

22 A I did indeed.

23 Q Okay.

24 Okay, Dr. Christensen, could you please define for
25 me "diseconomies of scale"?

1 A Sure. Diseconomies of scale is a situation where
2 marginal cost is higher than average cost.

3 Q Is that the same as decreasing returns to scale?

4 A Yes.

5 Q Under what circumstances can diseconomies of scale
6 exist? Under what circumstances can marginal costs be
7 greater than I think you said average costs?

8 A Yes.

9 Q Okay.

10 A Well, I am not quite sure I understand the
11 question in that marginal costs means that the cost of the
12 next unit produced is higher than the average of all the
13 previous units produced.

14 Q I am looking for a concrete example of a situation
15 where in a real business what circumstances would lead to a
16 situation where marginal costs are greater than average
17 costs. That is what I am looking for. If you can give me
18 an example --

19 A Sure. Sure. A typical textbook example would be
20 where a firm is operating above optimal capacity and so in
21 the short run it has to employ highly expensive additional
22 inputs to produce the marginal quantity that is inputs that
23 are more expensive than average.

24 To make that a little bit more concrete, if I may,
25 I think what economists usually have in mind is a situation

1 where you might have a fairly capital intensive activity
2 which uses relatively little incremental labor or I should
3 say marginal labor for the marginal production, but if the
4 capacity of the equipment is reached and still the firm
5 needs to produce more units, then it becomes more highly
6 labor-intensive and so it might require a very expensive
7 marginal addition of labor which is substantially above the
8 average cost of the capital and labor combined for the
9 previous units produced.

10 Q Is that a situation, if I understood you
11 correctly, where the firm is operating at a level where it
12 does not have sufficient capacity I think you said to
13 operate at the optimum level?

14 A To operate with the optimum mix at the optimum
15 level, yes.

16 Q Okay, and that is a situation of decreasing
17 returns to scale?

18 A Not exactly.

19 Q Okay. Can you explain the difference for me?

20 A Sure. Because the kind of situation I was
21 describing is where capital was fixed, and we were only
22 looking at increasing labor.

23 By definition, when you are talking about the
24 returns to scale, scale implies varying all factors of
25 production, so when we are looking at increasing the scale

1 of operations, we would hypothetically be thinking about
2 increasing the amount of capital available as well.

3 Q Okay. Dr. Christensen, could you turn to page 30
4 of your testimony, please.

5 There you indicate, and I am looking at the
6 heading of the page, that long-run incremental costs may not
7 satisfy statutory cost floor requirements. Is that correct?

8 A Yes.

9 Q Am I also correct that that statement assumes that
10 long-run incremental costs are, as you later indicate on
11 lines 7 to 8, "less than the actual costs incurred by the
12 Postal Service"?

13 A Yes.

14 Q What do you mean there by the actual costs
15 incurred by the Postal Service?

16 A Well, what I am contrasting here is the situation
17 where in the long-run we can conceive of a firm such as the
18 Postal Service starting from scratch and optimally designing
19 an entirely new network, a new set of facilities, building
20 all plants and constructing the network in the optimal way.

21 The Postal Service would never have that
22 opportunity. The Postal Service is always going to be
23 building from an historical situation where there are lots
24 of long-lived facilities in place and the Postal Service
25 will go forward, planning to optimize based on that as a

1 constraint as opposed to the situation where there would be
2 a blank slate, if you like, and the firm could start from
3 scratch.

4 That would be a level -- well, if you could start
5 from scratch you would expect the costs to be lower in
6 totality than the costs that even going forward if the
7 Postal Service behaved optimally would be able to achieve,
8 and that is what the distinction is.

9 Q Well, I apologize, but I am just a little bit
10 confused about which situation is the one where long-run
11 costs are less than the actual costs incurred?

12 Is that the one where you are starting with a
13 blank slate?

14 A Yes.

15 Q Okay -- and of course that is not the situation we
16 face now?

17 A That's correct.

18 MR. McKEEVER: That is all I have, Mr. Chairman.

19 CHAIRMAN GLEIMAN: I actually was out there
20 listening, hanging on your every word.

21 MR. McKEEVER: I could see you.

22 CHAIRMAN GLEIMAN: Is there any followup?

23 Yes, Mr. McLaughlin.

24 CROSS EXAMINATION

25 BY MR. McLAUGHLIN:

1 Q Mr. Christensen, Mr. Baker asked you some
2 questions concerning a hypothetical of his which assumed
3 that the Postal Service simply stopped providing any
4 transportation service, just eliminated transportation
5 entirely.

6 Does the Postal Service offer transportation
7 service independent of its other cost functions?

8 A I'm sorry, I don't understand the question.

9 Q Well, let me just -- is the transportation
10 function linked to the mail processing function and as well
11 linked to the delivery function in terms of its actual
12 operations?

13 A Are you asking me is transportation that is
14 provided by the Postal Service part of their overall
15 operation of processing and delivering the mail?

16 Q Yes. For example, when a consumer -- let's say
17 that consumer takes a letter to a local post office. There
18 is mail processing incurred at that local post office. Is
19 that correct?

20 A Yes.

21 Q And then if that letter is destined to someplace
22 other than that same local post office, there needs to be
23 some way to get it from that point after it's processed
24 locally to the next point in the chain. Is that correct?

25 A Yes.

1 Q It has to be transported.

2 A That is correct.

3 Q And is that transportation service that the Postal
4 Service provides -- is it linked operationally to the mail
5 processing function?

6 A I don't know what you mean by linked
7 operationally.

8 Q Well, okay. For example, are transportation
9 schedules to your knowledge ever geared to mail processing
10 times or other things such as critical dispatch times that
11 are linked operationally between the mail processing
12 function and the transportation function and the next mail
13 processing step?

14 A I don't know.

15 Q You don't know.

16 If there were a connection between the
17 transportation function operationally and the mail
18 processing functions, and if there were service requirements
19 that needed to be met for mail, is it possible that the
20 level of institutional costs for transportation service
21 might be influenced by the need to tie in transportation
22 schedules with critical dispatch mail processing schedules?

23 A I'm not sure I understand the question, but let me
24 take a crack at it. I think you're asking me that is it
25 possible that when we're looking at cost causation that

1 there is some aspect of transportation and mail processing
2 that interact in the process of causing costs, and since we
3 earlier agreed I believe that costs that are not caused in
4 such a way are institutional, that the bottom line of your
5 question is, you know, is there a possible linkage to
6 institutional costs through this mechanism. And I think if
7 I follow this hypothetical correctly I think the answer is
8 yes.

9 MR. McLAUGHLIN: I have no further questions.

10 CHAIRMAN GLEIMAN: Mr. Baker?

11 FURTHER CROSS EXAMINATION

12 BY MR. BAKER:

13 Q To follow up on Mr. McLaughlin's questions to you,
14 a mailer can enter his or her mail at many places, can he
15 not? I mean, if I wanted to send a letter to New York, I
16 could mail it from my -- leave it in my mail box, I could
17 take it to the post office here, I could actually carry it
18 to New York and drop it in a mail box in New York, right?

19 A I believe that's correct. Yes.

20 Q Are you aware that in some classes of mail,
21 mailers can receive discounts if they enter their mail at
22 particular Postal Service destination facilities?

23 A It's my understanding that that is the case.

24 Q Do you have -- is it your understanding that the
25 discounts that those mailers can receive when they do that

1 are based on the -- the Postal Service's costs that it
2 avoids by virtue of the mailer taking it to those points
3 rather than the Postal Service taking the mail to those
4 points?

5 A I don't know.

6 Q You don't know.

7 MR. BAKER: I have no more questions, Mr.
8 Chairman.

9 CHAIRMAN GLEIMAN: Any further followup?
10 Questions from the bench?

11 Commissioner LeBlanc?

12 COMMISSIONER LeBLANC: Dr. Christensen, I just --
13 I'm not an economist, so bear with me here, but I think I
14 want to try to understand something that you were talking
15 about in your testimony where you say in the -- you talk
16 about it in the purpose of your testimony and then you talk
17 about it I think it's back on page -- I had it underlined;
18 now I can't find it. But you were talking about where the
19 costing -- shared costs again with Mr. McKeever.

20 If a product leaves the system, a service leaves
21 the system, then is it your testimony that the marginal
22 costs then in effect will increase in total? Is that a way
23 of -- did I --

24 THE WITNESS: I don't believe I have made that
25 connection. No.

1 COMMISSIONER LeBLANC: Okay. So the costs remain
2 in the system even though a service or a product leaves, and
3 there's still a shared cost there; is that correct?

4 THE WITNESS: Yes.

5 COMMISSIONER LeBLANC: Okay. Just wanted to
6 clarify that.

7 Now, you seem to be critical in some ways and yet
8 not critical of the Postal Service's some data if you
9 will --

10 THE WITNESS: Sorry, what's --

11 COMMISSIONER LeBLANC: Well, let me say it another
12 way. Are you familiar with the RPW?

13 THE WITNESS: Generally. Generally. Yes.

14 COMMISSIONER LeBLANC: All right. Is that -- it's
15 not something that has been brought out or really tested as
16 such, so how would you look at it as far as your total
17 costing or in your particular case here what you're trying
18 to do?

19 THE WITNESS: Okay. If I understand the question,
20 the issue is how do we know which costs are truly volume
21 variable --

22 COMMISSIONER LeBLANC: Exactly.

23 THE WITNESS: And which are not. And we can never
24 know by simply looking at individual costs and trying to
25 decide judgmentally. That's why I think what the Postal

1 Service is putting forward is a very important step forward
2 of using statistical analysis that reflects the large body
3 of economic literature on how to in fact infer volume
4 variable costs which indeed has been implemented by Dr.
5 Bradley and Mr. Degen. So that is really the key here is
6 that in fact there is a consistent method which uses
7 real-world data from the Postal Service to implement the
8 conceptually correct way of in fact identifying volume
9 variability.
10 which to my understanding is of critical importance to your
11 ratemaking decisions.

12 COMMISSIONER LeBLANC: Suppose that volume is way
13 off down the road. What will that do to the data?

14 THE WITNESS: Well, the volume variabilities that
15 are being estimated in the Postal Service submission are
16 based on real world observed data.

17 None of this is hypothetical data. None of it is
18 based on forecasts. It is based on actual data.

19 COMMISSIONER LeBLANC: I had better go back and
20 check that then. Thank you very much. Thank you, Mr.
21 Chairman.

22 CHAIRMAN GLEIMAN: You characterized Witness
23 Chown's so-called metric as being without economic content.

24 Can you define the phrase "economic content" to
25 me? I don't know what that means.

1 THE WITNESS: Yes. What I mean is having any
2 relationship to any economic concepts having to do with cost
3 causation, marginal cost, incremental cost, the concepts
4 that were discussed in Dr. Panzar and other testimonies --
5 that's what I mean.

6 CHAIRMAN GLEIMAN: Have the concepts of marginal
7 cost and incremental cost been around since the beginning of
8 time?

9 THE WITNESS: Not quite that long.

10 [Laughter.]

11 CHAIRMAN GLEIMAN: So at some point if someone had
12 presented the concepts of marginal cost and incremental
13 cost, perhaps if one of your ancestors might have been on a
14 witness stand somewhere suggesting that the proposals were
15 without economic content because they didn't relate to
16 anything that existed at that point in time in the
17 literature, is that not correct?

18 THE WITNESS: I would accept that as fair, sure.

19 CHAIRMAN GLEIMAN: I am just trying to put the
20 concept of economic content in perspective.

21 Do I understand from the section of your testimony
22 at page 5, subpart A, that it is your view that the only way
23 to proceed here, the only proper way to proceed here is to
24 accept Bradley and Degen together in toto?

25 THE WITNESS: I wouldn't say it is the only way to

1 proceed. It is the way that I would recommend proceeding.

2 CHAIRMAN GLEIMAN: So it's an all-or-none as far
3 as you are concerned?

4 THE WITNESS: Well, in the sense that this is an
5 integrated piece of work.

6 Dr. Bradley's work and Mr. Degen's work have not
7 been done independently of each and just forced together.
8 These were part of a package that was conceived based on the
9 framework laid out by Dr. Panzar and very consistent with
10 Appendix H from recent presentations by the Postal Service.

11 This is not a new approach to costing. Some of
12 the empirical work that implements it is new, but I think
13 that is an important step forward.

14 CHAIRMAN GLEIMAN: Would we be making a serious
15 mistake not to accept both of them flat out in toto, in your
16 opinion? Or let me put it this way, would it be a step in
17 the wrong direction not to accept both of them flat out?

18 THE WITNESS: Well, recognizing that I am going to
19 give you my opinion, and ultimately it's your opinion and
20 the opinions of the other Commissioners that matter --

21 CHAIRMAN GLEIMAN: I understand. If I wasn't in
22 your opinion, sir, I wouldn't ask.

23 THE WITNESS: Okay.

24 CHAIRMAN GLEIMAN: I know sometimes when I ask
25 questions people think I am not interested in the answers.

1 I am interested in the answers, otherwise I wouldn't ask the
2 questions.

3 THE WITNESS: It indeed is my opinion that
4 accepting in toto the framework and the results put forward
5 by the Postal Service in this package of Dr. Panzar, Dr.
6 Bradley and Mr. Degen is by far preferable to any of the
7 other alternatives that are available at this time.

8 CHAIRMAN GLEIMAN: Do I understand correctly that
9 you feel that the test of 3622(b)(3) is -- well, let me back
10 off a little bit.

11 Do I understand correctly from the exchanges that
12 you had with Mr. McKeever that you think if we were to
13 recommend rates that had no markup at all, and I am not
14 talking about any special classes where there might be
15 some -- or subclasses where there might be some reason in
16 law to give special consideration -- but that as a general
17 principle 3622(b)(3) could be met with zero markup over
18 marginal cost?

19 THE WITNESS: Well, certainly not for all
20 subclasses because it's my understanding that that would
21 fall then far short of recovering all costs.

22 CHAIRMAN GLEIMAN: But we could do it for all
23 subclasses except one? We could have zero markups on
24 everything except for one subclass which could then bear all
25 the, quote, "shared or joint" -- and whatever the other part

1 of that phrase was -- cost of the Postal Service?

2 THE WITNESS: Well, I am not an attorney so I
3 can't say what the legal status of it is, but my
4 understanding of the Postal Reform Act is that this
5 Commission has broad discretion for setting rates.

6 I believe there is language to the effect that
7 above what I interpret as incremental costs this Commission
8 can decide what is a reasonable amount of shared cost to
9 allocate to the various classes, and that discretion ranges
10 from zero to all of the shared costs.

11 Now I think the extremes are probably not very
12 practical, but is it within your discretion? I believe it
13 is.

14 CHAIRMAN GLEIMAN: As a general proposition then,
15 you would agree that we have the authority or you would
16 submit that we have the authority to have numerous
17 subclasses with zero markup and that they would still --
18 because in your opinion they would meet the incremental cost
19 test they would also meet the requirements of 3622(b)(3)?

20 I know you are not a lawyer --

21 THE WITNESS: Yes.

22 CHAIRMAN GLEIMAN: -- but you made reference to
23 3622(b)(3).

24 THE WITNESS: Right. If I may say, from a point
25 of view as an economist I believe that in an economic sense

1 it meets that requirement. Whether it meets the requirement
2 legally or not, I don't have an opinion.

3 CHAIRMAN GLEIMAN: You indicated in response to my
4 colleague that you were comfortable with Bradley and Degen
5 because it was based on actual data, not projected data, as
6 he had thought perhaps you were making some reference to.
7 Is that correct -- that you are comfortable?

8 THE WITNESS: Yes. That is one of the reasons
9 that I am comfortable with Bradley/Degen. Right.

10 CHAIRMAN GLEIMAN: Have you been involved in the
11 Westat, the recent review of the recent Westat study of RPW?

12 THE WITNESS: I have not.

13 CHAIRMAN GLEIMAN: Okay. Are you aware that there
14 is such a review by Westat?

15 THE WITNESS: I am not.

16 CHAIRMAN GLEIMAN: You were in the hearing room
17 yesterday, as I recall.

18 THE WITNESS: A large part of yesterday. I
19 confess I was not here till 10:15, but I was here for most
20 of the day.

21 CHAIRMAN GLEIMAN: Were you here at that point in
22 the evening when several of us who were here had a -- were
23 confused about a document that was being used by Dow Jones
24 to cross-examine a witness? It was Witness Higgins I think
25 was the witness who was being cross-examined by Dow Jones.

1 It was initially purported to be some pages out of a Postal
2 Service library reference that was relied on by Dr. Bradley.

3 THE WITNESS: I'm afraid I had left by that time.
4 I don't recall hearing that part of the testimony.

5 CHAIRMAN GLEIMAN: Are you comfortable with the
6 idea that a manual operation for mail processing could --
7 data collected by the Postal Service over a particular
8 accounting period for a manual operation in mail processing
9 would provide information that 30,000 pieces of mail per
10 hour could be processed?

11 THE WITNESS: I don't have an opinion on that one
12 way or the other.

13 CHAIRMAN GLEIMAN: Well, let's try it in pieces
14 per minute. Do you think that it's reasonable to assume
15 that on a facilitywide basis over a four-week period that on
16 a per-hour basis 500 pieces of mail per minute were
17 processed in a manual processing setting?

18 THE WITNESS: I'm sorry, I just don't know
19 anything about the specifics of the question, whether we're
20 talking about a large facility and a large number of people
21 processing mail --

22 CHAIRMAN GLEIMAN: Pieces -- you're running into
23 the same problem that we ran into last night trying to
24 understand what it was that was being presented. And
25 basically what we're told was piece handlings per hour.

1 Forget how many people are in the facility. Forget the mail
2 volume of the facility, because it's just a number that
3 comes by dividing, you know, one number into another, and
4 the answer is that in facility X during accounting period Y
5 looking at manual processing of mail, 500 pieces of mail
6 were processed per minute for that entire four-week period,
7 for every minute in that four-week period 500 pieces of mail
8 were processed. And if I'm mischaracterizing the situation
9 we were presented with last night, I'm sure that Postal
10 Service counsel will correct me when they get an
11 opportunity.

12 THE WITNESS: Okay. Again, I really don't know,
13 but I think what you're asking me, does that sound like a
14 large number. It sounds like you're conveying it sounds
15 like a large number to you, and it does sound like a large
16 number. Is it implausible? I just don't have enough
17 operational knowledge to know?

18 CHAIRMAN GLEIMAN: Do you have anything to do with
19 something called TFP? Total factor productivity?

20 THE WITNESS: My firm in fact computes TFP for the
21 Postal Service. Yes.

22 CHAIRMAN GLEIMAN: TFP doesn't rely on MODS data,
23 though. Is that correct?

24 THE WITNESS: I have to say I don't know.

25 CHAIRMAN GLEIMAN: I have no further questions. I

1 don't know whether any of my colleagues do.

2 Followup as a consequence of questions from the
3 bench?

4 MR. McKEEVER: Yes, Mr. Chairman.

5 FURTHER CROSS EXAMINATION

6 BY MR. McKEEVER:

7 Q Dr. Christensen, in response to I think a question
8 from the Chairman you indicated that in your view it was far
9 preferable to accept Panzar, Bradley, and Degen as a unit.
10 Is that correct? Do you remember that?

11 A That is correct. Preferable to the alternatives.

12 Q And I take it -- well, tell me, is that because
13 those three pieces of work, taken as a unit, measure the
14 marginal costs of the different subclasses of mail?

15 A Not only measure them, but insofar as I can tell
16 without knowing all the details of each of those studies,
17 that they do it in a coherent, consistent way that is better
18 than the alternatives available to us.

19 Q But the key is that they're putting numbers on
20 marginal costs. Marginal costs is the key; is that right?

21 A That is indeed the key. Right.

22 Q Okay.

23 MR. McKEEVER: That's all I have, Mr. Chairman.

24 CHAIRMAN GLEIMAN: Is there any further followup?

25 [No response.]

1 CHAIRMAN GLEIMAN: Dr. Christensen, if I may, just
2 another question or two about joining and making it all or
3 nothing on Bradley and Degen.

4 You don't think that the analysis of Bradley
5 stands all on its own, that it's good, solid volume
6 variability analysis without anything else?

7 THE WITNESS: It's good, solid analysis of the
8 elasticity of costs with respect to cost drivers, but that's
9 not -- my understanding is that's not the end objective.

10 CHAIRMAN GLEIMAN: You don't think that Degen and
11 the way he distributes costs using the MODS pools and with
12 some help from IOCS stands on its own as an improvement over
13 the way that costs have been distributed in the past?

14 THE WITNESS: With -- I believe it is an
15 improvement, but it has to be taken within the context which
16 it is, which is a different framework from what has been
17 used in the past. It is a framework of looking at piece
18 handlings within cost pools, and that context has to be kept
19 in mind, and that indeed is what links Bradley and Degen.

20 CHAIRMAN GLEIMAN: I understand there's a link
21 between Bradley and Degen. What I'm confused about, though,
22 is if Bradley is an improvement, and Degen is an
23 improvement, if someone were to have a problem with one or
24 the other to a varying degree, why would one then not adopt
25 the improvement in one or the other and deal with the

1 concerns that he or she might have about the remaining?

2 THE WITNESS: Well, it's a fair question and we
3 want to adopt improvements where we can. I think overall is
4 where we get the biggest improvement is to have a consistent
5 new framework that we can implement.

6 If some part of the overall package is deemed to
7 be flawed, and I don't think it is, then the question is
8 well, how can we correct for that without the notion of
9 let's either throw out Bradley or let's throw out Degen and
10 substitute something that may not be linked in a consistent
11 way with it.

12 I think we have to be very cautious about using
13 either without the other but I wouldn't say it's impossible
14 to do it in a way that makes sense.

15 CHAIRMAN GLEIMAN: Is the Bradley model the only
16 econometric model that exists?

17 THE WITNESS: It is the only model that I know of
18 that estimates elasticities of cost with respect to cost
19 drivers.

20 CHAIRMAN GLEIMAN: And assuming for the sake of
21 discussion it's the only model, does that mean that it is
22 the correct model?

23 THE WITNESS: Not by definition, no, but I believe
24 it is the correct model.

25 CHAIRMAN GLEIMAN: Thank you. Follow-up?

1 MR. McKEEVER: I apologize, Mr. Chairman, but I do
2 have a couple more.

3 CHAIRMAN GLEIMAN: Certainly.

4 FURTHER CROSS EXAMINATION

5 BY MR. McKEEVER:

6 Q Dr. Christensen, the purpose of Dr. Bradley's
7 volume variability analysis is again to determine marginal
8 costs?

9 A The purpose of the combined analyses of Dr.
10 Bradley and Mr. Degen is to determine marginal costs.

11 Q Well, Dr. Bradley testified yesterday that he was
12 interested in finding out the impact of volumes -- the
13 impact on cost of small sustained changes in volume.

14 Were you here, did you hear that testimony?

15 A I did.

16 Q And is one of the reasons you prefer Dr. Bradley's
17 analysis precisely because that was its purpose?

18 A Well, I think I've already stated that and maybe
19 you just want me to say it again but --

20 Q I just want to be clear on that --

21 A -- but the purpose is to estimate marginal costs
22 as I've stated upfront in my testimony.

23 MR. McKEEVER: Okay. Thank you, Dr. Christensen.

24 THE WITNESS: You're welcome.

25 MR. McKEEVER: It is sometimes the case though

1 that when there's a lot that goes in between one is not sure
2 that you are ending up where you started, that's all.

3 CHAIRMAN GLEIMAN: I'm glad to know that someone
4 else has that feeling occasionally too.

5 Any further follow-up? If not, that brings us to
6 redirect.

7 Would you like some time with your witness, Mr.
8 Koetting?

9 MR. KOETTING: I would, Mr. Chairman.

10 CHAIRMAN GLEIMAN: Let's take ten.

11 MR. KOETTING: Thank you.

12 [Recess.]

13 CHAIRMAN GLEIMAN: Mr. Koetting, as soon as your
14 witness is ready.

15 MR. KOETTING: Thank you, Mr. Chairman. We do
16 have a few questions.

17 REDIRECT EXAMINATION

18 BY MR. KOETTING:

19 Q Dr. Christensen, several points -- counsel for
20 UPS, Mr. McKeever asked you something along the lines of
21 whether or not the objective of the new exercise conducted
22 by Witnesses Bradley and Degen was the measurement of
23 marginal cost. Do you recall those conversations?

24 A Yes, I do.

25 Q Is it possible to measure incremental costs

1 without measuring marginal costs?

2 A No, it is not. Marginal cost is a component of
3 incremental cost.

4 Q There was also some discussion between the
5 Chairman and yourself regarding some numbers that were
6 floated around last night, and if I can, I would like to try
7 to cut through to what I think is the crux of the question
8 from the Chairman.

9 If somebody were to put you in front of a case of
10 mail and ask if you would expect to observe a person
11 standing at the case manually sorting mail, would you expect
12 that person would be able to manually case 500 pieces per
13 minute?

14 A I would not.

15 Q Do you know whether or not Dr. Bradley had any
16 procedures to eliminate such observations from the data that
17 he was using to estimate variabilities for mail processing
18 costs?

19 A Yes. My understanding is that Dr. Bradley had
20 procedures that he called data scrub procedures, the purpose
21 of which were precisely to eliminate observations that
22 clearly were not possible.

23 Q In your experience with other types of economic
24 data, are reported instances of anomalous data things that
25 happen or are these kinds of things unique to postal data?

1 A No, they're definitely not unique to postal data.
2 I've dealt with a lot of data sets in my career, and I don't
3 believe I've encountered one yet that's perfect, and the
4 point isn't to seek a perfect data set but, rather, to make
5 the best use of data that are available.

6 Q Do you recall conversations you had both with Mr.
7 McKeever and the Chairman regarding a mark-up of zero over
8 incremental cost and whether or not that would satisfy
9 Section 3622(b)(3) of the Postal Reorganization Act?

10 A Yes, I do recall that.

11 Q Was it your intent to suggest that a mark-up of
12 zero for a sub-class over incremental cost would be
13 reasonable in every instance?

14 A Oh, no, not at all.

15 What I was expressing was that if, after looking
16 at all the criteria that the Commission is supposed to
17 consider, that they decided that it -- in a particular
18 instance, it was reasonable to have a zero mark-up over
19 marginal costs, it was my understanding from an economic
20 point of view that that would not violate any economic
21 principle that's important for rate-making.

22 Q Now, you just said zero mark-up over marginal
23 cost. Is that what you intended to say?

24 A Sorry. No, I meant to say over incremental costs.

25 MR. KOETTING: That's all we have, Mr. Chairman.

1 CHAIRMAN GLEIMAN: Mr. McKeever?

2 RECROSS EXAMINATION

3 BY MR. McKEEVER:

4 Q Dr. Christensen, do you know how Dr. Bradley went
5 about identifying and deleting data representing situations
6 that were not physically possible, the specific method he
7 used?

8 A I don't know the details. When I was here hearing
9 the testimony, I recall some discussion about lopping off
10 the tails, so to speak, 1 percent of the data as being
11 outliers.

12 MR. McKEEVER: That's all I have, Mr. Chairman.

13 CHAIRMAN GLEIMAN: I just want to make sure I
14 understand some of your responses before.

15 You are not all that familiar with MODS data
16 pools?

17 THE WITNESS: No, I am not.

18 CHAIRMAN GLEIMAN: You seem to be very familiar
19 with both the analysis of Witnesses Bradley and Degen.
20 Would you care to offer me an opinion on which one's
21 analysis involves more subjectivity?

22 THE WITNESS: I really don't have an opinion on
23 that.

24 CHAIRMAN GLEIMAN: Do fixed effects models, the
25 econometric equations or models, have variables in them?

1 THE WITNESS: Yes.

2 CHAIRMAN GLEIMAN: We already established you
3 don't know about the MODS data pools, so I am not sure I can
4 ask you any questions about the MODS data pools.

5 Are you familiar with IOCS?

6 THE WITNESS: Generally.

7 CHAIRMAN GLEIMAN: Do you know how many variables
8 there were or weren't in Dr. Bradley's many equations?

9 THE WITNESS: Sir, are you asking me about the
10 number of variables of each specific equation or overall how
11 many variables?

12 CHAIRMAN GLEIMAN: Overall -- both ways would be
13 nice.

14 THE WITNESS: Well, he had a lot of equations and
15 therefore since there are a lot of equations I guess there
16 are a lot of variables. No disagreement there.

17 In terms of individual equations, the key
18 variables in my opinion are the cost drivers and then there
19 are other variables that are important to control so that in
20 fact he is doing a fixed effects panel estimation, which I
21 believe is extremely important, and that is based on my own
22 experience of having done a large number of econometric
23 analyses and doing -- allowing for those specific fixed
24 effects is extremely important to be able to get proper
25 estimation in a pool time series data set.

1 CHAIRMAN GLEIMAN: Is there one way and only one
2 way to do fixed effects models? I mean is there a textbook
3 somewhere that tells you that these are the required and
4 only constants you can have and these are the required
5 variables and only variables you can have, but that you must
6 have all those variables?

7 THE WITNESS: Well, in terms of the way the fixed
8 effects model is set up, there are basically binary
9 variables -- that is, variables that are either on or off --
10 to capture the fact that certain observations are for
11 certain facilities, rather than simply lumping together all
12 the observations which would then be implicitly assuming
13 that there is one standard cost equation that is general
14 enough to capture and reflect differences in costs' behavior
15 over all the different facilities, and I believe that is a
16 very extreme assumption that Dr. Bradley correctly did not
17 make.

18 CHAIRMAN GLEIMAN: So you think it's better to
19 just forget that there's differences in the world for
20 econometric purposes -- for econometric simplicity?

21 THE WITNESS: No. No, I'm sorry, I'm glad you
22 asked the clarifying question. Just the opposite.

23 CHAIRMAN GLEIMAN: I thought you just told me
24 that -- well, maybe I didn't understand your response then
25 on the differences from facility to facility.

1 THE WITNESS: No, it is important to recognize the
2 differences from facility to facility, and that is what the
3 fixed effects model does.

4 If one simply does an aggregate cross-sectional
5 analysis, you are wiping out all those differences. You are
6 ignoring all those differences from facility to facility.

7 CHAIRMAN GLEIMAN: I am not going to ask you to
8 define differences from facility to facility and
9 cross-sectional analysis because we obviously operate on a
10 different wavelength on some of these definitions but I
11 thank you.

12 Is there any further follow-up?

13 If not, and there is nothing from the Postal
14 Service further, if not I want to thank you, Dr.
15 Christensen.

16 We appreciate your appearance here today and your
17 contributions to our record. I learned a lot today
18 including all these years when I heard people talk about
19 Christensen & Associates and TFP that they didn't mean Dr.
20 Christensen -- they meant somebody else, but if there is
21 nothing further, you are excused.

22 THE WITNESS: Thank you.

23 CHAIRMAN GLEIMAN: Our next witness is appearing
24 on behalf of Advo. Ms. Crowder is already under oath. Mr.
25 McLaughlin, if you are prepared to introduce your witness

1 and her rebuttal testimony into the record.

2 Whereupon,

3 ANTOINETTE CROWDER,

4 a rebuttal witness, was called for examination by counsel
5 for Advo and, having been previously duly sworn, was
6 examined and testified as follows:

7 DIRECT EXAMINATION

8 BY MR. McLAUGHLIN:

9 Q Ms. Crowder, I'm handing you a copy of a document
10 captioned Rebuttal Testimony of Antoinette Crowder on behalf
11 of Advo, Inc., identified as Advo-RT-1. And was this
12 testimony prepared by you or under your direction and
13 supervision?

14 A Yes, it was.

15 Q Do you have any corrections?

16 MR. McLAUGHLIN: Mr. Chairman, there are some
17 corrections, and I have corrected pages that I'll hand out.

18 CHAIRMAN GLEIMAN: Thank you, sir.

19 BY MR. McLAUGHLIN:

20 Q Ms. Crowder, could you identify the corrections
21 that you have to your testimony?

22 A Yes. Page 27, one the first line, the first line
23 now reads: Witness Donlan demonstrates that the unit mail
24 processing costs from non walk sequenced declined 0.76 cents
25 or. We just added to the 0.7, we changed it to 0.76.

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1 On page 28, on line 13 we added the modifier test
2 year before rates to the total ECR nonletter costs. And in
3 the footnote that is associated with that, footnote 2, we
4 have added test year before rates to modify the word
5 "volume." So it should read test year before rates volume.

6 On page 29, line 12, 2.4759 cents has been changed
7 to 2.4807 cents, and the footnote has also changed. The
8 last number in the footnote now reads 1.041 instead of
9 1.039.

10 On page 36, line 16, the percentages in that line
11 have been changed from 38.3 percent to 39.8 percent, and
12 from 54.9 percent to 58.3 percent.

13 Page 53. Line 7 on page 53 we corrected the
14 spelling of "disaggregated."

15 And on page 54, line 4, the word "be," b-e, is
16 taken out.

17 Q With those corrections is your testimony true and
18 correct to the best of your knowledge and belief?

19 A Yes, sir.

20 MR. McLAUGHLIN: Mr. Chairman, at this time I move
21 that Advo-RT-1 be received into evidence and transcribed
22 into the record.

23 CHAIRMAN GLEIMAN: Are there any objections?

24 Hearing none, Ms. Crowder's testimony and exhibits
25 are received into evidence, and I direct that they be

1 transcribed into the record at this point.

2 [Rebuttal Testimony and Exhibits of
3 Antoinette Crowder, Advo-RT-1, was
4 received into evidence and
5 transcribed into the record.]
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ADVO-RT-1

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

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

REBUTTAL TESTIMONY
OF
ANTOINETTE CROWDER
ON BEHALF OF
ADVO, INC.

Communications with respect to this document should be sent to:

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Counsel for ADVO, INC.

March 9, 1998

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ATTACHMENT A AUTOBIOGRAPHICAL SKETCH

1 INTRODUCTION, SUMMARY, AND CONCLUSIONS

2 A. Introduction and Summary

3 My name is Antoinette Crowder and I am a senior consultant with
4 TRANSCOMM, Inc., in Falls Church, Virginia. I have testified before the Postal Rate
5 Commission in this and prior proceedings and my autobiographical sketch is included
6 as an attachment to this testimony. The purpose of my testimony is to address issues
7 raised in the direct testimony of ABA/NAA witness Clifton (ABA/NAA-T-1), AAPS
8 witness Bradstreet (AAPS-T-1), NAA witnesses Donlan (NAA-T-2) and Chown
9 (NAA-T-1), and USPS witness Baron (Statement in Reponse to Notice of Inquiry No. 3).

10 Following is a summary of my conclusions with respect to the testimony of these
11 witnesses. More detailed analyses are presented separately in the sections which
12 follow.

13 B. Conclusions

14 1. Rebuttal to ABA/NAA Witness Clifton

15 ABA/NAA witness Clifton criticizes the Standard A rate structure and
16 USPS witness McGrane's weight cost study, claiming that: (1) the Standard A rate
17 structure below the breakpoint is not cost based, (2) witness McGrane's weight cost
18 study is flawed, and (3) Standard A rates are being "subsidized" by First Class rates.
19 His criticisms are superficial and wrong. For ECR mail, the weight cost study is
20 reliable and shows a cost pattern that is clearly discernible, consistent with the
21 underlying characteristics of the mail and postal operations, and corroborated by prior
22 studies over the last 15 years that have consistently shown the same pattern of cost

1 behavior. It demonstrates that the USPS-proposed piece-related rates and discounts
2 up to the 3.3 ounce breakpoint for ECR are appropriate. It also demonstrates, contrary
3 to AAPS witness Bradstreet's claim, that weight has little effect on costs beyond the
4 breakpoint and that the USPS proposed pound rate, although still too high, is an
5 improvement and a step in the right direction.

6 Witness Clifton's allegation that Standard A ECR is subsidized by First Class
7 Presort has no legitimate basis, economic or otherwise. His definition of subsidy is
8 strained and convoluted, especially when one of the "subsidized" subclasses (ECR)
9 makes a contribution to institutional cost which is over double either its marginal or
10 short-term incremental costs. His recommendations should be rejected.

11 **2. Rebuttal to AAPS Witness Bradstreet**

12 AAPS witness Bradstreet recognizes that in-office delivery costs are
13 piece-related, but he claims that out-of-office costs are weight-related. His attempts to
14 demonstrate his point are riddled with simplistic and unrealistic assumptions that do not
15 reflect the real world delivery environment. In particular, he ignores the substantial
16 excess delivery weight capacity available in the system and the significant flexibility
17 that supervisors and carriers have to deal with unexpected volumes. Moreover, the
18 deferrability of Standard A mail generates out-of-office cost savings because it can be
19 used to levelize carrier workloads. Therefore, despite his claims to the contrary, overall
20 delivery costs are not sensitive to weight. Finally, even if one were to assume some
21 ECR city carrier costs were weight-related, the impact on the ECR per pound cost
22 would be minimal.

1 3. Rebuttal to NAA Witness Donlan

2 NAA witness Donlan criticizes the USPS proposed Regular ECR high-
3 density and saturation discounts and recommends that the Commission retain the
4 current (MC 95-1) discount levels. In the USPS proposal, these discounts are based on
5 the combined delivery and mail processing unit cost differences among the density-
6 related categories. This is a major improvement over the prior method which ignored
7 the substantial mail processing cost differences due to the high-density and saturation
8 nature of this mail. Donlan argues that the data used by the USPS "do not represent
9 current operating conditions," that its analytical approach "accounts for DPS-related
10 mail processing costs but ignores offsetting delivery costs savings," and that the data
11 are not reliable (page 12). His conclusions are superficial and do not support his
12 proposal to retain the MC95-1 density-related rate differentials. Indeed, even when the
13 USPS-estimated ECR unit costs are adjusted to reflect his data, they still support the
14 USPS-proposed discounts. For ECR non-letters, the adjusted cost differentials are
15 substantially greater than the proposed rate differentials, reflecting very conservative
16 cost passthroughs. For ECR letters, the adjusted cost differentials are only slightly
17 below the proposed rate differentials, consistent with the valid USPS policy of
18 encouraging diversion of ECR Basic-rated letters to Automation rate categories.

1 **4. Rebuttal to NAA Witness Chown**

2 NAA witness Chown's latest version of her functionalized institutional
3 costs, so-called "weighted attributable costs," suffers the same defects as her earlier
4 R90-1 pricing scheme. Her approach, which tries to reapportion costs for pricing
5 purposes ostensibly to set prices that reflect the "benefit" each class receives from
6 institutional costs, is really an attempt to achieve higher rates for low-cost, price-
7 sensitive, high-contribution ECR mail which competes with newspapers. Rather than
8 simplifying or allowing better informed pricing decisions, her approach would
9 complicate and obfuscate the pricing process, introduce greater instability and less
10 consistency in application of the statutory pricing factors, and lead in the wrong
11 direction toward rates that are based on mechanistic cost allocations rather than sound
12 economic and market considerations. Witness Chown's approach makes no economic
13 or ratemaking sense and should again be rejected.

14 **5. Rebuttal to Witness Baron**

15 At the hearing on Commission Notice of Inquiry No. 3, USPS witness
16 Baron claimed that the mathematical model of city delivery load time presented in my
17 testimony (JP-NOI-1), and followed in the "Propositions" presented in the Presiding
18 Officer's Notice of Areas of Likely Inquiry at the Hearing, was "invalid" because the load
19 time at a stop that "gets the average volumes" does not equal the "average of the load
20 times calculated over all the stops." (TR16167) My testimony here demonstrates that
21 witness Baron's oblique criticism is misplaced. The crux of my earlier testimony – that
22 the mismatch between the LTV modeled load time and elasticities and the STS

1 estimate of accrued load time necessarily results in a substantial overstatement of
2 attributable load time costs — remains equally valid regardless of the nuance raised by
3 witness Baron. I demonstrate mathematically that even if the load time model were
4 disaggregated by stop as witness Baron seems to suggest, rather than measured at the
5 system mean volume level, the problem I identify still exists and needs to be corrected.
6 This can be done either by (1) treating the modeled LTV load time as the correct
7 measure of load time or (2) substantially adjusting downward the elasticities from the
8 LTV model that are applied to the STS estimate of load time. Under the first approach,
9 a separate fixed stop time correction is necessary, as I have proposed. Under either
10 approach, if load time variability were estimated at a more disaggregated level, as
11 suggested by witness Baron, elemental load time would be reduced even more.

12 Separately, I show that witness Baron's apparent concern that there was little
13 saturation flats volume reflected in the LTV data is likewise misplaced. There was
14 proportionately more carrier route and saturation mail volume in the system at the time
15 of the LTV test than in the 1996 base year, and there is no reason to believe that the
16 LTV models do not reflect the presence of saturation mail.

1 I. REBUTTAL TO ABA/NAA WITNESS CLIFTON

2 Witness Clifton's testimony on behalf of ABA and NAA (ABA/NAA-T-1) is a
3 strained cobbling-together of unrelated issues leading to wholly unsupported
4 conclusions. ABA's interest is in reducing the rates for 1-3 ounce First Class Presort
5 mail that its members use. NAA's clear interest, by contrast, is in increasing the rates
6 for Standard A mail with which its members compete. Witness Clifton tries to merge
7 these different objectives by crafting a linkage between these issues. He contends that
8 rates for 1-3 ounce Standard A mail do not cover their "incremental" costs and, from
9 there, leaps to the conclusion that Standard A mail is being "cross-subsidized" by First
10 Class Presort mail. His remedy is to finance his proposed reductions in First Class
11 Presort extra-ounce rates (ABA's objective) by raising rates for Standard A mail (NAA's
12 objective).

13 My testimony shows that (1) Clifton's criticisms of USPS witness McGrane's
14 Standard A weight cost study are superficial and unjustified, (2) his claim that the
15 Standard A rate structure below the 3.3-ounce breakpoint is not cost based is wrong,
16 and (3) his contention that the Standard A rate structure somehow results in a
17 cross-subsidy between Standard A mail and First Class mail is frivolous.

18 My testimony also shows that AAPS witness Bradstreet's opposition to the USPS
19 proposed pound rate for ECR mail is unfounded because the proposed pound rate very
20 substantially exceeds ECR pound-related costs.

1 **A. ECR Cost and Rate Structure**

2 **1. ECR 1996 Weight Cost Study**

3 Witness Clifton criticizes two aspects of the USPS weight cost study
 4 which he finds "anomalous" or "peculiar:" (a) the first-ounce cost is higher than that for
 5 second and third ounces, and (b) unit costs for several ounces beyond the 3.3-ounce
 6 breakpoint are lower than the first-ounce cost. These facts are neither anomalous nor
 7 peculiar but reflect the actual makeup and cost characteristics of the mail.

8 To demonstrate this, I have refined USPS witness McGrane's weight cost study
 9 to show unit costs by ounce increment for letters and flats, separately, for (1) ECR mail
 10 unadjusted for worksharing differences, (2) ECR basic presort mail which is not drop
 11 shipped, termed here as "non-workshared" mail; and (3) ECR saturation mail which is
 12 drop shipped to the destination delivery office, termed as "100% workshared" mail.
 13 These are derived by applying the discount-related cost differences identified by the
 14 USPS to the corresponding volumes and costs provided by witness McGrane in LR
 15 H-182. In addition, several other adjustments to the LR H-182 data and method were
 16 made:

- 17 ● Costs which were based on cost data by shape from LR H-108 have been
 18 adjusted to reflect the latest revisions to LR H-108.
- 19 ● Volumes, weight, and cubic feet have been adjusted to match LR H-108
 20 (i.e., the RPW figures).
- 21 ● Letter volumes and costs below the breakpoint were identified and are
 22 called "letters" in this testimony.

- 1 • Above the breakpoint, all volumes and costs identified as "letters" in LR
2 H-182 are instead included in the volumes and costs of "flats," since
3 letter-shaped mail over the breakpoint is treated for rate purposes as non-
4 letters.

5 The resulting costs by weight increment are shown at the end of this section in
6 Figure 1 for flats, and in Figure 2 for letters. For both letters and flats, costs in the first
7 ounce increment are higher than for subsequent increments up to three ounces (*i.e.*,
8 near the piece/pound breakpoint). For non-workshared flats beyond the breakpoint,
9 the pattern of unit costs gradually increases with moderate fluctuations, except for a
10 sharp upward spike at the final 15-16-ounce increment. For 100%-workshared flats
11 beyond the breakpoint, the pattern of unit costs is relatively flat throughout most of the
12 range, with a similar spike in the last weight increment. These results fully support the
13 USPS-proposed ECR rate structure with (a) a uniform minimum-per-piece rate through
14 at least the 3.3-ounce breakpoint, and (b) a substantially lower pound rate above the
15 breakpoint.

16 Contrary to Witness Clifton's claim, the higher unit costs in the first ounce
17 increment for both ECR letters and flats and the declining costs over several ounces
18 beyond the breakpoint are not "anomalous." In fact, those results reflect the real
19 makeup and cost characteristics of the mail. At least two factors contribute to this cost
20 pattern. First, a portion of letters and flats under one ounce, because of their light
21 weight, tend to be flimsy and more difficult to handle in piece-related processing and
22 casing functions. Second, non-workshared basic letters and flats have a low address
23 density which, coupled with light piece weight, tends to result in less efficient

1 containerization and packaging than heavier weight pieces. This can cause less
2 efficient handling and extra bundle/piece handling prior to being sent to the delivery
3 carrier. These preparation-related efficiencies counterbalance weight-related
4 transportation costs over the first several ounce increments. As discussed below, this
5 higher cost for pieces under one ounce is hardly new and has shown up consistently in
6 every weight cost study presented over the last 15 years.

7 With respect to Standard A "weight-related" costs, witness Clifton's only two
8 points are that "more trays" are needed for 2-ounce than for 1-ounce letter mail and
9 that letter automation throughputs decline with increasing weight.¹ His "more trays"
10 argument ignores the efficiencies mentioned above:

- 11 • A 1-ounce ECR basic mailing with 20 pieces per carrier route would fill
12 only a tiny portion of a carrier-route tray and would have to be prepared
13 as bundles in a 5-digit or even 3-digit tray, requiring extra bundle sorts for
14 distribution to carriers. A 2- or 3-ounce basic mailing would, as mailing
15 density increased, permit preparation as full 5-digit or carrier route trays
16 that bypass sorting steps and, perhaps, do not have to be unbundled.
- 17 • For ECR basic flats, as piece weight increases, there are improved
18 containerization efficiencies that likewise bypass extra handling prior to
19 reaching the carrier.

20 His "automation throughput" argument is also simplistic. While some ECR letters may
21 undergo DPS processing, unlike First Class Presort, they require no other sortation.
22 And, none of the 58% of the subclass represented by non-letters requires automation.
23 In any event, any such automation costs caused by ECR are already included in the
24 ECR unit costs shown in Figures 1 and 2. Thus, witness Clifton has presented no

¹ His only analysis of the effect of weight on Standard A costs is his "brief evaluation" in Appendix A, pages A.11-12.

1 sound reason for disregarding the clear pattern of ECR unit costs over the 0-3 ounce
2 range.

3 He also questions the ECR weight cost study results in the higher weight ranges,
4 claiming that "the results for higher weights are even more peculiar." (Appendix A, page
5 A.11) His concerns are misplaced. The pattern of cost for ECR mail, even above the
6 breakpoint where the volumes eventually become thinner, is clearly discernible and
7 expected.¹ Adjusting the weight cost data to reflect non-workshared and 100%
8 workshared mail smooths out the pattern shown in the original aggregated results that
9 apparently form the basis of witness Clifton's cursory analysis.

10 The only two obvious anomalies are a drop at the 12-13-ounce increment and a
11 significant upward spike at the last 15-16-ounce increment. These two increments
12 have only about 34 million and 11 million pieces, respectively, out of the total of over
13 16 billion ECR flats, constituting only 0.2% and 0.1% of total ECR flat volumes.² Given

¹ The cost pattern over the first seven ounces (the range addressed by Clifton), is particularly reliable because it encompasses 98% of total ECR volumes. Almost 86% of the ECR flat volume is in the 1-7 ounce weight cells, where there is a very shallow positive slope to the non-workshared curve, while slightly more than 3% of the volume is in the 7-16 ounce weight cells where the non-workshared curve steepens.

² Of all the weight increments, the 15-16 ounce increment is the one most clearly out of line with the overall pattern. The cost jumps about 8¢ in this one increment, double the next largest increment-to-increment variation. Although there is no clear explanation other than a data anomaly due to the very small volume in this increment, almost 98% of the mail in this increment is ECR basic rate mail. Thus, the big jump in the unit cost for "100% workshared" mail (*i.e.*, saturation DDU mail) in this increment is not a true cost effect, but a purely mathematical byproduct of the aberrationally high cost for basic level mail which overwhelms the adjustments for worksharing cost differences. In addition, the average weight for mail in this 15-16

(continued...)

1 these relatively small volumes in the very high weight increments, some anomalies are
2 not surprising. The important point is that even with these two anomalies, the overall
3 pattern of costs over the entire weight range, even above 8 ounces, is still quite clear.
4 If the data were truly unreliable, one would expect the unit costs to be wildly scattered
5 in no discernible pattern, which is clearly not the case.

6 **2. Reliability And Consistency With Prior Weight Cost Studies**

7 The consistency of the 1996 weight cost study results with prior such
8 studies of BRR and carrier route further confirms its reliability. If the data were
9 unreliable, one would expect that different studies from different years would show
10 dramatically different patterns. That is clearly not the case. There have been at least
11 three prior cost weight analyses of BRR and/or carrier route mail that show the same,
12 consistent overall pattern in cost behavior: (1) a study of 1993 IOCS costs for BRR
13 carrier route mail conducted by Christensen Associates, contained in LR-MCR-12 in
14 Docket MC95-1; (2) a study of 1989 IOCS tallies for BRR carrier route letter mail
15 prepared by the Office of Consumer Advocate; and (3) a study of 1982-1983 BRR costs
16 presented by USPS witness Madison in Docket R84-1.

17 For ECR letters within the 0-3 ounce range, Figure 3 compares the 1996 results
18 with the Christensen 1993 results and the OCA 1989 results. Although the absolute
19 cost values from these three studies differ, the overall cost pattern is the same. In each
20 case, the costs for the 0-1 ounce increment are higher than for the next two ounce

²(...continued)

ounce increment is exactly 16.0 ounces, suggesting that it either contains some non-
ECR mail weighing in excess of 16 ounces or some data error.

1 increments, consistent with both the 1996 weight cost study and my explanation of
2 them.¹ This disproves Clifton's implications that witness McGrane's 1996 results for
3 letters under 3 ounces are either unreliable, aberrational, or "anomalous."

4 This same consistency with prior studies applies as well to the ECR overall cost
5 pattern beyond 3 ounces. Figure 4 compares the non-workshared flat costs for 1996
6 and 1993. The curves are remarkably similar. In both, unit costs decline after the first
7 ounce increment, level off for several increments, and then gradually increase with
8 weight. The 1996 curve begins increasing at an earlier point around 5 ounces and has
9 a slightly greater slope because it includes weight-related transportation costs not
10 included in the 1993 IOCS-only costs.

11 This same cost pattern appears in the 1982-1983 study, shown in Figure 5.
12 Witness Madison's results include total costs for all BRR mail (carrier route and
13 non-carrier route combined). The same general pattern emerges though: a significant
14 decline beyond the first ounce increment, relatively flat costs beyond the breakpoint,
15 and an upward slope beyond 8 ounces. The fact that all these studies, conducted over
16 a 15-year span, show a consistent weight cost curve confirms that the curve developed
17 from the 1996 weight cost study is neither "anomalous" or "erratic."

¹ The 1996 figures show a narrowing of the cost difference between under-1-ounce and 1-3-ounce letters, compared to the earlier studies. This reflects the fact that a portion of ECR letters are now being barcoded and processed through automation as a transitional effort to increase DPS volumes. This requires greater handling costs than before. This effect is more pronounced in the 1-3-ounce range because the flimsiness of some under-1-ounce pieces likely prevents them from being automated.

1 **3. ECR Cost Structure And Rates**

2 The unit cost data by ounce increment in Figure 1 demonstrate that the
 3 ECR rate structure proposed by the Postal Service is sound and well-supported by the
 4 underlying ECR cost structure, contrary to the allegations of witness Clifton. Costs
 5 below the breakpoint clearly show a flat or declining relationship with weight, consistent
 6 with the proposed minimum per piece rate structure. Above the breakpoint, costs
 7 increase only moderately with weight for non-workshared mail and, through 15 ounces,
 8 scarcely at all for 100% workshared saturation mail.

9 In particular, these results also demonstrate that the USPS proposed reduction
 10 in the pound rate is not only fully justified but very conservative in relation to the low
 11 weight-related costs beyond the breakpoint, contrary to the claims of AAPS witness
 12 Bradstreet. The following table compares the unit costs, in the 2-3 ounce increment
 13 (average 2.5 oz. weight) and in the 15-16 ounce increment (average 16 oz. weight),
 14 with the Postal Service's proposed ECR rates:

15 **Costs, Rates, And Implicit Regular ECR Cost Coverages**
 16 **For 2.5- and 16-oz. Flats**

17	<u>ECR Basic, no drop ship</u>	<u>2.5 oz.</u>	<u>16 oz.</u>
18	Unit Cost	9.58¢	27.70¢
19	USPS Proposed Rate	16.40¢	58.50¢
20	Implicit Cost Coverage	171%	211%

21 ECR Saturation, DDU entry

22	Unit Cost	3.34¢	10.75¢
23	USPS Proposed Rate	11.80¢	45.20¢
24	Implicit Cost Coverage	353%	420%

1 For both non-workshared and 100% workshared ECR mail, the 16-ounce pieces have a
2 higher implicit unit contribution and cost coverage than the 2.5-ounce pieces. The
3 implicit contributions and cost coverages of saturation mail also substantially exceed
4 those of basic mail.

5 These comparisons, based on the Figure 1 unit costs in the 15-16 ounce
6 increment, substantially *overstate* costs above the breakpoint and understate the true
7 contribution and coverage of pound-rated mail. As noted earlier, the ECR unit costs in
8 Figure 1 for the last 16th ounce increment are anomalously high, way out of line with
9 the cost pattern for the other increments. If the last four ounce increments were
10 aggregated, the resulting unit cost would be sharply lower, approximately 18.3¢ for
11 non-workshared mail, in line with the cost pattern in the other increments below 12
12 ounces. If a straight "cost line" were drawn from the 3rd ounce increment to the 16th
13 ounce increment, the line would substantially exceed the unit costs in every single
14 weight increment between 3 and 16 ounces, especially in the increments beyond 8
15 ounces. Thus, an estimate of costs per pound based on the slope of that line clearly
16 overstates true weight-related costs.

17 The difference between the unit costs at 2.5-ounces and 16-ounces implies a
18 weight-related cost of about 18.1¢ per pound for non-workshared mail and 7.4¢ per
19 pound for 100%-workshared mail – *assuming* a straight-line weight-cost relationship
20 between those two points. These pound costs are only a fraction of the USPS
21 proposed 53¢ pound rate for non-drop shipped mail and 42¢ for DDU drop shipped
22 mail. However, as Figure 1 clearly shows, a straight-line cost estimate based on the

1 abnormally high 16th-ounce unit cost substantially overstates the weight-cost
2 relationship at all weight increments between 3- and 16-ounces. A far more reasonable
3 estimate of the cost curve over that range, based either on a weighting of the costs in
4 the 12-16 ounce increment or a conservative smoothing of the curve over the entire
5 3-16 ounce range would yield an even lower per pound cost.

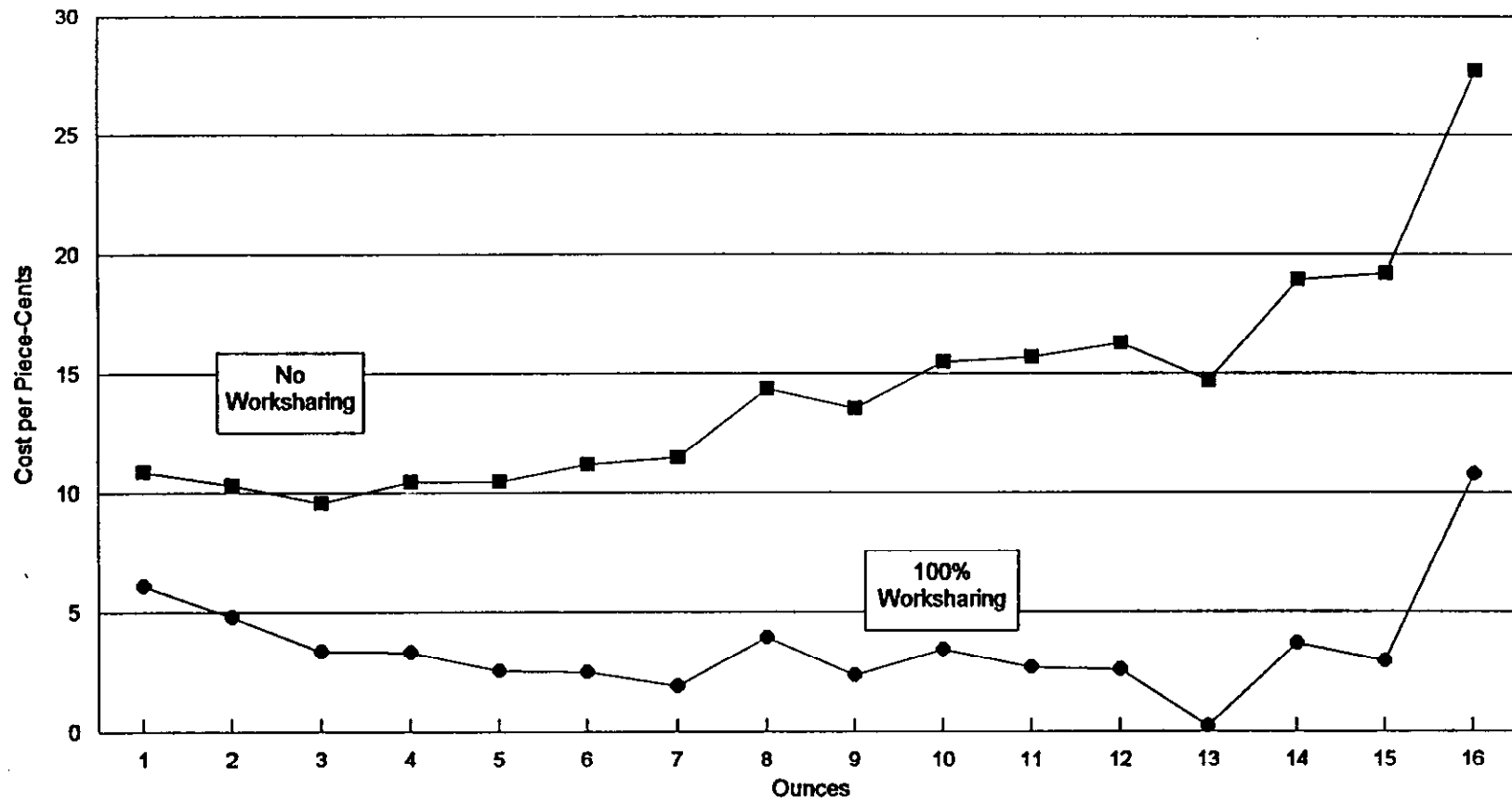
6 **B. ECR Cost Coverage**

7 Witness Clifton's justification for shifting institutional cost from First Class
8 Presort to Standard A ECR is his assertion that Standard A is "apparently" receiving a
9 subsidy from First Class. His subsidy contention, in turn, is predicated on his
10 assumption that the minimum-per-piece rate for Standard A mail under the breakpoint
11 "is not cost justified" in relation to the rate and cost for first-ounce mail. (ABA/NAA-T-1,
12 page 2)

13 As explained above, the ECR per piece rate structure over the first three ounces
14 is reasonable and justified by the ECR cost structure. There is no conceivable cross
15 subsidy because the rates charged for second- and third-ounce ECR mail far more than
16 cover their costs. This lynchpin of witness Clifton's cross-subsidy argument is simply
17 wrong. Beyond that, his strange concept of cross subsidy bears no relation to the
18 correct and accepted economic and regulatory concepts. Given that Standard A, and
19 ECR in particular, make a large contribution to institutional cost, his definition of
20 subsidy comports with no legitimate economic definition. His use of the modifier
21 "apparent" indicates his own discomfort with this assertion. Following
22 cross-examination, he also provided a written response which alleges, without any

1 support, that Standard A does not cover its incremental costs. (2/27/98 Answers of
2 ABA and NAA Witness Clifton to Questions Posed During Hearing)
3 Witness Clifton's is an extremely strained and convoluted definition of subsidy,
4 especially when one of the supposedly "subsidized" subclasses, ECR mail, makes an
5 institutional contribution that is more than double its marginal or short-term incremental
6 costs. As shown in Clifton's own Table 1, the proposed cost coverage of ECR is over
7 228%. Even if Clifton were correct in his assertion about "below cost" rates for
8 second-and third-ounces of Standard A mail (which he clearly is not), there would still
9 be no legitimate basis to claim a "cross-subsidy" between Standard A Regular/ECR and
10 First Class.

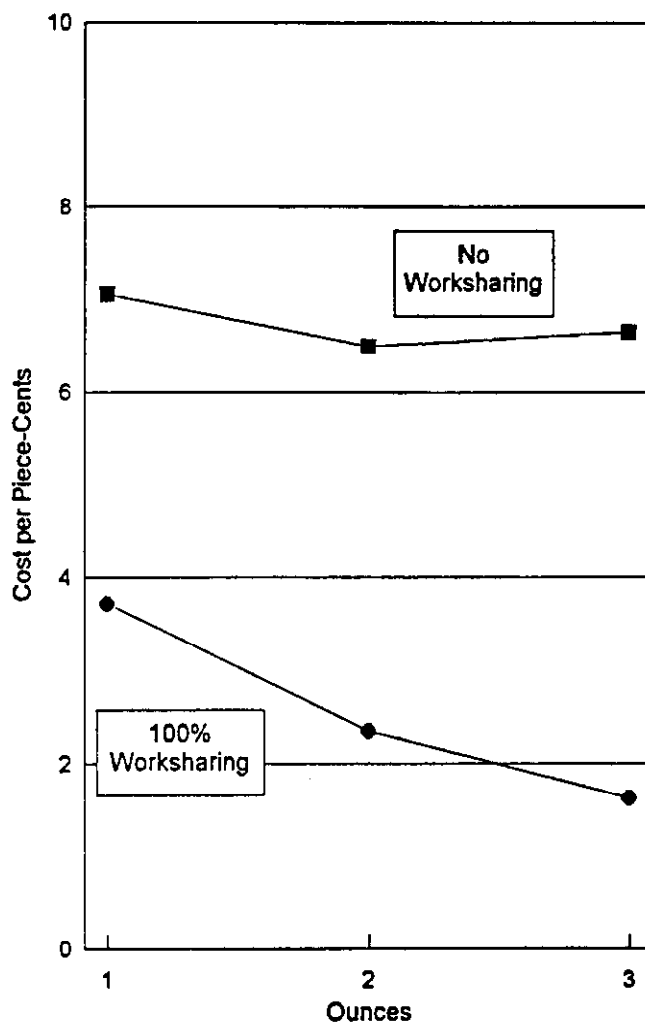
Figure 1
Average Cost per Piece
1996: ECR Flats



Sources: LR-H-182 adjusted (see ADVO Library Reference).

Figure 2

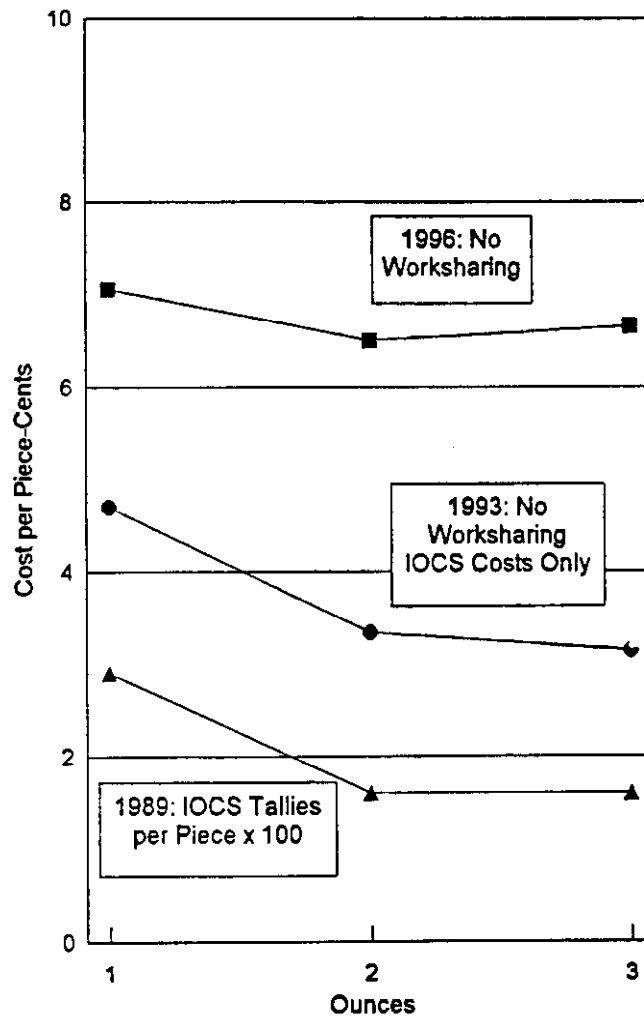
Average Cost per Piece 1996: ECR Letters



Sources: LR-H-182 adjusted (see ADVO Library Reference).

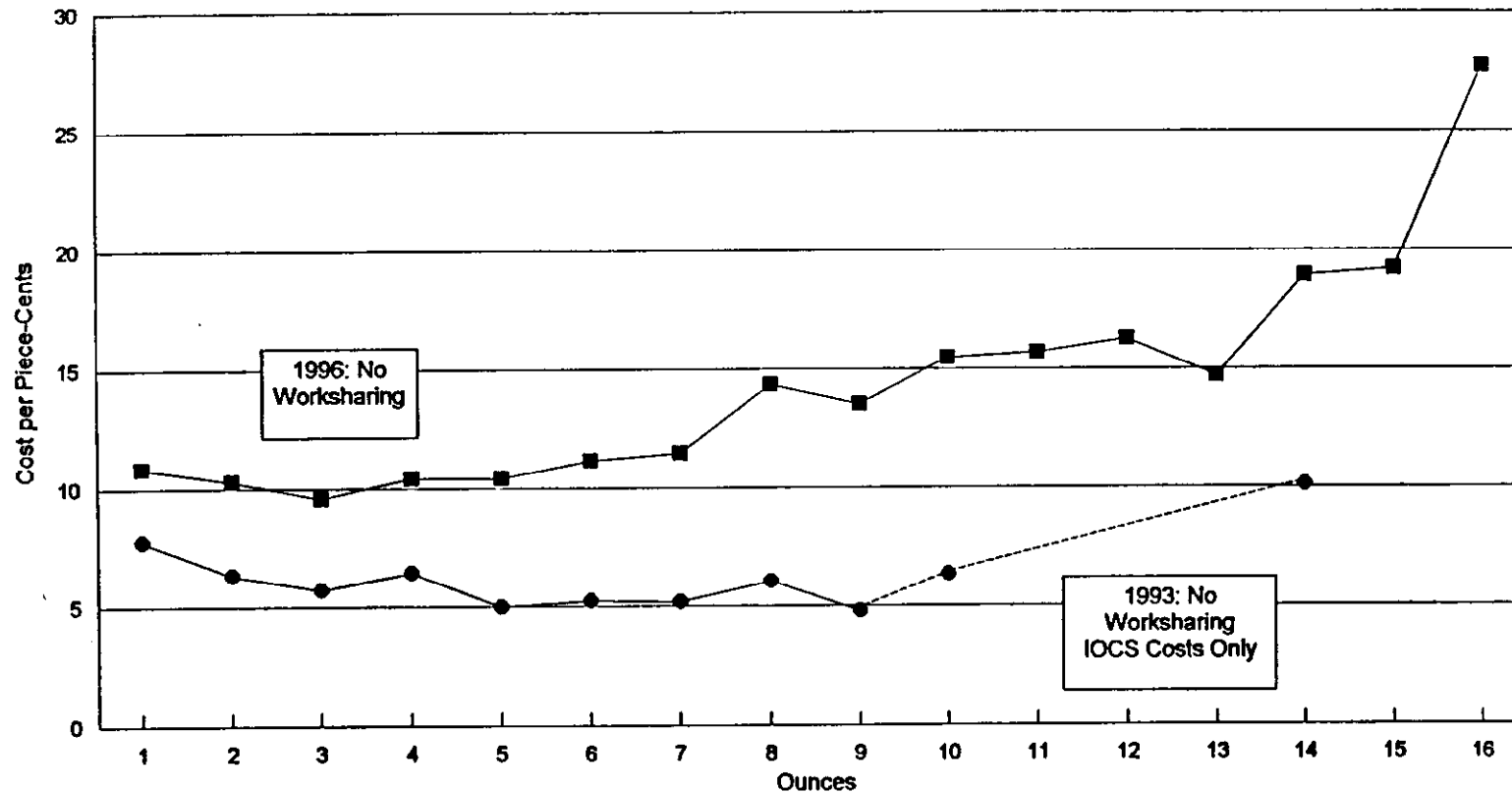
Figure 3

Average Cost per Piece 1989, 1993, and 1996: Letters



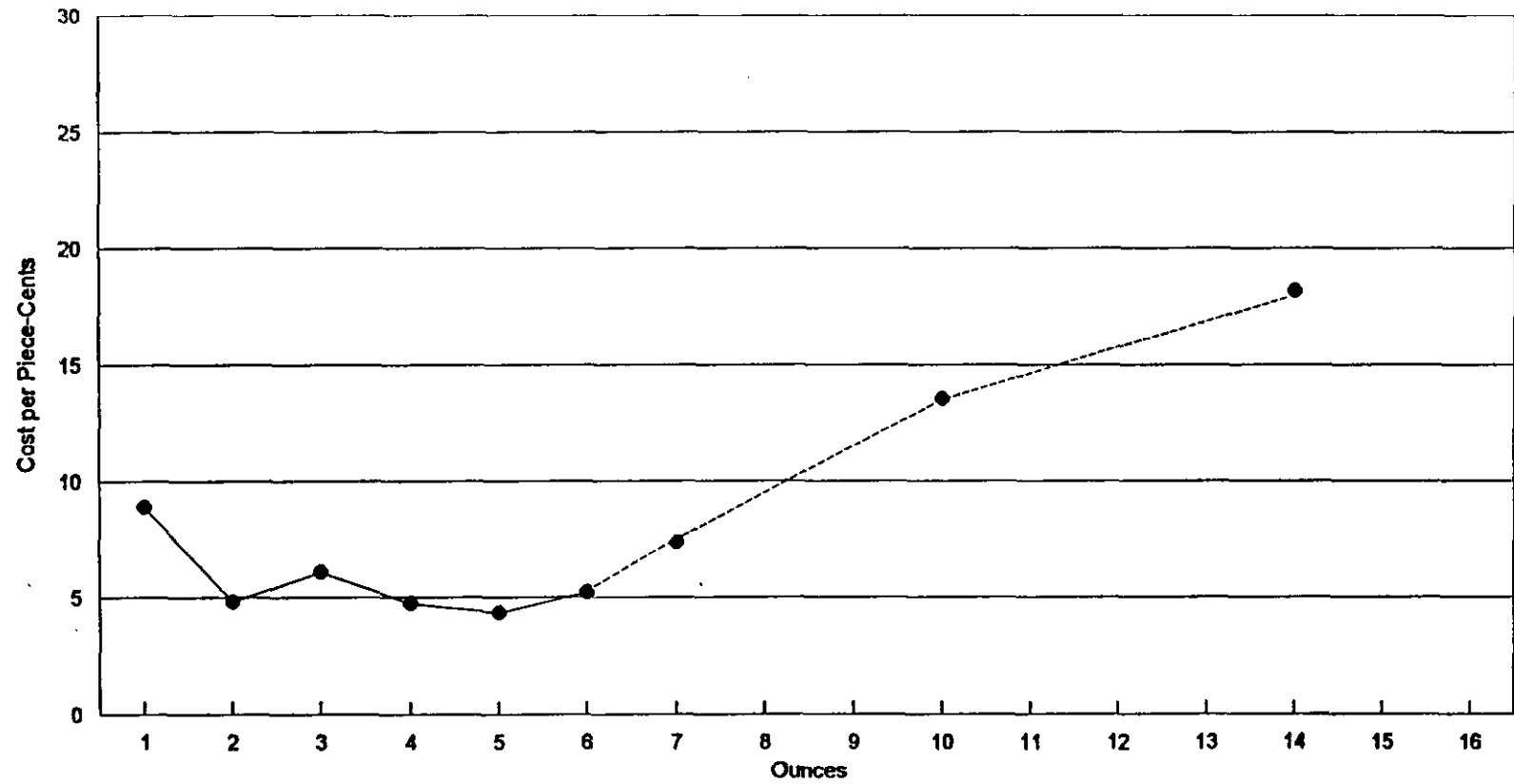
Sources: 1996: LR-H-182 adjusted (see ADVO Library Reference).
 1993: LR-MCR-12 adjusted (see ADVO Library Reference).
 1989: Report of the Office of Consumer Advocate, "Third-Class Weight-Shape Cost Study," Feb. 27, 1989.

Figure 4
Average Cost per Piece
1993 and 1996 No Worksharing: Flats



Sources: 1996: LR-H-182 adjusted (see ADVO Library Reference).
1993: LR-MCR-12 adjusted (see ADVO Library Reference).

Figure 5
Average Cost per Piece-Unadjusted
1982-83 BRR Letters and Flats Combined



Source: USPS-RT-8 (R84-1)

1 **II. REBUTTAL TO AAPS WITNESS BRADSTREET**

2 Although AAPS witness Bradstreet recognizes that in-office delivery costs are piece-
3 related, he claims that out-of-office costs are weight-related and attempts to demonstrate his
4 point with a simplistic, unrealistic example of a large increase in saturation mail weight and its
5 effect on a city carrier park and loop route. His flawed conclusions are based on
6 misconceptions about (1) the characteristics of typical route, loops, stops and volumes in the
7 postal system, (2) the delivery weight capacity in the system, (3) the factors that affect carrier
8 loops and workload, and (4) the flexibility within the system to handle additional volume
9 efficiently.

10 **A. City Carrier Loops and Weight**

11 In his testimony, witness Bradstreet poses a hypothetical purporting to show the effect
12 on carrier park and loop time of increasing the weight of a saturation mailing from 0.25 to 3.3
13 ounces, on a route with 600 deliveries. (AAPS-T-1, page 37) His hypothetical does not
14 account for the fact that routes are made up of numerous small loops. He also assumes that
15 the volume of other mail was already at or near the 35-pound satchel weight limit. In response
16 to a USPS interrogatory asking him to elaborate on his hypothetical assuming the route was
17 divided into ten separate loops, witness Bradstreet claims that the carrier would still have to
18 make many extra trips to deliver the mail. (USPS/AAPS-T1-18) As discussed below, this
19 example is extreme in its assumptions about typical route characteristics and extra trips.

20 **1. Number of Stops on a Loop**

21 Witness Bradstreet's discussion is based on a hypothetical carrier route with
22 600 stops divided into 10 loops, averaging 60 stops per loop, with each loop close to its 35
23 pound weight constraint. This example, however, is highly atypical. USPS data from a
24 representative sample of residential park and loop routes, taken in 1986, show that the

1 average loop covers only 25.1 stops per loop – less than half the number in witness
 2 Bradstreet's example.¹ Of all the loops, only 3% contained 60 or more stops.
 3 The average mail weight per stop, based on CCS data, was 12.5 ounces in 1986 and
 4 12.8 ounces in 1996.² Both figures produce an average of about 20 pounds of mail per loop,
 5 far below the 35-pound limit and leaving ample capacity to easily accommodate witness
 6 Bradstreet's additional 3-ounce per stop (5 pounds per loop) weight increase.
 7 Even this may understate the available capacity on typical single-delivery stop loops,
 8 because the above data for both average stops per loop and average weight per stop include
 9 that for dismounts and short loops which serve high-volume stops such as businesses and
 10 multiple-delivery residential addresses.³ Dismounts are established due to permanent large
 11 daily volumes as well as non-volume reasons (e.g., delivery points that cannot be efficiently
 12 accessed from other loop walking paths). An increase in weight on these dismounts

¹ This was calculated from the 1986 Foot Access Test data, taken from a representative sample of park and loop routes, made available in USPS LR E-87. (R87-1, USPS-RT-10, page 89, and TR 9346-9347) The FAT residential park and loop data are in the ADVO Library Reference.

² Numbers of actual CCS stops and volumes by class were derived from the USPS base year costing spreadsheets for 1986 and 1996. Piece volumes for each class were multiplied by the CRA average piece weight for each class. The class total weights were summed and divided by number of actual stops. All three stop types were averaged together. This average weight per stop includes high volume stops, thus overstating the average weight on typical single-delivery residential stops. (See the ADVO Library Reference.)

³ The Foot Access Test data show that park and loop routes typically have a mix of loops that include dismount stops or short loops with only a few stops that may serve high-volume points such as multiple residential units and business strips adjoining residential areas. Of the total loops/dismounts, 17% served 10 or less stops. These data also show an average of 1.3 loops per parking point. USPS witness Nelson presents 1996 data showing that motorized carriers, including those on park and loop routes, deliver to a mix of routine loops and dismounts. On average, 56.5% of the parking points (which are closely correlated with number of loops) are dismounts. (USPS-T-19, WP 1.14)

1 does not add new discounts, but may in fact allow use of more efficient containerization for
2 the delivery, thus actually reducing carrier time.

3 A better estimate of weight per loop on "single-delivery" residential loops can be
4 obtained by factoring out high volume stops and using a more representative average weight
5 per single-delivery residential stop. If the 17% of loops/discounts with 10 or less stops each
6 are removed from the Foot Access Test data in order to eliminate most of the high-volume
7 discounts and business loops, then the number of single delivery stops per remaining loop
8 averages 29.4. Using the average daily weight of 6.6 ounces per household (i.e., delivery
9 rather than stop) from the 1995 Household Diary Study, which likely is more representative of
10 the stop weight for single delivery stops, an average "single delivery" loop receives
11 approximately 12 pounds of mail and could even more easily accommodate a 3.3 ounce per
12 stop increase.

13 In summary, the delivery system has far more capacity to handle weight volume than
14 assumed in witness Bradstreet's examples. Moreover, as discussed below, carriers have
15 substantial flexibility to deal with unexpected weight volume.

16 2. Loop and Route Restructuring

17 The relatively low average number of stops and weight per loop and the
18 resulting large weight capacity in the system are due to factors other than weight. The number
19 of city routes and loops changes periodically as a result of two piece-volume-related workload
20 drivers: (a) in-office time to case volume and (b) number of stops and deliveries which must
21 be covered. Given the permanent non-volume-related conditions of the geographic coverage
22 area, (which witness Bradstreet acknowledges), each restructuring involves shifting pieces of
23 territory to create geographically contiguous routes. This involves shifting loops or pieces of
24 loops from one route to another and, sometimes, consolidating into a new route some loops or

1 pieces of loops from a few established routes. Theoretically, the result can be either more or
 2 less loops for the grouping of routes, depending upon a variety of non-volume-related factors;
 3 but, the data show and information that I have gathered indicate that generally additional,
 4 smaller loops are created from the process.

5 The non-volume-related or institutional factors affecting route and loop structuring
 6 include geographic coverage, groupings of addresses, special service requirements for
 7 particular addresses, traffic patterns, parking availability, safety, terrain, and maintenance of
 8 contiguous addresses within a route.¹ It also must account for interspersed dismount and
 9 curblane deliveries. Accordingly, excess weight capacity is not deliberately designed into
 10 loops but is an incidental byproduct of other more important route structuring considerations.
 11 Mail weight on loops is unlikely to be a factor in the creation or restructuring of routes or loops
 12 within a route.

13 3. **Delivery Deferrability**

14 Witness Bradstreet's discussion about large hypothetical increases in weight
 15 per stop and loop is also unrealistic because it ignores not only the characteristics of typical
 16 routes but also the substantial flexibility when carriers and their supervisors have to deal with

¹ For example, a major consideration is the inherent complexity of designing loops so they do not retrace portions covered by other loops on the route. Extra parking points and shorter loops minimize a carrier's total walking time. Geography and the availability of suitable parking points are also factors. Short loops with few stops may be established for cul de sacs, streets near the edges of a carrier's route adjacent to another route, portions of a route that are somewhat geographically isolated or left untraced by other loops. Terrain and spacing between stops is also a major non-volume consideration. Hilly suburban areas with widely spaced houses will have many fewer stops per loop than close-together row or town houses in a flat urban area, not because of mail weight but because the smaller loops minimize walking (and overall run) time. Safety also affects the location and number of parking points and, hence, loop size. For example, there is a need to avoid establishment of parking points on hills, busy streets, blind corners or curves, or at points requiring the carrier to walk across busy streets. The data presented by USPS witness Nelson show some of the variety of reasons why loops are created (e.g., safety, improved performance, no curbside delivery, deliveries across street, separated streets, line of travel).

1 unexpectedly high volumes. Carriers and supervisors know, even before the carrier begins
2 casing the day's mail, if they have a particularly large amount of volume to deliver. ECR
3 saturation mailings, because of their deferrability, actually give carriers more flexibility to deal
4 with unexpected volumes than do mailings of other classes.

5 With saturation mailings, the carrier can defer the entire mailing for delivery the next
6 day. Alternatively, the carrier can deliver only portions of the saturation mailing on the first
7 day, either selectively by loop or even within a loop, and defer the remaining addresses for
8 later delivery. For example, on a particular loop, by carrying out and delivering only the
9 saturation mail for the first half of the loop, and deferring the pieces for the remainder of the
10 loop, the carrier would cut in half the "additional weight per loop" that Bradstreet assumes.
11 This is, in fact, what happens in the real world.

12 The combination of the excess delivery weight capacity in the system described earlier
13 and the flexibility to deal with unexpected or unusually high mail volumes (whether saturation
14 or other mail) through deferral of all or portions of a saturation mailing, demonstrates that the
15 purported effects of weight alleged by witness Bradstreet are greatly overstated and
16 unrealistic.

17 4. Activities Associated With Loops

18 As demonstrated above, the weight effect on loops is not meaningful. Even to
19 the extent that, in some rare instances, an extra loop is required, the additional time would not
20 be nearly as great as witness Bradstreet implies. In his example, he overstates the amount of
21 loop-related workload such as additional satchel reloadings and walking. There is some
22 additional time associated with additional satchel reloadings; but satchel reloading itself
23 involves handling bundles of mail volume which must all be loaded into the satchel regardless
24 of the number of loops. Also, carriers do not depart from their line of travel to return to their

1 vehicles. Parking points are established in order to minimize run time; and drive time is
 2 efficiently substituted for walk time. That is why the data presented above show nearly a one-
 3 to-one relationship between parking points and loops associated with those parking points, so
 4 that carriers can minimize their walking time.

5 Drive time may also increase slightly as the number of loops increases; although, for
 6 an established route, new parking points are usually on the established line of travel.
 7 Moreover, since the number of loops in the system is generally unaffected by weight, the
 8 same can be said of drive time and all other loop-related activities. For these reasons, I
 9 disagree with USPS witness Nelson's attribution of park and loop drive time on the basis of
 10 weight. Nevertheless, the USPS already attributes witness Nelson's estimate of "weight-
 11 related" drive time cost. If included in the weight cost study on a per pound basis, those drive
 12 time costs, which are clearly inappropriate and excessive, would generate only a 0.74¢ pound
 13 cost.¹

14 B. Other Delivery Costs

15 Without any analysis or support, witness Bradstreet implies that other ECR delivery
 16 costs are also weight related. He is wrong:

- 17 (1) Approximately 41% of ECR delivery cost is represented by rural carrier costs.
 18 These are incurred on the basis of number of pieces by shape and relevant
 19 service characteristic. Moreover, the piece-related nature of rural carrier costs
 20 demonstrates that costs associated with curblin routes are not weight-related

¹ This is calculated as $(\$20,226 * 1.305 * 1.152) / (4,111,416 \text{ ECR pounds})$,
 where: \$20,226,000 is the ECR park and loop drive time base year cost; 1.152 is the
 street support burden, and 1.305 is the piggyback.

1 (2) The other 59% of ECR delivery cost is city carrier out-of-office cost. This cost
 2 also varies with piece volume. Elemental load varies with shape while
 3 coverage-related load and access varies with coverage-generating
 4 characteristics. For FY96, almost 42% of accrued city out-of-office time is
 5 associated with stops coverage volume characteristics; and over 15% is
 6 associated with volume shape characteristics.¹ The remaining out-of-office
 7 activities, called street support, varies to the same extent as the number of
 8 routes (i.e., total city carrier in- and out-of-office time).

9 (3) Approximately 25% of city volume is delivered by the 21% of city routes that are
 10 (non-park and loop) motorized or curblane. (ADVO/USPS-5 and 30) Further,
 11 even within park and loop routes, there are route segments that involve
 12 curblane or dismount deliveries. These types of routes and deliveries have no
 13 weight constraints.

14 C. Sensitivity Analysis of ECR Weight-Related Delivery Costs

15 In general, carrier park and loop costs are not weight sensitive. Even assuming
 16 hypothetically that they were, the amount that could be considered weight-related is quite
 17 small. Even if all ECR attributable drive time and street support were hypothetically assumed
 18 to be weight-related, the increase in the pound-related cost would be only 3.6¢.² If this
 19 amount were added to the ECR weight-related costs identified by USPS witness McGrane
 20 and in Section II of this testimony, the result would still be a pound-related cost that is only a
 21 fraction of the USPS proposed ECR pound rate.

¹ This is calculated as $(\$2,423,713 + \$730,559) / \$7,515,110 = .42$ and
 $(\$1,151,721 / \$7,515,110) = .15$.

² Calculated as $[(\$20,226 + \$94,758) * 1.305] / (4,111,416 \text{ ECR pounds})$. From
 1996 ECR base year costs.

1 **III. REBUTTAL TO NAA WITNESS DONLAN**

2 The USPS proposed discounts for ECR high-density and saturation mail are
3 based on a substantially improved cost analysis that recognizes not only delivery but
4 mail processing unit cost differences among density-related rate categories. In the past,
5 the substantial mail processing cost differences have been ignored. The USPS
6 approach represents an improvement in both tracing costs to underlying mail
7 characteristics and ratemaking efficiency.

8 NAA witness Donlan criticizes the USPS analysis and recommends the
9 Commission retain the current (MC95-1) discount levels which reflect only the delivery
10 cost differences. (NAA-T-2) He disputes the improved USPS disaggregation of mail
11 processing costs for ECR walk-sequenced (basic rated) and non-walk-sequenced
12 (high-density and saturation rated) mail on grounds that:

- 13 • "The available data do not represent current operating conditions." (page
14 12)
- 15 • "The analytical approach used by the Postal Service accounts for DPS-
16 related mail processing costs but ignores offsetting delivery cost savings."
17 (page 12)
- 18 • "The Postal Service has not demonstrated that its analysis reliably
19 measures cost differences among ECR presort tiers." (page 12)

20 His assertions are incorrect and his recommendations should be rejected. The USPS
21 proposed ECR rates are fully supportable.

1 A. ECR Non-Letter Costs and Rates

2 1. Mail Processing Unit Costs

3 The USPS develops unit mail processing cost differences between ECR
4 walk-sequence and non-walk-sequence mail using 1996 In-Office Cost System (IOCS)
5 data, which identifies time/cost proportions by both shape and walk-sequence
6 endorsement. For Regular ECR, witness McGrane (a) disaggregates the base year
7 ECR IOCS mail processing costs into letter and non-letter walk-sequencing and non-
8 walk-sequencing categories and (b) applies the appropriate piggyback factors. (USPS-
9 ST-44) Witness Daniel uses those costs to calculate dropship-normalized test year unit
10 mail processing costs for the ECR letter and non-letter density-related categories.
11 (USPS-T-29) In turn, witness Moeller converts those results to the ECR shape- and
12 density-related rates. (USPS-T-36)

13 Witness Donlan criticizes the use of 1996 cost data, claiming that they do not
14 accurately reflect costs in the post-reclass period. Of the 13 accounting periods for
15 1996, only the last 2.5 periods occurred after reclass. For the pre- and post-reclass
16 periods of 1996, he presents the ECR non-letter density-related mail processing unit
17 costs.

1	MAIL PROCESSING UNIT COST DIFFERENCES BETWEEN	
2	WALK SEQUENCED AND NON-WALK-SEQUENCED	
3	STANDARD A ECR NON-LETTER MAIL	
4	<i>Pre-Reclassification</i>	
5	Non Walk-Sequenced	2.441¢
6	Walk-Sequenced	0.277¢
7	Difference	2.164¢
8	<i>Post-Reclassification</i>	
9	Non Walk-Sequenced	1.683¢
10	Walk-Sequenced	0.218¢
11	Difference	1.465¢

12 From these data, he concludes :

13 . . . there is a substantial difference in the cost data between the pre-
 14 reclassification and post-reclassification periods . . . [and] . . . the cost
 15 difference between walk-sequenced and non walk-sequenced non-letters has
 16 declined by approximately 0.7 cents per piece since reclassification. (page 9)

17 and

18 . . . the data used by Witness McGrane to estimate walk-sequence mail
 19 processing costs are not representative of current operating conditions . . . [and
 20 that since] . . . Witnesses Daniel and Moeller rely on these data, their estimates
 21 of mail processing units costs and the proposed discounts do not properly
 22 account for the impact of new ECR preparation and entry requirements. (page
 23 10)

24 Focusing only on pre-reclass *cost differences*, he concludes that the USPS
 25 proposed discounts are too great. His alternative is to maintain the discounts at the
 26 MC95-1 level. What he ignores is the absolute decline in *cost levels* for each category.
 27 Discounts, cost savings, and passthroughs are only mechanisms used to reach the
 28 correct rate levels for each rate category. The proper emphasis should be on the cost
 29 levels for each density-related rate category.

Revised March 18, 1998

1 Witness Donlan demonstrates that the unit mail processing cost declined 0.76¢
2 or 31% in the post-reclass period while walk-sequenced unit cost declined 0.06¢ or
3 21%. Moreover, these cost savings are not reflected in the test-year results developed
4 by witness Daniel.¹ If witness Donlan's post-reclass data are correct, then ECR unit
5 costs would have to be revised as follows.

¹ The USPS roll-forward of 1996 ECR non-letter data does not include such cost savings. This is clear in witness Daniel's Exhibit USPS-29D, page 1, where she "rolls-forward" 1996 mail processing costs into the test year. Her factor of 0.9915 reconciles the 1996 cost (calculated as base year unit cost multiplied by the average wage rate increase from base year to test year) with the unit cost implicit in the test year data and USPS LR H-106. Thus, the CRA roll-forward does not include ECR non-letter cost savings of the magnitude estimated by witness Donlan.

Revised March 18, 1998

**Standard A Regular ECR
Unit Non-Letter Cost Estimates (for Discounts)**

		Mail Processing Plus Delivery	Mail Processing	Delivery
3	USPS-29C			
4	Basic	8.6042¢	2.7552¢	5.8490¢
5	Hi-Density	5.8426	0.6856	5.1570
6	Saturation	4.1816	0.6856	3.4960
7	USPS-29C			
8	(Adjusted to Reflect			
9	Cost Savings) ¹			
10	Basic	7.9778¢	2.1288¢	5.8490¢
11	Hi-Density	5.7949	0.6379	5.1570
12	Saturation	4.1339	0.6379	3.4960

13 Given his post-reclass cost savings, total TYBR ECR non-letter costs should be
14 reduced by \$71.5 million.² If witness Donlan's post-reclass data are reliable enough to
15 refute the

¹ Based on the approach described in USPS-29C, page 2, and USPS-29D, pages 1 and 3, the adjusted mail processing costs in the table are calculated as follows:

$$\begin{aligned} \text{non-walk-sequenced} \quad 1.683\phi * 1.053 * .9915 &= 1.7571\phi, \text{ and} \\ 1.7571\phi + 0.3717\phi &= 2.1288\phi \end{aligned}$$
$$\begin{aligned} \text{walk-sequenced} \quad 0.218\phi * 1.053 * .9915 &= 0.2276\phi, \text{ and} \\ 0.2276\phi + 0.4103\phi &= 0.6379\phi. \end{aligned}$$

² This is calculated as:

TYBR volume * (difference between USPS unit cost and Adjusted unit cost).

Non-walk-sequenced savings	10,706.61 * (2.7552¢ - 2.1288¢)	=	\$67.06M
Walk-sequenced savings	9,323.43 * (0.6856¢ - 0.6379¢)	=	\$4.45M
Total savings	\$67.06 + \$4.45	=	\$71.5M.

Revised March 18, 1998

1 USPS estimated cost differences, they should be reliable enough to re-estimate those
 2 cost differences and reduce test year cost levels.

3 **2. ECR Non-Letter Density Discounts**

4 Even if one believes witness Donlan's data, the USPS proposed ECR
 5 non-letter density-based rate differentials are reasonable. When the test year non-letter
 6 costs are adjusted to reflect his cost savings, the USPS proposed non-letter density-
 7 based rate differentials are substantially less than the underlying cost differences and
 8 generate extremely conservative passthroughs. Moreover, the delivery cost difference
 9 alone supports the USPS-proposed Basic to Saturation rate differential of 2.3¢. The
 10 delivery cost differences are:

- 11 • 2.353¢ for test year 1998 from USPS-29C, or
- 12 • 2.4807¢ from the MC95-1 Opinion cost differential, updated to test year
- 13 1998.¹

14 Witness Donlan's recommendation to retain the MC95-1 discount level is
 15 completely unjustified. Even if there were reason to be concerned about reclass
 16 impacts on witness McGrane's results, the extremely small passthrough of the cost
 17 difference should allay them. However, as discussed below, there is no reason to be
 18 concerned.

¹ This was derived from Table V-5 of the MC95-1 Opinion (page V-265):
 basic to saturation non-letter cost difference of 2.3830¢ multiplied by the 1995 to 1998
 weighted-average city and rural carrier wage rate ratio of 1.041.

**Standard A Regular ECR Non-Letters
Mail Processing and Delivery Test Year Cost Differences
Supporting Density Discounts**

		Differentials Basic to High-Density	Differentials Basic to Saturation
4	USPS Mail Processing		
5	and Delivery Cost (USPS-	2.7616¢	4.4226¢
6	29C)		
7	USPS Mail Processing	2.1829¢	3.8439¢
8	and Delivery Cost (USPS-		
9	29C Adjusted for Reclass		
10	Savings)		
11	USPS Proposed Rate	1.1000¢	2.3000¢
12	Passthrough (USPS-29C)	39.8%	52.0%
13	Passthrough (USPS-29C	50.4%	59.8%
14	Adjusted for Reclass		
15	Savings)		
16	MC95-1 Rate	0.8000¢	1.8000¢
17	(Implicit Passthrough	(36.6%)	(46.8%)
18	Based on Adjustment for		
19	Reclass Savings)		

20 B. ECR Letter Costs and Rates

21 Witness Donlan takes a different approach on the density discounts for ECR
22 letters; he does not even show pre- and post-reclass letter mail processing costs.
23 Perhaps this is because, relative to base year costs, the post-reclass cost difference
24 between ECR walk-sequenced and non-walk-sequenced letters has increased 1.863¢
25 or almost 136%. The majority of that increase appears to be related to increased
26 automation. Witness Donlan claims that the USPS has not recognized ECR letter
27 delivery cost savings and, therefore, the USPS cost estimates overstate the actual cost

1 difference between walk-sequenced and non-walk-sequenced letter mail, which causes
2 proposed ECR basic letter costs and rates to be too high.

3 He is wrong here as well. First, the cost differential he appears concerned
4 about is the one between basic-rated and high-density/saturation-rated letters while the
5 one he derives is the post-reclass difference between the average of automation-
6 rated/basic-rated and high-density/saturation-rated letters. Second, he fails to
7 recognize that just as the automation-related mail processing costs are included within
8 the base year ECR letter costs, so are the automation-related delivery cost savings, to
9 the extent there are any.

10 **1. Mail Processing Unit Costs**

11 The following table shows ECR letter mail processing costs. Unlike non-
12 letter unit cost which decreased, the post-reclass unit cost for non-walk-sequenced
13 letters increased 1.843¢. But, post-reclass walk-sequenced letter unit cost declined,
14 by 0.02¢ or almost 6%. A closer review of the data shows that non-walk-sequenced
15 letters experienced more automation in the post-reclass period than in pre-class as
16 reflected by the unit cost increase between the two periods. This is not surprising since
17 reclass resulted in an ECR Automation Letter rate category which did not exist before.

1	MAIL PROCESSING UNIT COST DIFFERENCES BETWEEN	
2	WALK SEQUENCED AND NON-WALK-SEQUENCED	
3	STANDARD A ECR LETTER MAIL	
4	<i>Pre-Reclassification</i>	
5	Non Walk-Sequenced	1.711¢
6	Walk-Sequenced	0.340¢
7	Difference	1.371¢
8	<i>Post-Reclassification</i>	
9	Non Walk-Sequenced	3.554¢
10	Walk-Sequenced	0.320¢
11	Difference	3.234¢

12 To develop the rate differential between basic-rated and high-density/saturation
 13 letters, however, the most appropriate cost differential is one based on either pre-
 14 reclass or average base year data: 1.371¢ or 1.570¢, respectively. The USPS choice
 15 of the latter appears more appropriate because (1) it is based on a full year of data
 16 which is substantially more reliable and (2) the related dropship characteristics are
 17 identifiable for use in normalizing unit mail processing costs among the letter
 18 categories.

19 However, the post-reclass increase in automation mail processing cost does not
 20 appear to be solely the result of the new automation carrier route letter category. From
 21 the data presented by witnesses McGrane and Donlan, it appears that basic-rate and
 22 walk-sequenced ECR letters were also automated in the base year. The former is
 23 evident from the large increases in OCR, remote encoding and platform costs for non-
 24 walk-sequenced letters while the latter is confirmed by the fact that there are BCS and

1 OCR processing costs attributed to walk-sequenced letters.¹ This is consistent with
2 USPS statements that, as a transitional step required to generate enough DPS volume
3 to ensure system-wide DPS cost savings, it automates walk-sequenced ECR letter mail
4 under certain conditions. (MC95-1, USPS-T-2, page 78; see also MC95-1, USPS-RT-
5 5, pages 28-30) Thus, it is clear that, for both the base and test years, automation mail
6 processing costs are associated with all categories of ECR letters. This is important to
7 know when assessing the extent to which the USPS has recognized the presence of
8 DPS-related delivery cost.

9 **2. Unit Delivery Costs**

10 USPS witness Hume (USPS-T-18) calculates unit delivery costs for the
11 four rate categories of ECR letters. He de-averages base-year attributable delivery
12 costs for ECR letters and then projects them to the test year along with their
13 piggybacks. Since base-year mail processing cost data show that all categories of
14 ECR letters experience automation, then it follows logically that all automation-related
15 delivery cost savings associated with that volume are included in base-year delivery
16 costs. Thus, both non-walk-sequenced and walk-sequenced letters are credited with
17 automation-related delivery cost savings experienced during the base year. And, by
18 starting with delivery costs which implicitly include these cost savings, witness Hume

¹ For example, the post-reclass period data show that BCS and OCR unit cost for walk-sequenced letters represents 31.8% of total walk-sequenced letter mail processing cost.

1 has implicitly included them in his analysis of ECR letter delivery costs.¹ Further,
 2 although apparently ignored by witness Donlan, witness Hume specifically calculates
 3 additional DPS-related delivery cost savings for automation ECR letters, recognizing
 4 the fact that the USPS intends to automate those letters to the maximum extent
 5 possible.

6 Accordingly, witness Donlan is incorrect in his assertion that DPS delivery
 7 savings have not been attributed to ECR letters. Witness Hume has explicitly identified
 8 DPS delivery savings for automation-rate ECR letters; and, to the extent there are DPS
 9 delivery savings for ECR letters, he has included them in the base and test year unit
 10 delivery costs for each non-automation-rate ECR letter category.² As a result, the test

¹ This is true for city and rural delivery costs. However, the USPS distribution key for rural non-DPS letters and rural Sector Segment/DPS letters delivered is incorrect in at least two respects. First, the non-DPS letters cost is distributed on the basis of total letters (including Sector Segment and DPS letters). This results in the ECR non-DPS letter cost being too low. (See, e.g., USPS/MPA-T3-1, 2, and 3.) Second, the Sector Segment/DPS letters cost is distributed with a faulty key, derived from an apparently outdated study, which does not recognize the substantial numbers of ECR letters that are DPS. Separately, ECR rural flat cost is also overstated by approximately \$4.0 million in the test year, with piggybacks. (Exhibit MPA 3-3, 2/11/98, shows the correction for ECR flats but does not show that the non-DPS/DPS distribution keys are flawed and therefore do not allocate DPS savings to ECR letters.) These errors should be corrected and, when correcting the distribution keys, the Commission should recognize that ECR letters also generate rural delivery DPS savings. Undoubtedly, if the distribution key is incorrect for ECR, it is likely incorrect for other subclasses as well. Since there does not appear to be a representative Sector Segment/DPS distribution key, one way to distribute these savings among the subclasses is to simply sum all rural letter costs together and distribute them on the basis of total letters.

² This analysis assumes that USPS automation of non-automation ECR letters generates a delivery cost savings relative to the delivery cost which they would otherwise incur. If, however, ECR letters are experiencing additional automation cost
 (continued...)

1 year mail processing and delivery costs for non-automation-rate letters match in terms
 2 of the automation costs and savings. However, a test-year *increase* in delivery cost
 3 savings for non-automation ECR letters, associated with witness Donlan's post-reclass
 4 increase in automation mail processing cost is not projected by the USPS, likely for at
 5 least two sound reasons:

- 6 • There is no way to measure the volume of base-year non-automation
 7 ECR letters which have been included in the DPS mailstream; and
- 8 • Diversion of non-automation ECR letters to the DPS mailstream is only a
 9 transitional step.

10 Neither of these supports witness Donlan's position.

11 3. ECR Letter Density Discounts

12 The USPS calculated cost differences among ECR letter rate categories
 13 are the most reasonable and reliable estimates available. They also make
 14 considerable sense. When converted to rate differentials reflecting near 100%
 15 passthroughs, they support the USPS policy of encouraging efficient conversion of
 16 ECR basic-rated letters to the Automation 5-Digit and Carrier Route categories.

²(...continued)

in order to increase cost savings for other letters in the system (rather than to increase cost savings which can be captured in the ECR letter delivery cost), then ECR should not be attributed the automation-related mail processing costs. Under either interpretation, however, test year ECR letter costs are overstated.

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**Standard A Regular ECR Letters
Mail Processing and Delivery Test Year Cost Differences
Supporting Density Discounts**

	Differential Basic to High-Density	Differential Basic to Saturation
USPS Mail Processing and Delivery Cost (USPS-29C)	2.1996¢	3.1066¢
USPS Mail Processing and Delivery Cost (USPS-29C Adjusted to Pre-Reclass Mail Processing Cost)	2.0082¢	2.9152¢
USPS Proposed Rate	2.1000¢	3.0000
Passthrough (USPS-29C)	95.5%	96.6%
Passthrough (USPS-29C Adjusted to Pre-Reclass Mail Processing Cost)	104.6%	102.9%
MC95-1 Rate (Implicit Passthrough)	0.8000¢ (39.8%)	1.7000¢ (58.3%)

C. Reliability of the IOCS Cost Data

Witness Donlan claims there is no indication of the reliability of the density-related mail processing cost data developed by witness McGrane. However, his apparent concern about reliability does not prevent him from drawing conclusions and making recommendations on the basis of a division of that same data into two much smaller portions: (1) a "pre-reclass period" which is approximately 42 weeks and (2) a post-reclass period which is approximately 11 weeks. He does not even attempt to explore the possibility that the data should be adjusted to (1) recognize seasonal variations in operational productivities, or (2) differences in proportions of high-density and saturation volumes or proportions of drop-shipment usage. Nor does he attempt to

1 verify that the costs and volumes for the two periods are correctly matched. For those
2 reasons alone, the partial-year data are clearly less reliable than the base-year data
3 developed by witnesses McGrane and Daniel. Yet he considers them sufficiently
4 reliable to state with certainty that there are decisive reclass cost changes which will
5 continue at that level past the base year.

6 Operationally, however, there are clear density-related mail processing cost
7 differences and witness McGrane's results are the best estimate of those cost
8 differences. In particular, they are considerably more reliable estimates than those
9 which assume there is *no* difference. Even witness Donlan does not question the
10 operational realities. There can be no other reasonable explanation for the large
11 density-related cost differences for both ECR letters and non-letters -- both in Regular
12 Rate and Non-Profit. Even witness Donlan's disaggregated pre- and post-reclass cost
13 differences are substantial. Increases in density correspond to decreases in unit cost.
14 Mailings with greater density reduce costs because:

- 15 • They are entered in more efficient containers (e.g., pallets or containers),
- 16 • They have more pieces in bundles, trays, and other containers (container
17 handling time is spread across more units), and
- 18 • They bypass certain operations that less-dense mailings require (e.g.,
19 opening and dumping 5-digit sacks, clerk/mailhandler distribution of
20 individual bundles to carrier route).

21 Given that there are clear density-related mail handling differences, as even
22 witness Donlan's own results show, it is wrong to ignore them and pretend that all ECR
23 letters and non-letters incur the same unit mail processing cost, regardless of density.
24 Costs based on such a false assumption are obviously less reliable than 1996 costs.

- 1 Even he does not question the appropriateness of density rate differentials derived
- 2 from the combined mail processing and delivery cost differentials. The USPS-proposed
- 3 ECR density-related cost differentials reflect reliable cost-tracing that is necessary for
- 4 efficient ratemaking.

1 IV. REBUTTAL TO WITNESS CHOWN

2 NAA witness Chown has again offered a version of her functionalized
3 institutional costs, fashioning "weighted attributable costs" as a basis for establishing
4 pricing markups. (NAA-T-1) It suffers the same defects as her closely-related R90-1
5 proposal. Although she has avoided discussing the effects her proposal would have on
6 rates by deferring to the Commission, its obvious aim is to substantially increase rates
7 for price-sensitive ECR mail that competes with newspapers.

8 A. Witness Chown's "Problem"

9 1. Her Ostensible Problem

10 Witness Chown claims there is a problem with the current method of
11 assigning institutional cost. According to her, the markup method can "result in a low
12 institutional cost assignment for subclasses that primarily use mail functions for which
13 few costs are attributed, even if the provision of these functions causes the Postal
14 Service to incur substantial institutional costs." (page 4) Although she does not and
15 cannot claim that low-cost subclasses are being subsidized, her illustration of the
16 "problem" involves a serious cross-subsidy among subclasses which could never occur
17 in postal ratemaking.

18 Her illustration describes three classes and two functions. Classes A and C use
19 both functions while Class B uses only one function, which happens to have a small
20 amount of institutional cost. With an equal percentage markup, she shows that Class B
21 contributes to the institutional costs of both functions, thus it subsidizes Classes A and
22 C. According to witness Chown, her approach is required in order to avoid such
23 situations.

1 However, in this example, it is easy to identify the subsidy problem. Classes A
2 and C are not covering their combined incremental costs while Class B covers more
3 than its standalone cost. A simple, straight-forward incremental cost test can identify
4 this; witness Chown's convoluted "functional" approach is not required to avoid such
5 an obvious problem. Further, this is not even a real problem for postal rates. With only
6 two minor exceptions, costs from each of witness Chown's four functional components
7 are attributed to each of the subclasses.¹ All subclasses use delivery service which
8 includes the bulk of postal institutional cost and all subclasses contribute to delivery
9 service institutional cost. As long as all subclasses recover the total of all delivery
10 service costs, there is no postal cross-subsidy problem, as witness Chown describes it,
11 and no need for her awkward and convoluted solution.²

¹ See Exhibit NAA-1B, page 2 of 2. The two minor exceptions are that Mailgrams and Nonprofit Periodicals are not attributed any window service attributable cost.

² Although the ostensible purpose of witness Chown's approach is to avoid subsidies, she ignores the most likely source of them. And, her approach could actually increase the likelihood of their occurrence. Since it links institutional cost with attributable cost, her approach shifts institutional delivery cost away from First Class and to ECR, whose rates, on average, are already set at well over two times their attributable cost. However, a significant portion of this institutional cost can be considered incremental to First Class; if First Class were eliminated from the system, there undoubtedly would be a substantial system restructuring which would eliminate a significant amount of institutional cost. Although this cost cannot be easily measured, it nevertheless exists. Since her approach would shift institutional cost away from First Class and toward ECR, it substantially increases the likelihood that (a) ECR rates may rise above their stand-alone level, and (b) First Class rates may dip below their longer-run incremental cost level.

1 **2. Her Real Problem**

2 Witness Chown's real problem is that she needs a reason to increase
3 rates for an extremely low-cost, high-contribution subclass which happens to be strong
4 competition to the newspapers, forcing them to offer innovative and reasonable-cost
5 services to their advertisers and consumers. Since witness Chown cannot find any
6 legitimate reason to increase ECR rates, she alleges that, because of worksharing,
7 ECR mail is not paying its fair share of postal institutional costs. And, she devises a
8 "metric" which blurs the true ECR marginal cost and ECR market and demand
9 conditions. Her allegations are self-serving. In fact, ECR is paying more than an
10 economically efficient share of postal institutional costs.

11 ECR mailers incur substantial fixed and variable costs to perform internal
12 worksharing, even prior to paying their postal rates. They cover their own worksharing
13 "institutional" and variable costs; they cover their postal attributable costs; and they
14 make a large contribution to postal institutional costs. Further, the presence of their
15 mail in the postal system, because of delivery scale and scope economies, reduces
16 both average attributable delivery cost and average per piece contribution for all
17 mailers. And, in the process of all this, they compete vigorously in the open market
18 among themselves and with other forms of advertising distribution and serve a variety
19 of advertisers and consumers who depend upon their availability. They make a large
20 contribution to postal institutional costs. They also make a large contribution to the
21 national economy. And, their strong presence keeps the entire advertising distribution
22 market competitive. Further, carrier route, now ECR, mailers have been doing this for

1 decades. There is nothing new in terms of ECR costs or worksharing that warrants an
2 increase in rates based on a contrived "weighting" of attributable costs.

3 Under economically efficient ratemaking, the rates for such a subclass would
4 recognize its true marginal costs which derive from the postal delivery system scale
5 and scope economies, its mailers' own internal worksharing efforts, and their particular
6 market and demand characteristics. Under these conditions, efficient ratemaking would
7 generate rates which (a) encourage the continued efficient use of the postal delivery
8 system for all mailers and (b) preserve the national economic benefits of a competitive
9 advertising distribution market. ECR attributable costs should be marked up with a
10 view towards the large and important contributions ECR mailers make to the entire
11 system and economy. This is exactly the efficient ratemaking effect that witness
12 Chown's approach is designed to offset.

13 **B. Weighted Attributable Costs**

14 In witness Chown's approach, total system attributable costs are redistributed to
15 the four postal functions on the basis of the institutional cost in those functions.
16 Attributable costs for functions with greater proportions of institutional costs are given
17 greater weight and those for functions with lesser proportions of institutional cost are
18 given lesser weight. This links institutional and attributable cost in a way that suggests
19 that attributable cost causes institutional cost. However, if there were some true
20 linkage, it would have already been identified and the "institutional" cost attributed on
21 the basis of that linkage. There is no cost-causal linkage. Because she needs to blur
22 the effect of the true marginal delivery cost to ECR, witness Chown improperly relates

1 institutional delivery costs to marginal costs. As the benefits from scale and scope
2 economies in delivery increase, her "metric" would also increase ECR "weighted
3 attributable costs." Instead of correctly recognizing the declining marginal costs and
4 increasing economic benefits of such a cost structure, her "metric" would have just the
5 opposite effect. Ratemaking based on such costs would be completely distorted and
6 generate entirely wrong price signals. Rather than benefit from such economies by
7 adding volume to the system, it would discourage the most price-sensitive volume.

8 Accordingly, witness Chown's weighted attributable costs have no economic
9 meaning. Even she acknowledges that they have no economic significance and claims
10 they are not even costs at all, but merely a "metric." (TR13307, 13311) Yet they
11 represent dollars that, for pricing purposes, are taken from the attributable costs of
12 some subclasses and added on top of those for other subclasses (notably ECR) to
13 establish a base upon which she believes pricing markups should be applied to
14 generate contributions by class. For ECR mail, her weighted attributable costs are
15 nothing more than attributable costs marked up by 65%, upon which a further markup is
16 applied to derive an additional contribution. Her "metric" should be rejected for what it
17 is: a meaningless, biased contrivance.

18 **C. Obfuscation of the Ratemaking Process**

19 Witness Chown's approach would obscure the information that the Commission
20 should have to make responsible, efficient markup decisions. It would undermine the
21 process of determining fair and reasonable rates. With her convoluted approach, the
22 Commission would have to markup something other than true attributable or marginal

1 costs. It would have to set a "markup" for a particular subclass without immediately
2 knowing the real rate level it had set or the impact of that rate level on the particular
3 subclass and its mailers. That important information would not be known until the
4 Commission translated its "markup" decisions to the real subclass attributable costs.
5 This is an extremely awkward, inefficient, and unnecessary way to set rates. Because
6 of the obfuscation, it also increases the possibility of unintended and/or absurd
7 consequences. Of course, this is just what a competitor to the postal system would
8 want to occur.

9 For example, if the USPS proposed cost coverages were applied to "weighted
10 attributable costs", the result would be a roughly 40% increase in ECR rates, with
11 reductions for many other subclasses. That result could easily be obscured by the
12 convoluted ratemaking approach by which it was developed. However, such a rate
13 increase would have a serious impact on low-cost ECR mail, the postal system, and the
14 economy. It would penalize ECR mailers which perform a lot of costly worksharing,
15 make a large contribution, and are most subject to competitive diversion. Over time, it
16 could drive such mail out of the system, leaving other mail with higher rates and
17 leaving many print advertisers with higher cost distributors and less distribution market
18 choices. Overall costs would increase for both mailers remaining in the system and for
19 advertisers diverted to alternatives. And, there would be a net loss to the national
20 economy as total advertising output would be reduced.

21 The only way to avoid such a ridiculous result would be to adopt dramatically
22 different cost coverages to retain reasonable, economically sound rates that consider

1 market and demand factors. Witness Chown essentially concedes that the current cost
2 coverage relationships would likely be inappropriate for use in marking up her
3 "weighted" attributable costs. (TR13424) The end result could well be re-weighted
4 cost coverages that, when applied to her weighted attributable costs, produce the same
5 rates as proposed by the USPS under the current approach.¹ If that is the case, then
6 why should the Commission take such a convoluted approach to get to the same
7 result?

8 **D. The Correct Approach**

9 The USPS has taken care to use the correct costing and ratemaking principles.
10 It has strived to identify correct volume-variable or marginal costs; it offers a set of
11 efficient Ramsey rates which can be used as an aid for allocating institutional cost
12 among the subclasses; and it provides short-run incremental subclass costs which can
13 be used to identify potential cross-subsidies. It also provides a thoughtful markup
14 proposal which reflects, to some extent, the market and demand conditions for each

¹ Witness Chown's approach produces other absurd results as well. It is extremely sensitive to changes in costs and costing methods. In her exhibits, she shows that under the USPS proposed costing method, the "weighted" attributable costs for ECR would be 65% higher than actual attributable costs, while First Class would have a weighted cost below actual attributable costs. Yet if the Commission were to reject the USPS proposal on mail processing variability and adopt a 100% variability, the effect under her approach would be to substantially increase the "weighting" of delivery costs and, as a result, increase the contribution for ECR mail relative to other mail, and First Class in particular. This instability would persist, requiring case by case changes in coverage relationships in order to avoid large rate fluctuations due to intervening cost changes.

- 1 subclass. These are the correct tools to use in setting efficient rates. Witness Chown's
- 2 proposal adds nothing of merit. Instead, her biased proposal unnecessarily complicates
- 3 and confuses the Commission's ratemaking responsibilities.

1 V. REBUTTAL TO USPS WITNESS BARON

2 In my testimony in response to Commission Notice of Inquiry No. 3 concerning
3 delivery carrier load time (JP-NOI-1), I present the correct approach to attribution of
4 load time, explain that the mismatch between the LTV modeled load time and
5 elasticities and the STS estimate of accrued load time necessarily results in a
6 substantial overstatement of attributable load time costs, and present a mathematical
7 demonstration of this problem. I subsequently demonstrate how the three Propositions
8 presented in the Presiding Officer's Notice of Areas of Likely Inquiry at the Hearing,
9 based on my mathematical model, confirm the correctness of my approach.

10 At the hearing, USPS witness Baron claimed that the average stop load time
11 predictions from the LTV stop load time models are invalid and that my derivation of
12 system load time variability, therefore, relied upon an "invalid initial equation." He
13 stated that using average stop volume in the models does not give average stop load
14 times. (TR16166-16167) His comments resurrect the issue of correct variability
15 calculation: should it be evaluated at the system-level mean value or at some more
16 disaggregated level?

17 In any case, under the Commission's R87-1 and R90-1 point estimate of the
18 mean value approach,¹ which witness Baron himself applied, the system-level
19 variability estimate derived by the Commission in Proposition 2 is correct. (TR16174)
20 Moreover, even if more disaggregated variability methods are used, the same
21 underlying variability measurement concepts described in my direct testimony and
22 Proposition 1 are appropriate, and the same problem I identified in my testimony – the

¹ R90-1 *Opinion*, page III-16.

1 mismatch between STS load time and LTV variability – would still exist. (TR16172-
2 16174) In any circumstance, this inherent core problem needs to be corrected either
3 by (1) treating the modeled LTV load time as the correct measure of load time for
4 application of the elemental variability or (2) substantially adjusting downward the
5 elasticities from the LTV model that are applied to the STS estimate of load time. Under
6 the first correction, a separate fixed stop time correction is necessary as I have
7 proposed.

8 Separately, witness Baron states that the LTV data contained "relatively few
9 observations on saturation flats." (TR 16155) If the LTV volumes are representative of
10 volumes in the system for that year (end of FY85 and beginning of FY86), and I have
11 no reason to believe they are not, then he is wrong. There was proportionately more
12 carrier route and saturation mail in the system in 1986 than in 1996.

13 **A. The Variability Disaggregation Issue**

14 In R90-1, ADVO witness Lerner described city carrier street time variability
15 measurement as a stops or route-level concept. (ADVO-T-1) Because the USPS uses
16 stop or route level models, variability measurement should be conducted at the
17 operational level, either as individual stops or individual routes. He demonstrated that
18 measuring system variability at mean volume (for stops or routes), as a single point
19 estimate, using the operational level models overstates the true variability when the
20 variability function is concave. However, the system level variability can be correctly

1 estimated in all cases as the cost-weighted sum of the separately developed
 2 variabilities (i.e., for each stop or route).¹

3 Witness Lerner's approach was opposed by both USPS and OCA witnesses;
 4 and the Commission chose not to adopt his or any of the other disaggregated
 5 approaches proposed by UPS and MOAA *et al.* witnesses, pending further study of the
 6 entire issue:

7 There is some substance to the arguments opposing use of the sample mean on
 8 this record. As a result, we are more cautious in our conclusion that the sample
 9 mean is generally suitable for evaluating carrier street time functions. . . . Further
 10 investigation might lead us to reevaluate the suitability of using the sample mean
 11 in other functional areas as well. (page III-16, paragraph 3035)

12 The Commission decided to evaluate variabilities at the system mean volume level.

13 **B. Interpretation of the Commission-Approved Mean Value Approach**

14 In adopting the mean value approach to load cost and variability measurement,
 15 the Commission chose to interpret the average of the stop volumes by stop type as the
 16 mean applying to all stops within the corresponding stops types. In this case, the
 17 derivation of system-wide load time variability as a function of average system-wide
 18 stop volumes, in the form shown in Proposition 1, is entirely correct. All stops are
 19 literally assumed to have constant and equal stop volumes and therefore the load time
 20 per stop is also constant and equal for each and every stop in the system. The
 21 variability so derived is interpreted as representative of the entire system load time
 22 variability.

¹ The cost-weighting approach is simply an extension of how function-level variabilities are aggregated to the system level for city carrier street time under the existing Commission and USPS approaches.

1 However with stop-to-stop variations in stop volume, these assumptions over-
 2 simplify the real situation. If there are individual stop differences in volumes, then
 3 estimating elemental load variabilities at the mean value of the stop volumes is not an
 4 accurate measure of the underlying system level relationship. With the economies
 5 indicated in the LTV models, the mean value approach overstates the true system level
 6 variability. Accordingly, a disaggregated approach to variability measurement is
 7 required to yield the correct lower elemental variabilities.¹ Even in this case, though,
 8 the total load time variability indicated in Proposition 2 must be applied in
 9 disaggregated form to yield the correct system level estimate.

10 C. A Disaggregated Approach

11 1. Disaggregated Variability Estimation

12 Ideally, correct system level variability estimation requires stops to be
 13 aggregated into homogenous groupings or strata where the underlying stop level
 14 volumes and physical characteristics are essentially the same. For ease of exposition
 15 here, these groupings are called "routes."² Modeled stop load times and variability
 16 estimates are then accurately captured and stratified according to different stop level
 17 characteristics and volumes that vary from route to route. When properly weighted,
 18 these separate variabilities, estimated as indicated by Proposition 2, can then be
 19 aggregated to determine the underlying system level relationship.

¹ The Commission called this "Jensen's Inequality." If the function is concave, the average of the function-predicted times or variabilities for the individual stop or route level volumes is less than those predicted from the function at mean level volume. (R90-1 *Opinion*, page III-15-16)

² Operationally, however, stops on a single route may differ considerably.

1 To show the essentials, assume a collection of (n) number of routes,
 2 representative of the entire system of routes, where each route represents a collection
 3 of homogenous stops. Route specific stops are homogenous in all characteristics -
 4 they all have the same stop volumes and physical characteristics that affect load time.
 5 Then for each route (i), the route-specific total load time can be indicated as:

$$6 \quad L(V_i) = g(V_i/S(V_i)) * S(V_i).$$

7 This is the functional relationship for total load time, now expressed at the route level,
 8 for route (i). Note that in this case volume per stop (V_i/S_i) is the same on each stop.
 9 Thus the actual load time per stop, $g(V_i/S_i)$, is also the same for all stops on the route.
 10 System level load time (L_s) is then given by the sum of the route specific load times:

$$11 \quad L_s = \sum L(V_i).$$

12 If load time is directly measured at the system level with the estimating relationship
 13 $L_s(V_s)$, where (V_s) is the sum of all route level volumes, then system level variability
 14 could be estimated directly using this relationship as:

$$15 \quad E = [d(L_s(V_s))/dV_s] * (V_s/L_s).$$

16 However, because the estimating relationships are at the route level, route (i) volume
 17 per stop must be used instead. Small changes in system load time (dL_s) are measured
 18 by sum of the route (i) load time changes:

$$19 \quad dL_s = \sum (dL(V_i)/dV_i) * dV_i.$$

20 Then dividing by (dV_s) gives the system level marginal change in load time with respect
 21 to system volume:

$$22 \quad dL_s/dV_s = \sum (dL(V_i)/dV_i) * dV_i/dV_s.$$

1 The marginal change in system load time is shown as a weighted average of the route-
 2 specific marginal load times. The route-specific weighting terms (dV_i/dV_s) express the
 3 marginal changes in route volumes as system volume varies. The weighting terms are
 4 essentially the probabilities that any given piece will affect a particular route.

5 With respect to these probabilities, assume that the volume variations at the
 6 system level and for all routes are proportional. For example in a two route system, this
 7 means that if volume on one route is twice as high as on the second route, then it is
 8 always twice as high, regardless of the total (system) volume. This is equivalent to
 9 saying that the probability of a piece going to the first route is always 67 percent and
 10 the probability of it going to the second route is always 33 percent. In the (n) route
 11 case, proportional variations in volume imply $(dV_s/V_s) = (dV_i/V_i)$ for all i from 1 to (n), or
 12 equivalently $(dV_i/dV_s) = (V_i/V_s)$ for all (i). Then substituting for (dV_i/dV_s) in the system
 13 marginal load time expression gives:

$$14 \quad dL_s/dV_s = \sum (dL(V_i)/dV_i) * (V_i/V_s).$$

15 System marginal load time is shown as the sum of the volume-weighted averages of
 16 the route-specific marginal load times. These weights are also the probabilities that
 17 each additional piece falls on the corresponding routes.

18 System level variability is then given by:

$$\begin{aligned} 19 \quad E &= (dL_s/dV_s) * (V_s/L_s) = \sum (dL(V_i)/dV_i) * (V_i/V_s) * (V_s/L_s) \\ 20 &= \sum (dL(V_i)/dV_i) * (V_i/L_s) \\ 21 &= \sum (dL(V_i)/dV_i) * (V_i/L_i) * (L_i/L_s) \\ 22 &= \sum E_i * (L_i/L_s), \end{aligned}$$

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1 where $L_i = L(V_i)$. This shows total load time variability as the sum of the load time
 2 weighted averages of the route-specific load time variabilities (all E_i).

3 Of course, the system load time variability derivation in Proposition 2 also
 4 applies at the route level. Applying the same steps to the route level load time
 5 expression, $L_i = g(V_i/S_i)*S_i$, it is obvious that $E_i = E_{vi} + (1 - E_{vi})*E_{si}$, where (E_{vi}) is the
 6 elemental load variability for route (i) and (E_{si}) is the stops-coverage variability for the
 7 same route. The fully disaggregated load time variability expression is then:

$$\begin{aligned} 8 \quad E &= \sum [E_{vi} + (1 - E_{vi})*E_{si}](L_i/L_s). \\ 9 \quad &= \sum E_{vi} (L_i/L_s) + \sum (1 - E_{vi})*E_{si}(L_i/L_s). \end{aligned}$$

10 The last expression shows system level variability as the sum of the cost-weighted
 11 averages of the route-specific elemental variabilities plus the sum of the cost-weighted
 12 averages of the route specific coverage-related variabilities. This is just as witness
 13 Lerner demonstrated in R90-1.¹ Of course there are other possible disaggregation
 14 levels but, in all of these, the Proposition 1 variability derivation still applies at the
 15 appropriately defined level.

16 2. Aggregation of Disaggregated Results

17 When using the USPS/Commission mean value approach, (a) total load
 18 time from which the variabilities are derived and (b) the system load time used to
 19 estimate volume variable load costs must have the same value. (TR16225-16228) The
 20 requirement is the same in the disaggregated variability approach. Correct system level
 21 variability estimation requires that the two load time values match at the system level.

¹ R90-1, ADVO-T-1, Appendix B.

Revised March 18, 1998

1 Because there is a difference between the LTV modeled (L_s) and STS system-
 2 wide load time (L_s'), this difference should be treated as fixed stop time and
 3 apportioned to individual routes on the basis of actual stops. Each of the route-level
 4 amounts is then multiplied by the appropriate route-level stop variability to determine
 5 the route-level volume variable cost adjustment. In mathematical form the system level
 6 adjustment is then described by:

$$7 \quad (L_s' - L_s) * \sum [S_i / \sum S_i] * (E_{si}) = \sum (L_s' - L_s) * [S_i / \sum S_i] * (E_{si}).$$

8 The term $(L_s' - L_s) * [S_i / \sum S_i]$ apportions the excess STS load time (*i.e.*, fixed stop time) to
 9 each route based on route shares of total actual stops. The route (*i*) volume variable
 10 fixed stop time is then $(L_s' - L_s) * [S_i / \sum S_i] * (E_{si})$, or the apportioned fixed stop time
 11 amount multiplied by the route-specific stops variability. Finally, all the terms are
 12 added to determine the system level correction.

13 **D. Saturation Volume in the 1986 USPS System**

14 Contrary to witness Baron's assertion, there was a considerable amount of
 15 carrier route saturation mail in the system in 1986. In fact, there may have been
 16 proportionately more such mail in the system in 1986 than in 1996:

- 17 • In 1986, carrier route mail was 54.9% of BRR volume. In 1996, it is only
 18 49.1% of BRR/Standard A volume, a decline of 5.8 percentage points.
- 19 • In 1986, carrier route mail was 16.8% of total domestic volume. In 1996, it is
 20 only 16.1% of total domestic volume, a decline of 0.7 percentage points.
- 21 • In 1989, 43.9% of carrier route mail was saturation while in 1996, only 35.0%
 22 of carrier route mail is saturation, a decline of 8.9 percentage points.

- 1 • In 1989, saturation mail was 22.6% of total BRR while in 1996, it was only
- 2 17.2% of total Standard A Regular.¹
- 3 Accordingly, the models adequately reflect the effect of saturation volume on load time.

¹ Sources: 1986 and 1996 Carrier Route, BRR and Total Mail data from RPW reports, adjusted for Government Mail; 1989 data from Carrier Route Special Study, LR F-199, Appendix 10; 1996 Standard A ECR saturation data from LR H-145, Section G2.

ATTACHMENT A
AUTOBIOGRAPHICAL SKETCH

My name is Antoinette Crowder and I am a senior consultant with TRANSCOMM, Inc., an engineering and economic consulting firm located in Falls Church, Virginia. I have been associated with TRANSCOMM for twenty-five years and, during that time, have been involved in a variety of projects dealing with costing, pricing, market and demand studies, economic and financial analyses, and research on numerous regulatory and policy issues. These activities have concerned the electric power, gas, communications, and postal/publishing industries. I have prepared and/or assisted in preparing numerous filings at various federal and state regulatory agencies on behalf of numerous clients. In addition, I am involved in the firm's international consulting activities, providing financial, economic and regulatory assistance to multi-national organizations, international firms, and national governments.

I have been involved in analyses of postal ratemaking and policy issues since the beginning of the R77-1 rate case. My work has involved revenue requirement, cost attribution and distribution, subclass rate structure and discounts, institutional cost allocations, service-quality measurement, demand and market assessment, and mail classification issues. I am part of the TRANSCOMM team that provides economic/financial advice on postal matters and monitors costs, financial statements, volumes, service levels, and other aspects of Postal Service operations on behalf of several clients.

I have testified before the Postal Rate Commission in six proceedings and have contributed to development of other testimony presented to the Commission. In Docket R84-1, I contributed to peak-load and second-class intra-SCF discount testimony. In Docket R87-1, I contributed to carrier-out-of-office and third-class/fourth-class Bound Printed Matter drop-ship discount testimony, and I also prepared and presented

rebuttal testimony on third-class presort discounts. In Dockets C89-3/MC89-1, I helped prepare and presented direct testimony on the proposed local saturation subclass. In Docket R90-1, I assisted in preparation of carrier-out-of-office cost and institutional cost coverage testimony and prepared and presented rebuttal testimony on third-class rates. In the R90-1 Remand, on behalf of a third-class mailer's group, I presented testimony concerning the attribution of city carrier coverage-related costs. I also presented two pieces of rebuttal testimony in Docket R94-1 and a rebuttal testimony in MC95-1.

Over the course of my 20-year involvement in postal ratemaking matters, I have had numerous opportunities to observe postal operations and have analyzed the cost aspects of those operations. I have also become familiar with economic costing and pricing concepts, both generally and as applied to postal ratemaking.

My education includes a B.S. in Biology from the University of Virginia, an M.S. in Biology from George Mason University, and additional course work in economics, mathematics and statistics.

CERTIFICATE OF SERVICE

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



Thomas W. McLaughlin

March 9, 1998

1 MR. McLAUGHLIN: Mr. Chairman, I might add that
2 the corrections she has just read have been incorporated on
3 the pages that are going into the record with a notation in
4 the upper right-hand corner that they are revised.

5 CHAIRMAN GLEIMAN: Thank you.

6 My records, and sometimes we lose a piece of
7 paper, show that two parties requested oral
8 cross-examination of this witness, Newspaper Association of
9 America and the United States Postal Service. Is there
10 another party who has cross-examination?

11 MS. BLAIR: Yes, Mr. Chairman, I'd like to do some
12 cross-examination on behalf of AAPPS, although we had not
13 previously submitted a request. We did inform Advo's
14 counsel yesterday of our desire, and it's our understanding
15 there's no objection.

16 CHAIRMAN GLEIMAN: I just thought we lost a piece
17 of paper somewhere in the system.

18 MS. BLAIR: No, your records are correct.

19 CHAIRMAN GLEIMAN: At least in that regard.

20 MS. BLAIR: At least in that regard.

21 MR. WELLS: Mr. Chairman, I would like to ask one
22 question of the witness, although I did not submit a written
23 request.

24 CHAIRMAN GLEIMAN: Well, why don't we start off
25 with -- I'm going to get the initials wrong -- Ms. Blair?

1 So I'll let you just identify them all over again.

2 CROSS EXAMINATION

3 BY MS. BLAIR:

4 Q Ms. Crowder, good morning. My name is Bonnie
5 Blair, and I'm appearing on behalf of the Association of
6 Alternate Postal Systems or AAPS.

7 Let me ask you to turn to page 17 of your
8 testimony, and specifically toward the bottom of the page
9 you have some criticism of the hypothetical dividing 600
10 stops into 10 loops. Do you see that?

11 A Yes.

12 Q The 60-stops-per-loop figure results from the
13 assumption of ten loops; is that correct?

14 A Yes.

15 Q Do you know where the ten-loop assumption came
16 from? Do you know whether that's Mr. Bradstreet's
17 assumption, or was that an assumption supplied by the Postal
18 Service?

19 A I believe Mr. Bradstreet began the example in his
20 testimony, and the Postal Service followed up, and I believe
21 the Postal Service is the one that defined the number of
22 stops per loop.

23 Q Looking at page 18 of your testimony, with respect
24 to the figure of 25.1 stops per loop, is that a median or a
25 mean?

1 A That's a mean.

2 Q So that would include small loops with very few
3 stops; correct?

4 A Yes, ma'am. It certainly would.

5 Q And I believe your figure is that 17 percent of
6 the loops have ten or fewer stops. Is that correct?

7 A Yes, ma'am.

8 Q Do you know how many loops have 50 or more stops?

9 A I have that information. I can look it up for
10 you, if you want.

11 Q Please. And for the record, would you please
12 indicate the source of your information?

13 A The source of the information is what I have
14 already described in that footnote. I am not exactly sure
15 of the question again, if you'd read it.

16 Q Sure. How many of the loops have 50 or more
17 stops, or what percentage?

18 A Ninety-four percent were less than 50. So, I
19 would assume roughly 6 percent were greater than 50.

20 Q And what percentage of the loops would have 40 or
21 more stops?

22 A Roughly 15 percent.

23 Q Looking at footnote 1 on page 18 of your
24 testimony, how many park and loop routes were in the sample
25 that you have referred to there?

1 A These were described as residential park and loop
2 routes, and there were 52 of them.

3 Q Fifty-two samples or 52 examples in the sample,
4 correct?

5 A There were 52 routes that were sampled.

6 Q And how do you know that it was a representative
7 sample?

8 A This data was presented in R87 as the foot access
9 test data, and at that time, intervenors questioned Mr.
10 Peter Hume, who presented this information, and one of the
11 pieces of information that came from that questioning was
12 his sample design.

13 The transcript cite that is in this footnote
14 describes his sample design. I can read that for you if you
15 wish.

16 The sample design looks reasonable to me. It's a
17 very brief description, and that is what I have.

18 Q So, you're relying on your review of his sample
19 design.

20 A I am relying on the fact that Mr. Hume, who, at
21 that time, was handling quite a bit of the Postal Service's
22 data collection for city carrier time, presented it. It was
23 accepted.

24 The information in that sample, taken from that
25 sample, was used to develop rates at that time, and it looks

1 reasonable to me.

2 Q What is the difference between a stop, as that
3 term is used on page 18, and a delivery, as that term is
4 used on page 19?

5 A These are terms that are used in the testing --
6 the foot access test, the curb-line access test, the LTV
7 test. When they were all developed, roughly the same time,
8 and presented by Mr. Hume, the Postal Service took care to
9 maintain consistency in those terms.

10 A stop is simply a point where the carrier stops
11 his motion, his walking motion or his driving motion, and
12 begins to deliver the mail. On that particular stop, there
13 may be several deliveries, and the simplest way for me to
14 explain it would be an example.

15 An example might be, in an apartment building,
16 where there are several blocks of mail-boxes, the blocks
17 --individual blocks of mail-boxes may be separated, but he
18 will go to one block of mail-boxes, he'll stop there and
19 begin to load mail. That would be considered a stop. Each
20 individual mail-box then would be considered a delivery.
21 When he finished that mail-box and he walks over to the next
22 mail-box, that would then be another stop with a set of
23 deliveries that went with that stop.

24 Q You show about twice as much average weight per
25 stop as average weight per delivery. Does this mean that

1 there are an average of about two deliveries per stop?

2 A No, I don't think that you can translate it that
3 way. I think that some of this data, the volume data, comes
4 from very high-volume stops that may have only one delivery
5 on them.

6 So, I'm not sure that you can translate a volume
7 ratio into a stop/delivery ratio. I'm not sure that works
8 that way. I really haven't looked at it.

9 But you have to understand that some single
10 delivery stops may be very high-volume. They may be very
11 large businesses where the carrier is bringing in a large
12 sack of pieces.

13 Q Do you know what the average number of deliveries
14 per stop is?

15 A Depends on the type of stop. You would have to
16 tell -- basically -- let me explain -- I don't have that
17 data with me, some of that data with me, but if you would
18 tell me what kind of stop you're talking about in terms of
19 number of deliveries, I may have something. So, if you could
20 tell me what it is that you're looking for, I'll see what I
21 have.

22 Q Can you generalize with respect to the number of
23 deliveries per stop?

24 A Okay, on LTV, this is the load time we have three
25 stop types, SDR, ^{is} single delivery, MDR is multiple delivery,

1 and business and mixed is what it sounds like. I honestly
2 can't remember what multiple delivery, the average number of
3 deliveries on an MDR stop was. It is in the data and I have
4 not brought that with me. There may be some of my
5 associates who have that and will look that up for you.

6 On the business and mixed stops, my recollection
7 was it was roughly two deliveries per stop for business and
8 mixed.

9 For MDR, I honestly -- it just completely escapes
10 me.

11 Q Let's use the business and mixed example of
12 roughly two deliveries per stop.

13 A Okay.

14 Q Adding an eight-ounce saturation mailing on that
15 type of route would add 25 pounds on a loop with
16 approximately 25 stops. Would that be correct?

17 A Eight ounces going to 25 stops?

18 Q Correct.

19 A I get about 12-1/2 pounds.

20 Q Remember, we are dealing with a type of group that
21 has two deliveries per stop.

22 A Yes, you're right.

23 MR. McLAUGHLIN: Excuse me. Is the assumption
24 that each stop on that route is a multiple delivery
25 residential stop on that loop?

1 THE WITNESS: This would be business and mixed.

2 MS. BLAIR: Yes, I'm using her -- I'm using Ms.
3 Crowder's description of the average number of deliveries
4 per stop on business and mixed, on a business and mixed
5 route.

6 THE WITNESS: And you're talking about this being
7 a business and mixed park and loop?

8 MS. BLAIR: Correct.

9 THE WITNESS: Okay. What you really mean is this
10 is a business route. Business and mixed is a stop type, but
11 we -- on a business route you certainly can have business
12 and mixed stops, and I will accept your assumption that you
13 could have 25 stops on that loop.

14 BY MS. BLAIR:

15 Q Let me ask it a different way. Is it not correct
16 that the amount of weight that would be added by a
17 saturation piece would depend upon not only the number of
18 stops but also the number of deliveries per stop?

19 A That's correct. That's correct.

20 Q Do you have any data on average deliveries per
21 loop as opposed to average stops per loop?

22 A No, I certainly don't have that.

23 Q In your example on page 19, you assumed that there
24 was one delivery per stop in that example; is that correct?

25 A Yes. What we were talking about here was single

1 delivery residential loops, and that is my term, in part
2 because I thought Mr. Bradstreet was really trying to zero
3 in on saturation, and saturation principally goes to
4 residential as opposed to business. So I was trying to work
5 with his description.

6 Q Isn't it the case that some residential loops have
7 cluster boxes as in apartment buildings or townhouses
8 grouped close together?

9 A Yes, that's true. However, cluster boxes are not
10 typically served on park and loop routes.

11 Q Even with your assumptions, wouldn't a --

12 A May I just back up on that?

13 Q Sure.

14 A I don't mean to explain -- cluster boxes can be
15 delivered on park and loop routes, but they are not
16 themselves considered park and loop stops. In other -- and
17 let me explain. A park and loop route can include non-park
18 and loop deliveries, so a park and loop carrier could have
19 at some point during his day a series of cluster boxes to
20 serve. They would not be considered loops, they would just
21 simply be considered curb line or dismount.

22 Q Would they be considered part of another loop, or
23 would they be excluded entirely?

24 A I don't believe that they would. If you want an
25 example of a multiple delivery that might be served on a

1 loop, an example might be some of the older neighborhoods
2 that have duplexes, and they might have mail box -- two mail
3 boxes on the same side of the door. The mailman, carrier,
4 would stop and he would load both mail boxes at the same
5 time, so that would be two deliveries on one stop, and that
6 does happen.

7 Q Even with the assumptions in your example, is it
8 not correct that the carrier would have to reload for any
9 additional piece weighing 10 ounces or more?

10 A I'm not sure exactly -- can you elaborate on the
11 question?

12 Q Sure. Looking at the assumptions in your example
13 --

14 A Which example are we talking about?

15 Q Page 19.

16 A Okay. In this one we have 29 stops per loop; is
17 that the example?

18 Q Right.

19 A And about 6.6 ounces per stop is the way we have
20 defined it now, and --

21 Q Because you have assumed that there is one
22 delivery per stop in this example.

23 A That's my example, yeah.

24 Q Okay.

25 A Now what am I --

1 Q I'm asking you to assume an additional saturation
2 piece weighing 10 ounces per more.

3 A Piece. And you want to know how much additional
4 weight that would be?

5 Q Right. And whether the carrier would have to do
6 an additional reload.

7 A I calculate that to be 30-1/2 pounds. Is that
8 --is that what you get?

9 MR. McLAUGHLIN: Excuse me. Just for
10 clarification, is that 30-1/2 total pounds including the
11 saturation mailing?

12 THE WITNESS: I am assuming 6.6 ounces as a base
13 load and then you are adding an additional 10 ounces per
14 stop.

15 MS. BLAIR: Right.

16 THE WITNESS: So that would be 16.6 ounces per
17 stop. Is that how you --

18 MS. BLAIR: Right.

19 THE WITNESS: I get 30-1/2 pounds.

20 BY MS. BLAIR:

21 Q Total?

22 A Yeah.

23 Q Okay.

24 A I think the satchel constraint is 35.

25 Q Is it true that --

1 A But let me say something else. In the case of
2 adding 10 ounces on a stop, that's quite a bit. If it did
3 happen that it did throw it over 35 pounds, let's assume the
4 rest of the volume on the stop was not six ounces, it was
5 maybe eight or 10 ounces, and that is extreme. It would
6 throw it over the satchel constraint. But the carrier would
7 know that ahead of time. There will be several different
8 things he could do ahead of time to avoid carrying 35 pounds
9 on that loop. He could split some of it to two different
10 days. I mean there would be several different things he
11 could do.

12 So even if you wanted to assume more weight for
13 that particular loop, there would be things that he could do
14 to avoid having to reloop on that particular day.

15 Q When the Postal Service commits to deliver a piece
16 for Advo on a date certain, does it honor those commitments?

17 A My understanding is -- and I haven't talked to
18 Advo recently about this -- my understanding is that that
19 mail can be delivered over two or three days. I don't have
20 precise numbers. I did have a very brief conversation with
21 Harry Buckel, and he indicated to me that 30 percent of his
22 mail was delivered on the second day. So -- and I have seen
23 numbers, Advo numbers, where there was volume delivered on
24 the first day and then some more on the second and some more
25 on the third, and I have in fact been in carrier offices

1 when that decision has been made to split some of that
2 volume to be delivered today and then a little bit more
3 tomorrow. I have actually seen them do it.

4 Q So you are not aware of circumstances where the
5 Postal Service makes a commitment for a date certain
6 delivery on Advo materials?

7 A Date certain? I don't believe so. Now there is
8 -- there are examples where volume will come in and the
9 mailer will ask or it will be on the mailing, please deliver
10 by a certain date. But that volume will have come in
11 several days ahead of time, and the office will then -- the
12 supervisors will then decide, okay, we need to deliver --
13 say the volume comes in on Monday, supervisors will say we
14 know this needs to be delivered by Friday, and they will
15 deliver a little bit each day. And if that's what you mean
16 by date certain, then that does happen, I know that.
17 Sometimes they don't even get it done by Friday, but they do
18 try that. But you have a whole five days there for it to be
19 delivered. And they will pace themselves. They do know
20 what their volumes are generally for each day.

21 MS. BLAIR: I have no further questions, Mr.
22 Chairman.

23 CHAIRMAN GLEIMAN: Mr. Wells?

24 CROSS EXAMINATION

25 BY MR. WELLS:

1 Q Ms. Crowder, you use a term on page 41, line 10 of
2 your testimony, and the terminology you use is an
3 economically ~~deficient~~^{efficient} share of Postal institutional costs.
4 Would you please define what that is?

5 A I'm sorry, sir, what line was that again?

6 Q Ten.

7 A Line 10. Yes, this is -- I am referring to
8 Witnesses Sherman and Bernstein in their direct, to me only
9 describing as an economically efficient share. I believe
10 their Ramsey price analyses define that for me, and that's
11 how I am basing it.

12 Q So your terminology means the Ramsey pricing?

13 A Yes, sir. That's exactly what I mean.

14 Q Thank you.

15 MR. WELLS: Thank you, Mr. Chairman.

16 CHAIRMAN GLEIMAN: Mr. Baker?

17 CROSS EXAMINATION

18 BY MR. BAKER:

19 Q Good morning, Ms. Crowder. I'm Bill Baker for the
20 Newspaper Association of America.

21 In an answer to a question from Ms. Blair, you
22 referred to an ADVO mailing that involved a split delivery.
23 Do you recall in what year that was?

24 A Let me make sure that I understand what -- are you
25 asking me whether -- are you talking about the ADVO data

1 that was supplied at some period in the past about when
2 their volume was delivered on the first day versus the
3 second day versus the third day?

4 Q Well, I was actually referring to the instance
5 where I think you had said that you had seen -- been in a
6 carrier office while you had seen that done.

7 A Yes, I have.

8 Q Do you recall what year that was?

9 A It was last year.

10 Q 1996.

11 CHAIRMAN GLEIMAN: Mr. Baker?

12 THE WITNESS: I believe it was '96.

13 CHAIRMAN GLEIMAN: Could you please either pull
14 the mike closer or speak up a bit? Thank you.

15 THE WITNESS: I have seen it in other years, as
16 well.

17 MR. BAKER: Okay.

18 BY MR. BAKER:

19 Q I'd like to ask you some questions about your
20 rebuttal to ABA/NAA Witness Clifton?

21 A Yes, sir.

22 Q First of all, you do not take issue, do you, with
23 Dr. Clifton's analysis of first-class costs itself, do you?

24 A I don't have a lot of experience in first-class.
25 I have not spent a lot of time looking at his first-class

1 cost analysis. I really don't want to make a judgement on
2 his cost analysis.

3 Q Okay. The thrust of your testimony is not that
4 there is some fault in what he has said about first-class
5 but, rather, in his solution and how it affects standard
6 ECR.

7 A Well, that is not entirely true. I found it very
8 strange that he was trying to compare first-class to
9 third-class, especially carrier route, given the tremendous
10 differences in the type of mail.

11 Since he was not explaining himself very clearly
12 in terms of what part of third-class he was really talking
13 about -- he was talking about carrier route -- I mean
14 third-class bulk, but I could not determine whether he was
15 talking about bulk-rate other or bulk-rate carrier route. I
16 assume he was also comparing first-class to carrier route,
17 and that simply did not make sense to me.

18 Q Well, did you have an opinion -- let me rephrase
19 it. I did not see in your testimony a critique, if you
20 will, of Dr. Clifton's analysis of the rate and cost for the
21 second and third ounce of first-class mail. Is that
22 correct?

23 A That is correct.

24 Q And apart from Dr. Clifton's issues of
25 cross-subsidy, cross-classes, and so forth, would you agree

1 with Dr. Clifton that, if there were shown to be a
2 920-percent cost coverage in the proposed rate for
3 work-shared extra ounces, that some relief might be
4 warranted?

5 A Not necessarily, and I would like to explain why.
6 I think Dr. Clifton believes that there is some problem
7 within first-class in terms of the first-class rate
8 structure. There may be -- I am not a first-class expert.
9 I haven't looked at his costs.

10 But if there is a problem within first-class, that
11 needs to be addressed within first-class. The cost coverage
12 that Dr. Clifton was describing is cost coverage for the
13 entire class versus cost coverage for standard A regular and
14 standard A carrier route, and I believe that that should be
15 considered a separate issue from within a class rate
16 structure.

17 If the Commission or the Postal Service is making
18 a proposal in terms of total cost coverage for a particular
19 class, then that is what it is. That should not have
20 anything to do with intra-class rate structure.

21 Q Is it your understanding that the 920-percent cost
22 coverage figure that Dr. Clifton used in his testimony was a
23 overall sub-class-wide figure, or was it for a smaller --

24 A My recollection was that it was for pre-sort --
25 what he called work-shared or pre-sort -- I'm not sure

1 whether it was letters alone or for pre-sort as a grouping.

2 Q All work-shared or only that portion of it that is
3 in the second and third ounce?

4 A I believe the 920 percent was his demonstration
5 for volume that weighed more than one ~~once~~ ounce.

6 Q To your knowledge, has the Postal Service -- oh,
7 never mind that. All right. Turning to your testimony at
8 page 8 and 9, you suggest two factors as possible
9 explanations for cost behavior for the first couple of
10 ounces of ECR mail.

11 A What lines are you referring to?

12 Q They start at lines 19 and 20.

13 A I'm sorry. I didn't hear.

14 Q Nineteen and 20.

15 A Nineteen and 20. Yes.

16 Q And the first one is that a portion of the ECR
17 letters and flats under one ounce may -- because ^{they are} ~~the~~ light
18 tend to be flimsy. I have heard this hypothesis in past
19 cases, and I believe even from you in maybe 1990. To your
20 knowledge, has the Postal Service studied this hypothesis to
21 see if it is true or not?

22 A Yes, it has.

23 Q And when was that?

24 A It was in a 1985 industrial engineering study.
25 And it was very interesting, the results of that study.

1 Q Have they done one since then, to your knowledge?

2 A No, that was a very time and cost consuming study
3 and I believe that they -- again, this is my recollection,
4 that it didn't appear to be generating enough information to
5 warrant its cost.

6 Q Do you know if the Postal Service has conducted,
7 or taken another look at the issue in light of the new
8 automation equipment that is now used in processing mail
9 that may not have been in use in 1985?

10 A Now, again, we are talking about the effect of a
11 flimsy piece on carrier casing?

12 Q Well, your testimony refers to piece-related
13 processing and casing functions.

14 A Okay. In terms of processing, I would define
15 processing as mail processing sortation, sortation at a
16 Postal processing facility, going through machines, letters,
17 carrier route letters will do that. Postal Service does
18 process carrier route letters to the DPS level. I don't
19 believe that Postal Service does any automation or machine
20 handling or sortation at processing facilities, piece
21 sortation at processing facilities for flats.

22 So, for the most part, when I describing -- when I
23 was writing this, I was envisioning the carrier casing the
24 mail manually, for the most part, and also casing flats more
25 so than letters. But it would apply equally to letters.

1 Q So to get -- I think I had asked a question as to
2 whether, to your knowledge, the Postal Service had updated
3 this -- done another study since 1985, and is the answer to
4 that no?

5 A No. The Postal Service has not done anything that
6 I am aware of.

7 Q That's fine. Also, continuing here on page 8 and
8 9, you cited two factors that were contributing to that. I
9 want to suggest a third hypothesis and your reaction as to
10 whether you think it is a possible one. And the third
11 hypothesis I would offer is that the IOCS tally-takers may
12 mislabel two or three ounce pieces as a one ounce piece in
13 their tally-taking, is that a possible hypothesis?

14 A You certainly can call it a hypothesis, but I
15 don't believe it is true. The IOCS tally-takers are clearly
16 instructed to weigh a piece if it is a single piece at that
17 time. There is a very clear instruction for them to do
18 that, and I have to assume that they follow their
19 instructions.

20 Q Is it possible that if they handle a piece and
21 they realize it is below the break point, they may skip that
22 step and record it as a one-ounce piece?

23 A Again, you can hypothesize that, but I don't
24 believe that occurs.

25 Q At page 11, paragraph -- immediately under the

1 caption heading, you refer to several prior cost weight
2 analyses of BRR and/or carrier route mail, and the first is
3 a 1993 study of IOCS costs by ^{Christensen}~~Christianson~~ Associates; the
4 second is the 1989 IOCS tallies for BRR that the OCA
5 prepared; and the third is the Madison study from R-84.

6 Let's look at the first two there, the
7 ^{Christensen}~~Christianson~~ and the OCA ones. These were based on the IOCS
8 solely? Is your recollection that those were IOCS solely?

9 A The '93, the '93 was based on IOCS -- the costs
10 that were associated with IOCS tallies.

11 Q Okay. What about the 1989?

12 A The '89, my understanding from the reading of that
13 report was that was strictly IOCS tallies.

14 Q Do you recall if there was a time where the Postal
15 Service revamped, for ^{want}~~went~~ of a better word, the IOCS system
16 and changed the number of tally takers?

17 A That they have changed the number of tallies that
18 they take?

19 Q Do you recall when that occurred?

20 A Actually, I cannot tell you exactly the year. I
21 believe that it may have been around '93, '94, '95. I can't
22 tell you exactly when.

23 Q All right. Now, I want to move to a different
24 subject, partly because Ms. Blair covered some of the
25 questions I was going to ask you, and while a number of

1 rebuttal witnesses offered critiques of Dr. Clifton and Ms.
2 Chown's testimony, only you offered some rebuttal to Mr.
3 Donlan's, so I would like to talk about that for a while.

4 A Okay.

5 Q He was feeling -- well, not to say he was feeling
6 left out.

7 Now, one point in Dr. -- not Dr. -- Mr. Donlan's
8 testimony was to dispute the record support offered by the
9 Postal Service to justify a change in presort level
10 discounts that would recognize the difference between basic
11 on one hand and high density saturation on the other; is
12 that right as a general proposition? He was taking issue
13 with the cost support used by the Postal Service to justify
14 the proposed presort differences between basic and high
15 density and saturation.

16 A He was taking issue with the -- my understanding
17 was he was taking issue with the mail processing cost
18 differences that the Postal Service offered.

19 Q Right. So was one of his basic points that the
20 base year mail processing costs used in this case include
21 both pre- and post-reclassification data?

22 A Yes.

23 Q And of the base year, 10.5 accounting periods
24 predated reclassification and 2.5 accounting periods were
25 after reclassification?

1 A Yes, sir, that's approximate.

2 Q And did -- and Mr. Donlan questioned whether, in
3 light of that, the evidence was sufficient or is sufficient
4 to support the Postal Service proposal, correct?

5 A Yes, he questioned that.

6 Q And you take issue with him in part?

7 A Yes. I believe that he -- if he had looked a
8 little further at the data, he would have realized that even
9 if we had recognized the -- at least in respect of the flats
10 or the non-letters, that it wouldn't have made any
11 difference.

12 Q I would like you --

13 A If we had recognized the post-reclass difference
14 that he is talking about, it really wouldn't have made a lot
15 of difference anyway.

16 Q Could you turn to page 28 of your testimony, and
17 direct your attention to the sentence that begins on line
18 14.

19 A Yes.

20 Q In this section here, you are discussing Mr.
21 Donlan's testimony regarding the cost estimates pre- and
22 post-reclassification, correct?

23 A Uh-huh.

24 Q And you state that if Witness Donlan's post-
25 reclass data are reliable enough to refute the USPS estimate

1 cost differences, they should be reliable enough to re-
2 estimate those cost differences and reduce test year costs.
3 Have I read that correctly?

4 A Yes.

5 Q Did Mr. Donlan testify that the post-
6 reclassification data are good enough to use as a basis for
7 new discounts?

8 A No. I'm saying that.

9 Q You're saying it? That's you, not him. Okay.

10 A I am using it as an example to demonstrate that --
11 I'm not sure exactly what Witness Donlan thought that data
12 represented since it only is derived from the last few
13 accounting periods, but he placed a lot of emphasis on it
14 and I thought it would be interesting to see, if we were to
15 recognize it, what would happen.

16 Q Do you -- is it your testimony that the two and a
17 half accounting periods of post-reclassification data are
18 good enough to use as a basis for new discounts in this
19 case?

20 A Is it my opinion?

21 Q Your opinion, yes.

22 A No. I think that you should use the entire year's
23 worth of data. I don't believe that there is going to be
24 -; - ^{for} ~~for~~ purposes of discount, I believe that those cost
25 differences are appropriate, particularly in view of the

1 fact that the Postal Service has not estimated any
2 additional cost savings for carrier route for the test year.
3 So that what we need to do is match the base year total cost
4 level to the cost differences. That is what the Postal
5 Service did. It matched the total base year cost for
6 carrier route with the cost differences for carrier route
7 and then rolled it forward to the test year. So I believe,
8 if they have done that, then it's appropriate in the test
9 year as well.

10 Q So is it your testimony that the Rate Commission
11 should use a full year's worth of data even though it knows
12 that the base year includes a mixture of both pre- and post-
13 reclassification data?

14 A Unless and until there is recognition that there
15 is cost savings from reclass that will extend to carrier
16 route, and there is no recognition of that now, I believe it
17 is appropriate, yes, sir.

18 Q If the Commission has reason to suspect that
19 certain data no longer reflect the operational realities of
20 the postal system, should it proceed in using the out of
21 date data in setting rates?

22 A My preference would be to identify the cost
23 savings that will come to carrier route as a result of
24 reclass. If I had that information, I would have used it.
25 I would have identified all of the cost savings that should

1 go to carrier route and then attributed that in order to
2 reduce the test year cost for carrier route, and if that
3 were done, then I would also have the information because I
4 already have information on the cost savings. If that were
5 done, then I would also have information on an appropriate
6 and matching cost difference for carrier route and I would
7 use that as well.

8 Q Are you aware that the Commission extended an
9 offer to the Governors to extend the case and make use of FY
10 '97 data?

11 A I am vaguely familiar of that. I don't know
12 exactly what FY '97 data was being discussed however.

13 Q Is it possible that FY '97 data, which would
14 include a year's worth of data under reclassification, might
15 have provided better cost information than we have on this
16 record on this particular issue about the cost savings from
17 reclassification?

18 A Yes, it is possible.

19 Q Thank you. Now I want to switch gears a little
20 bit and ask you some questions about the presort tier
21 structure in ECR mail.

22 Today's rate structure does recognize the
23 difference between basic high density and saturation mail,
24 correct?

25 A Yes, sir.

1 Q And is it your recollection that these presort
2 tier differences were created in Docket Number R90-1?

3 A Yes -- for letters -- excuse me for nonletters. I
4 don't believe there was a high density tier for letters back
5 then. I could be mistaken.

6 Q And do you recall in that case whether the Postal
7 Service provided testimony in support of those differences
8 in the form of testimony by Witness Shipe?

9 A Yes, sir. I remember that.

10 Q In fact, did you offer rebuttal testimony which
11 discussed it?

12 A Yes.

13 Q Okay -- and do you recall if the analysis offered
14 by Mr. Shipe in that case based the cost differences between
15 presort tiers on differences in the speed of in-office
16 casing of the mail?

17 A He based the cost differences on productivity
18 differences, yes.

19 Q Indeed, were you in the hearing room in that case
20 on the day there was a videotape played of a postal employee
21 actually casing mail?

22 A I missed that.

23 Q Do you recall whether in Dockets R94-1 and MC95-1
24 the tier discounts in those cases were based upon the Shipe
25 analysis adjusted for labor cost differences?

1 A Yes. They used the productivities from Shipe.

2 Q Now in this case the Postal Service is proposing
3 to base the difference in tiers on differences in mail
4 processing costs as well, is that correct?

5 A Yes.

6 Q Okay -- or at least that is between the ^{basic}~~basic~~ on
7 the one hand and the high density and saturation on the
8 other?

9 A Yes, sir.

10 Q Okay -- and that is a new development in this
11 case?

12 A Yes, sir.

13 Q Okay. In this case was it Postal Service Witness
14 Hume that developed test year unit costs for carrier
15 delivery functions --

16 A Yes, it was.

17 Q And his unit costs were given to Witness Daniel,
18 who combined them, combined mail processing and delivery
19 costs?

20 A Yes, sir.

21 Q And did Witness Daniel also incorporate some
22 information from Witness McGrane's exhibit -- what is now
23 Exhibit 44-A regarding mail processing cost differences
24 between basic on the one hand and high density and
25 saturation on the other?

1 A Effectively Witness McGrane de-averaged the mail
2 processing cost into that for basic on one side and high
3 density and saturation on the other.

4 Q And Mr. McGrane did so by using the terminology of
5 walk sequence --

6 A Versus non-walk sequence.

7 Q -- and non-walk sequence? That's correct? Okay.

8 Now Mr. Donlan's testimony discussed the fact that
9 the Postal Service will sometimes process ECR basic letters
10 on automation equipment to achieve delivery point
11 sequencing, correct?

12 A I recall him mentioning something about that, yes.

13 Q And do you recall whether he pointed out that the
14 ECR basic letter mailers effectively attribute cost for this
15 additional DPS mail processing incurred in this process?

16 A I'm sorry. Would you read that again, please?

17 Q Okay. Do you recall that Mr. Donlan's testimony
18 was that the cost estimates provided in this case by Witness
19 Daniel effectively has a higher level of attributable costs
20 for mail processing as a consequence of this DPS processing
21 of the ECR mail?

22 A Yes, and I appreciate him pointing it out.

23 Q Okay. And now, Mr. Donlan's testimony goes on to
24 say that the Postal Service fails to account for DPS-related
25 delivery cost savings resulting from this processing,

1 correct?

2 A Yes, sir.

3 Q Now, in your testimony on page 31, lines 6 through
4 9, you suggest that Mr. Donlan has erred because, and I
5 quote, "He fails to recognize that just as the automation-
6 related mail processing costs are included within the base
7 year ECR letter costs, so are the automation-related
8 delivery cost savings, to the extent there are any." Did I
9 read that correctly?

10 A Yes, sir.

11 Q First, do you believe that DPS sequencing does
12 result in automation-related delivery cost savings?

13 A For the system in general, yes, I do.

14 Q Okay.

15 Now, if you may to page 23 -- excuse me -- 33 of
16 your testimony, lines 17 and 18 -- well, starting maybe a
17 little bit before -- you state that, in Witness Hume's
18 testimony, both non-walk sequenced and walk sequenced
19 letters are credited with automation-related delivery cost
20 savings in the base year, which you say is implicitly
21 included in Witness Hume's testimony, correct?

22 A Yes, sir.

23 Q Did Witness Hume estimate delivery costs for ECR
24 letter mail?

25 A He effectively -- for -- there are basically three

1 components to delivery cost -- cost segment 6, which is in-
2 office; cost segment 7 -- cost segment 6 is city carrier in-
3 office; cost segment 7, which is out-of-office for city
4 carriers; and cost segment 10, which is rural carriers --
5 and effectively, that information -- that cost information
6 is identifiable by the Postal Service related to shape.

7 In other words, it's possible to identify those
8 costs by letters, separate cost by flats, and a separate
9 cost by parcels, and he took that information and developed
10 it. He put it together, identified it. He processed that
11 information, along with the CCS volumes, and came up with
12 unit costs for the test year for letters and flats and then,
13 separately, for the three density or four density tiers for
14 letters and the three density tiers for flats --

15 Q I may have

16 A -- non-letters.

17 Q I may have used -- gave Witness Hume credit with a
18 stronger verb than he deserved. Is it safe to say he
19 presented this information in his testimony?

20 A He effectively processed the cost and volume
21 information that the Postal Service routinely collects, and
22 then, separately for letters, he de-averaged that into the -
23 - what he estimated as the automation carrier route letter
24 cost, the basic rate letter cost, and so forth. He did the
25 same thing separately for non-letters.

1 Q So, he does derive separate cost estimates for
2 each category of ECR mail.

3 A Each density-related category, yes.

4 Q And by shape?

5 A And by shape for letters and nonletters.

6 Q For letters and nonletters I believe he used the
7 word "flats," but okay.

8 Does he -- what did Mr. Hume assume about the
9 level of DPS processing received by basic ECR letter mail?

10 A He had some information. I can't recall what
11 library reference. It may have been H-129. And he
12 identified projected cost savings for automation -- for
13 automation carrier route letter mail, and associated those
14 cost savings for that mail and worked that into his test
15 year unit cost for automation letters.

16 Q Um-hum.

17 A Only for city carriers. Not for rural carriers.

18 Effectively it wasn't his fault. He just didn't
19 have that information.

20 Q Did he work that in, though, for nonautomation
21 letters?

22 A Not explicitly.

23 Q That's what's the difference between explicit and
24 implicit?

25 A That is the difference in the base year. Carrier

1 route letters, whether they were automation or
2 nonautomation, whether they were basic rate or high density
3 or saturation rate, those letters were processed through
4 automation and put into the DPS bundles, and implicitly that
5 cost savings is in the base year numbers that Hume works
6 with.

7 Q Perhaps for clarity I am going to now hand you a
8 copy of table B-6 from Witness Hume's testimony. Perhaps
9 let us follow this.

10 MR. BAKER: Mr. Chairman, I have handed the
11 witness a copy of USPS-18-B, table B-6, from the testimony
12 of Witness Hume. I do not see an errata date. This is the
13 most recent version of it I have, but we've -- we can
14 proceed at this point.

15 BY MR. BAKER:

16 Q This is entitled The Reconciliation of Standard
17 Mail Categories. Correct, Ms. Crowder?

18 A Yes.

19 Q Okay.

20 A That's what it's called.

21 Q And what we have is a list of different categories
22 of ECR standard mail -- oh, standard mail actually, not just
23 ECR but standard mail, along with basic unit costs, DPS unit
24 costs, effective unit costs, DPS unit savings and so forth.

25 Can you see that?

1 A Yes, sir.

2 Q Okay. Now when you were testifying a little while
3 ago about Witness Hume making an adjustment for automation
4 letters, is that adjustment found on line 5A of this
5 exhibit?

6 A I'm not sure what you mean by is the adjustment
7 found. I have no doubt the adjustment is reflected in this
8 line. Let me clarify.

9 Q Um-hum.

10 A Witness Hume's spreadsheets are extremely
11 complicated. I have been through them very carefully. I
12 cannot now tell you, however, exactly at what point he
13 entered the test year cost savings. But I suspect they are
14 reflected in here. In fact, I have no doubt they are. But
15 I don't believe they were entered at this point.

16 Q Okay. All right. The point is that they appear
17 in column J under the category of pre-bar-coded carrier
18 route letters, with a number. And in the enhanced carrier
19 route six categories listed there, the column J labeled DPS
20 unit saving, he has a blank. Is that correct?

21 A That's correct.

22 Q Okay. Does Witness Hume assume that each category
23 of ECR letter mail receives the same amount of DPS
24 processing?

25 A No. Let me clarify this.

1 Q Um-hum.

2 A Witness Hume takes the base year carrier costs.
3 Base year. In the base-year costs are DPS cost savings. He
4 doesn't explicitly identify them. They are buried in there.
5 ECR letters were processed in the base year to the DPS
6 level. The cost savings are recognized in the level of
7 carrier letter cost, city carrier letter cost. If they had
8 not been DPS'd, that level of carrier city carrier cost for
9 letters would be higher. There is no explicit
10 identification. I cannot give you an exact amount of cost
11 savings. But it is in there. These are IOCS costs, and
12 there is no doubt in my mind that they're in there.

13 Now on this other where we are talking about
14 automation carrier route letters, Witness Hume took
15 anticipated DPS cost savings in the test year and allocated
16 to the automation categories, and that is likely what is in
17 this line. I can trace it back for you at another time, if
18 you want. But this is talking about the anticipated cost
19 savings for the test year. I am talking about cost savings
20 that are already buried in the base year.

21 Q All right. But Witness Hume does not assume or --
22 Witness Hume does not present differences in cost savings
23 from DPS sequencing in this table, does he, between the
24 different categories of ECR?

25 A Would you repeat that?

1 Q Does Witness Hume's Table B-6 make any adjustment
2 for DPS unit costs or DPS unit cost savings within the ECR
3 categories?

4 A For automation carrier route letters, yes, he
5 does.

6 Q But not for the other categories?

7 A He does not have separate items there for the
8 other categories of letters.

9 Q Okay. Now density discounts are based upon the
10 differences in the costs between the different tiers of ECR
11 letter mail, correct?

12 A Yes.

13 Q Now if Mr. Hume has assumed that there is no
14 difference in the level of DPS processing among the various
15 tiers of ECR letter mail, then the cost differences between
16 the tiers would not reflect any differences in cost savings
17 from DPS processing, would they?

18 A Let me write this one down.

19 Q Okay. If Witness Hume assumes that there is no
20 difference in the level of DPS processing among the tiers of
21 ECR letter mail --

22 A Yes.

23 Q -- then the cost differences between the tiers
24 would not reflect any differences in cost savings from DPS
25 processing, would they?

1 A I am not sure I am answering exactly this question
2 but I'll try.

3 Hume, Witness Hume separated out automation
4 carrier route letters and treated them separately.

5 He then took the rest of carrier route letters and
6 de-averaged them, de-averaged their cost into the three
7 density tiers, three density levels. In each level there is
8 a little bit of DPS cost savings because the total amount of
9 cost -- he starts with base year cost and in that base year,
10 in that total base year cost are DPS cost savings.

11 When he de-averages that base year cost into the
12 three density levels he also de-averages the DPS. There is
13 a little bit of DPS cost savings in each of those three de-
14 averaged costs, de-averaged unit costs.

15 I believe that is appropriate given that each of
16 those three tiers contains volume that was DPS'd. It also
17 contains volume that wasn't.

18 Does that answer the question?

19 Q I am thinking about it. Do you know what
20 proportion of ECR basic letter mail is DPS'd?

21 A No. There is information in Library References
22 but I don't have it right now.

23 Q Okay. Similarly, does the same answer apply if I
24 asked the portion of ECR saturation mail that might be
25 DPS'd?

1 A Let me back up.

2 Q Okay.

3 A In the Library References that the Postal Service
4 has provided, it has an estimate of the proportion of
5 automation carrier route that is DPS'd. It has its own
6 estimate.

7 I believe it also has an estimate for -- this
8 estimate is for the test year. That is only its
9 expectation. There is no estimate that I have been able to
10 find of the amount of ECR letters, automation or non-
11 automation that have been processed through DPS.

12 There is no information that I know of -- none --
13 but I do know that it is done. I can see it in the IOCS
14 tallies and I know it because several Postal Service
15 witnesses have said so.

16 There is just simply no quantification.

17 Q Okay, and when you say that you are talking about
18 historical base year quantifications?

19 A I am talking about 1996 and actually before.

20 Q Right -- and before, right, and in fact Dr. Halldi,
21 do you recall whether he has testimony regarding Val-Pak's
22 mailings --

23 A I remember Dr. Halldi's testimony in MC95-1. He
24 even suggested a combination rate category for automation
25 saturation letters.

1 Q If I can sum up your testimony at this point then,
2 am I correct to say that it is your testimony that Witness
3 Hume presents no ECR DPS savings at a category specific
4 except for the pre-bar-coded letters, but that it's your
5 belief that any differences are reflected in the base year
6 unit costs already?

7 A I don't want to agree, because I can't remember
8 everything you said, but I will repeat what I think you
9 said.

10 Q Okay.

11 A There are DPS cost savings in the base year for
12 carrier route letters. I can't quantify them, but they're
13 there. The Postal Service has estimated additional DPS cost
14 savings for automation carrier route in the test year, and
15 that is what Mr. Hume -- Witness Hume -- has explicitly
16 identified in his spreadsheets and in his results.

17 In the test year for nonautomation ^{there are DPS} ~~the RDPS~~ --
18 implicitly ^{there are DPS} ~~the RDPS~~ cost savings for nonautomation carrier
19 route letters, because Witness Hume simply rolled forward
20 the base year unit cost into test year unit cost. So they
21 are there implicitly for the other carrier route letters,
22 and there may even be some additional implicit DPS cost
23 savings for automation carrier route letters.

24 The only thing that is not recognized is that
25 rural carrier costs for DPS are not recognized. That is

1 something we're working on. Carrier route letters are
2 DPS'd, and they should receive some recognition for DPS cost
3 savings in the base year for rural just as they are
4 receiving implicit recognition for DPS cost savings for city
5 carriers.

6 Q At page 36, lines -- that's not the page. That is
7 not the right side.

8 Page 35, lines 8 and 9, you state the diversion of
9 nonautomation ECR letters to the DPS mail stream is a
10 transitional step, and you repeat that statement at another
11 point in your testimony which I'm not finding right now.
12 But I noticed I believe when you stated that you based your
13 statement -- not here, but on the other page -- I'm sorry, I
14 don't have the better side -- on the Postal Service
15 testimony from MC95-1. Do you remember you did that?

16 A What are you looking for again?

17 Q The support for the -- oh, okay, I found it. It's
18 on page 33, lines 2 through 4, where you stated -- this
19 phenomenon of the DPSing of these nonwalk sequence letters
20 consistent with USPS statements that it's a transitional
21 step required to generate enough DPS volume it automates
22 some walk sequence ECR letter mail under certain conditions.

23 And I notice that your citation there is to
24 testimony from MC95-1. Are there any Postal Service
25 statements in this proceeding that the Postal Service still

1 regards this as a transitional step?

2 A I believe there is. I can't recall. I think it
3 may be Witness Moden.

4 Q Do you recall or do you know what the length of
5 that transition is likely to be?

6 A No, I don't.

7 Q Okay. Do you expect the Postal Service to
8 continue to divert nonautomation ECR letters to the DPS mail
9 stream in the test year?

10 A I suspect they still will be doing that, but I am
11 not going to swear to that one.

12 Q Okay.

13 A Let me explain something, however. There are DPS
14 costs in the mail processing costs for carrier route
15 letters. As a result, they must be matched with the DPS
16 cost savings at the carrier level.

17 I am really not absolutely certain that it's to
18 carrier route letters' benefit to be in the DPS mail stream.
19 It is to the Postal Service system benefit to have carrier
20 route letters in the mail stream, carrier route DPS letters
21 in the mail stream. This is for the benefit of the entire
22 system is for the benefit of the DPS program. It's not
23 necessarily for the benefit of carrier route letters that
24 are nonautomation to be attributed with this mail processing
25 cost and then only partly attributed with the delivery cost

1 savings.

2 Q Is it a mistake to attribute the DPS costs to
3 them, to these letters?

4 A It is in their mail processing cost. It cannot be
5 separated out.

6 Q So --

7 A So it is appropriate to give them also the
8 delivery cost savings that are associated with that.

9 Q So your criticism is not the inclusion on the one
10 hand. It's the exclusion on the other?

11 A No. The inclusion comes through the IOCS and we
12 can't separate that information out to be DPS related.

13 It is not just the IOCS costs that are associated
14 with the automation equipment itself. It is also costs that
15 are associated with taking carrier route letters that are
16 dropped at a carrier's office and taking them back upstream
17 to the processing facility.

18 Those additional costs are also buried in the mail
19 processing costs for carrier route letters.

20 Q So are you saying that if it were possible to
21 identify and isolate the extra costs the Postal Service may
22 incur in taking these letters back for DPS sequencing you
23 would consider that those costs should not be attributed to
24 ECR mail?

25 A As long as ECR mail gets credit for the cost

1 savings, I see no problem with it.

2 Again I am not sure that this is to the carrier
3 route letter's benefit even with the cost savings. Carrier
4 route letters are very low cost to process to begin with.
5 The only reason why they are going into the DPS program is
6 to benefit the entire system.

7 The postal operations require a certain level of
8 letters in the DPS mailstream in order to make it efficient
9 and to acquire cost savings and carrier route letters, so to
10 speak, are like -- they are being used to get those benefits
11 but I don't believe that carrier route letters themselves
12 get a whole lot of benefit out of this. In fact, they
13 probably are attributed more costs than their -- I know that
14 they are attributed more costs than their cost savings.

15 Q Are you saying a type of mail needs to receive a
16 benefit from the postal operation to be attributed to the
17 cost of that operation?

18 A What I am saying is if there is an automation cost
19 that carrier route letters are being attributed then at a
20 very minimum automation carrier route letters ought to be
21 getting the cost savings from that DPS.

22 Q Now let's -- I want to take a hypothetical --
23 well, I am sure it happens but we'll treat it as a
24 hypothetical situation where a saturation letter mailing and
25 an ECR basic letter mailing are both diverted to the DPS

1 mailstream and on the same day at the same time.

2 Is it likely that these two mailings would become
3 merged during the DPS processing?

4 A You are talking about saturation and basic?

5 Q Yes, if they are both sent back to be DPS'd.

6 A If they are automatable they would be merged into
7 the DPS mailstream.

8 Q And when these merged letters then reach the
9 carrier, would they receive any additional or incur any
10 additional in-office delivery costs?

11 A They would not be cased of course, but he would
12 have to pick them up and carry them out.

13 Q Right -- and would that -- in this instance does
14 the DPS sequencing result in lower, in-office costs for this
15 mail?

16 A That's my point -- yes.

17 Q Right, okay. Would there be any difference in the
18 in-office delivery costs associated with the basic letters
19 compared to the saturation letters when they have both been
20 DPS'd in my hypothetical?

21 A No.

22 Q Okay. So to the extent that both ECR basic and
23 saturation letters are diverted to the DPS mailstream, then
24 there would be no difference in the in-office costs of
25 handling those letters, would there?

1 A That's right, and that is exactly the point. It's
2 already in the costs that Witness Hume used before he de-
3 averaged.

4 Q Well, in this situation, then, Mr. Shipe's in-
5 office costs have disappeared, haven't they?

6 A No, they haven't.

7 Q Why not? We have just --

8 A His productivities are still there.

9 Q But they're not -- we're talking about mail that
10 isn't cased anymore.

11 A What we're talking about now is a weighted
12 average. Part of the weighted average is the non-DPS
13 casing, which comes from Witness Shipe.

14 Q Uh-huh.

15 A And the other part of the weighted average is the
16 DPS processing.

17 Q Right. But in looking at the two mailings of the
18 saturation and the basic that are both DPS, then there is no
19 in-office casing difference for those mails.

20 A For those particular mailings, but we are
21 developing rate differences for the entire sub-class.

22 Q Now, assume that the basic letter mailing is sent
23 back for DPS processing and that there is also a mailing of
24 saturation letters that are cased by the carrier in the
25 office, and in this situation, does the basic mailing incur

1 mail processing costs that the saturation mailing does not?

2 A That's true.

3 Q And conversely, does the saturation mailing incur
4 in-office costs that the basic mailing would avoid?

5 A That's true.

6 MR. BAKER: Okay.

7 Mr. Chairman, I'd like to shift gears and talk
8 about Ms. Chown's testimony briefly, and I think we can wrap
9 it up by one, if that's appropriate.

10 CHAIRMAN GLEIMAN: Fire away, sir.

11 MR. BAKER: Okay.

12 BY MR. BAKER:

13 Q Could you turn to page 4 of your testimony?

14 I want to take a look at your footnote 2 on that
15 page and, in particular, the last four or five lines of the
16 footnote, and here you express a concern, using your
17 language, of shifting institutional costs away from first-
18 class towards ECR, that the Chown proposal would increase
19 the likelihood that ECR rates could rise above their stand-
20 alone level and that first-class rates would dip below their
21 long run incremental cost level. Do you see that?

22 A Yes, sir.

23 Q Whether rates are set by current method or by Ms.
24 Chown's method, would you agree that, in either case, rates
25 should cover the attributable costs?

1 A Repeat that, please.

2 Q Regardless of whether we -- the Commission uses
3 its traditional approach or uses Ms. Chown's weighted costs.
4 In either event, the final rates should cover the
5 attributable costs, correct?

6 A In this case, where there is scale economies, I
7 think that the rates should cover their marginal cost, at a
8 minimum, marginal being attributable.

9 Q Okay. Should they also cover the incremental
10 costs of the product?

11 A Yes, I believe they should.

12 Q Is one -- would one way to avoid the problem you
13 refer to in note 2 be to define attributable costs as long
14 run incremental costs?

15 A For what purpose?

16 Q To avoid a price -- well, let's put it this way.
17 If every sub-class is priced above its long run incremental
18 cost, would any sub-class be above its stand-alone cost?

19 A If every sub-class was priced at its longer run
20 incremental cost, then no sub-class would be priced above
21 its stand-alone. I would like to identify longer run as
22 I've got it here in this footnote.

23 Q All right. What is that?

24 A Longer run would mean that, if you pulled a sub-
25 class out, the system would completely readjust to recognize

1 and collect all of the savings that it could from the
2 removal of that sub-class.

3 Q Is that a different definition that they used by
4 Witness Takis in this case when he presented --

5 A Yes, it is. It's a different definition.

6 Q On page 41, beginning at line 11, you talk about
7 ECR mailers incur costs in work-sharing.

8 A Yes, sir.

9 Q That's true of all mailers, isn't it? Any mailer
10 that engages in work-sharing incurs costs in doing so,
11 doesn't it?

12 A Yes.

13 Q Um-hum. What is the relevance to postal rates of
14 how much it costs any mailer to sort its own mail?

15 A The relevance is actually two. The first part is
16 that when you identify the volumes and the volume reaction
17 to a change in price, one of the things that you need to
18 recognize is that the mailer -- the mailers of that volume
19 will be incurring costs to send that volume to the Postal
20 Service.

21 The second relevance is that if the mailers are
22 performing work-sharing and saving the Postal Service that
23 cost, those mailers should receive the benefit of that
24 savings. In other words, the discount, the work-sharing
25 discount should reflect all of the costs that are saved by

1 the Postal Service, because the mailer is undertaking that
2 activity.

3 Q Should the discount be based on the cost to the
4 mailer of doing the work-sharing?

5 A The discount should be based on the entire cost
6 savings that the mailer is permitting the Postal Service to
7 make, because the mailer is undertaking that activity
8 instead. The relevance of this is that in making efficient
9 decisions when a mailer needs to make an efficient decision
10 about whether he is going to work-share or not work-share,
11 he needs to compare his entire cost to do the work-sharing
12 versus the entire cost savings to the Postal Service.

13 Q Should the Postal Service's discounts be based on
14 the Postal Service's costs?

15 A All of the Postal Service's costs that would be
16 saved.

17 Q Right.

18 A But they are not now.

19 Q Right. They should not be based on the mailers'
20 costs?

21 A No.

22 Q Okay.

23 A But the decision needs to be made on the basis of
24 both sets of costs.

25 Q Okay. I'd like you also to turn to page 44, lines

1 9 through 11 of your testimony, where you discuss what might
2 happen if the Postal Service's proposed cost coverages were
3 applied to weighted attributable costs. And I just want to
4 clarify. Did Ms. Chown propose that that happen?

5 A No, she didn't.

6 Q Oh, okay.

7 A She didn't propose any cost coverages.

8 Q Did she express some doubt in her testimony
9 whether Postal Service cost coverages necessarily reflect
10 what -- the mix of functions used by the subclass?

11 A Would you repeat that, please?

12 Q Yes. Did she express some doubt whether cost
13 coverages we have today have consciously taken into account
14 the mix of functions used by the subclasses of mail?

15 A She was concerned about the mix of functions that
16 each of the subclasses used according to her terminology.
17 She mentioned something about that they benefit from that.

18 Q Further down in that paragraph you discuss the
19 consequences that might have happened if that were done --
20 that is, if there were a 40 percent increase in the ECR
21 rates, and you conclude that it is a competitive -- mail
22 would be subject to competitive diversion and there would be
23 a net loss ultimately to the national economy.

24 If it is a competitive market -- I am not
25 proposing a 40 percent increase in the ECR rates, although

1 my client might like it, but if it is a competitive market
2 why wouldn't the advertising move to a different media?

3 A I think sometimes it does.

4 MR. BAKER: Okay, all right. I have no more
5 questions, Mr. Chairman.

6 CHAIRMAN GLEIMAN: Thank you, Mr. Baker.

7 We are going to break for lunch now and we are
8 going to come back at a quarter after 2:00.

9 I just have one quick question --

10 THE WITNESS: Yes, sir?

11 CHAIRMAN GLEIMAN: -- by way of a clarification.

12 A moment ago you were asked a question and you
13 responded that the decision needs to be made on both sets of
14 costs -- the mailer's cost to perform the work and the cost
15 the Postal Service avoids --

16 THE WITNESS: Yes, sir.

17 CHAIRMAN GLEIMAN: -- as a consequence of the
18 mailers doing the work, and I lost it for a minute there.

19 THE WITNESS: Okay.

20 CHAIRMAN GLEIMAN: What decision was that?

21 THE WITNESS: The work-sharing decision. What I
22 am talking about is --

23 CHAIRMAN GLEIMAN: The mailer's decision as to
24 whether that mailer wants to do the work?

25 THE WITNESS: Yes, sir. That's the one that has

1 been discussed over time.

2 CHAIRMAN GLEIMAN: Thank you.

3 MR. BAKER: Mr. Chairman, may I move my cross-
4 examination, mark it and put it in the transcript?

5 CHAIRMAN GLEIMAN: You can attempt to do that?

6 MR. BAKER: Well, I would like to mark this
7 document as NAA Cross-Examination Exhibit 1 and I believe it
8 is already I believe in the record as the testimony of
9 Witness Hume, so I would ask only that it be included in the
10 transcript.

11 CHAIRMAN GLEIMAN: I will direct that NAA-XE-1 be
12 transcribed into the record at this point.

13 [Cross-Examination Exhibit No.
14 NAA-XE-1 was received into evidence
15 and transcribed into the record.]

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NAA X-E 1

TABLE B-6 RECONCILIATION OF STANDARD MAIL CATEGORIES

USPS-188
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COMBINED CITY & RURAL		FY98	Model Projected				
06-Jul	(e)	(g)	(h)	(i)	(j)	(k)	(l)
07:00 PM	90 Percent of Full Up	Base Unit Cost	DPS Unit Cost	Effective Unit Cost	DPS Unit Saving	Projected Reclass Volume FY98	Cost
STANDARD MAIL							
PreBarcoded							
1	Basic Letters	4.609	3.173	3.460	1.149	3,157,220	109,239
1a		0.200	0.800				
2	Basic Flats	6.222		6.222		231,300	14,391
2a							
3	3-Digit Letters	4.609	3.173	3.417	1.182	9,750,410	333,181
3a		0.170	0.830				
4	3/5-Digit Flats	6.222		6.222		9,299,380	578,607
4a							
5	5-Digit Letters	4.609	3.173	3.359	1.249	3,016,550	101,340
		0.130	0.870				
5a	Carrier Route Letters	3.794	2.999	3.357	0.438	2,123,220	71,268
6		0.450	0.550				
6a	Enhanced Carrier Route						
7	Basic Letters	4.367		4.367		6,781,040	296,119
7a							
8	Basic Flats	5.849		5.849		10,706,610	626,261
8a							
9	High Density Letters	3.759		3.759		394,080	14,815
9a							
10	High Density Flats	5.157		5.157		1,150,760	59,345
10a							
11	Saturation Letters	2.852		2.852		3,095,860	88,282
11a							
12	Saturation Flats	3.496		3.496		6,172,670	265,686
12a							
Regular							
13	Basic Letters	4.609	3.173	3.819	0.790	2,012,520	76,856
13a		0.450	0.550				
14	3/5-Digit Letters	4.609	3.173	3.790	0.818	2,841,620	111,483
14a		0.430	0.570				
14r	Basic & 3/5-Digit Flats	7.012		7.012		3,950,010	276,962
PERIODICALS MAIL							
15	Publications Service	6.269		6.269		7,084,978	444,135
16	TY98 Loaded						
	Unit Cost						
17	4.864	Total 3rr		4.863		34,359,010	1,602,049
			3rr Itr	3.506		20,878,320	732,088
18			3rr III	6.453		13,480,660	869,961
19	4.445	Total 3crr		4.447		32,424,240	1,441,778
			3crr Itr	3.796		12,394,200	470,483
20			3crr III	4.849		20,030,040	971,295
21	6.271	Publications		6.269		7,084,978	444,135

1 CHAIRMAN GLEIMAN: And we'll see you all at a
2 quarter after 2:00, where we will pick up with Mr. Cooper's
3 cross examination of this witness -- 2:15 -- that was 15,
4 not 50 -- 15.

5 [Whereupon, at 12:59 p.m., the hearing was
6 recessed, to reconvene at 2:15 p.m., this same day.]

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1 AFTERNOON SESSION

2 [2:15 p.m.]

3 CHAIRMAN GLEIMAN: When last we met I think we
4 were ready for the Postal Service to cross-examine.

5 Mr. Cooper?

6 MR. COOPER: Thank you, Mr. Chairman.

7 Whereupon,

8 ANTOINETTE CROWDER,

9 the witness on the stand at the time of the recess, having
10 been previously duly sworn, was further examined and
11 testified as follows:

12 CROSS EXAMINATION

13 BY MR. COOPER:

14 Q Ms. Crowder, the thrust of my questions are just
15 going to be trying to understand further the concepts that
16 you're developing and try to clarify some things.

17 I have two specific instances in which there may
18 be a typo. I'd like to talk to you about those.

19 On page 47 of your testimony at line 19 you refer
20 to a proposition 2, and I was wondering -- it appeared to us
21 that you may have meant proposition 1 in that instance.
22 Could you check that for us?

23 A I'll have to get back to you, because I don't have
24 it with me.

25 Q Okay.

1 CHAIRMAN GLEIMAN: Can you help us, Mr.
2 McLaughlin?

3 MR. McLAUGHLIN: Well, I have -- I think I have
4 that here with me somewhere. What I don't know is whether
5 the witness might need a few minutes to look that over. Let
6 me just show it to her.

7 CHAIRMAN GLEIMAN: Fine.

8 BY MR. COOPER:

9 Q While your counsel is getting that out, the other
10 instance was on page 50, line 8, where you again refer to
11 proposition 2.

12 A Okay.

13 Oh, you're right.

14 Q That on --

15 A Can I make a correction now?

16 Q Please.

17 A Okay, this is what I'd like to say.

18 Q Please, go on.

19 MR. McLAUGHLIN: Which page are we on here?

20 THE WITNESS: On page 47.

21 MR. McLAUGHLIN: Okay.

22 THE WITNESS: On line 19 what I would like to say,
23 the variability estimate derived by the Commission in
24 proposition 1 is correct and modified by me in my response
25 to proposition 2 is also correct.

1 MR. McLAUGHLIN: Should that be "and as modified
2 by me"?

3 THE WITNESS: I guess.

4 MR. McLAUGHLIN: What I would like to do, Mr.
5 Chairman, is have it stated so that it comes out in a
6 correct fashion rather than leaving ambiguity in the record.

7 THE WITNESS: Let me say it again.

8 MR. McLAUGHLIN: Okay.

9 THE WITNESS: And I'll start on line 18 where it
10 says "the system level variability estimate derived by the
11 Commission in ^{Proposition}~~proposition~~ 1 is correct, and the variability
12 estimate derived by me in response to ^{Proposition}~~proposition~~ 2 is also
13 correct."

14 CHAIRMAN GLEIMAN: Do we now have this one place
15 in all of our transcripts, many volumes, that is
16 unambiguous? We agree on that? We agree on what it's
17 supposed to say? Okay.

18 THE WITNESS: It may not be grammatically correct.

19 BY MR. COOPER:

20 Q How would you change the reference on page 50,
21 line 8?

22 A That one because it is dealing with the
23 disaggregated. On page 50, line 8, we are talking about the
24 disaggregated approach here and as such we are talking about
25 the estimated stop load time as estimated by the LTV models.

1 I would just simply change line 8 to say

2 ^{Proposition 1}
~~"proposition one"~~ --

3 Q Instead of proposition two.

4 A Instead of proposition two.

5 Q Okay.

6 A The distinction being that on page 47 we are
7 talking about a point estimate of the mean value approach
8 and in that case I want to be clear that the load time to
9 which those variabilities are applied should be the modeled
10 load time. That would be the LTV model load time, rather
11 than the STS time.

12 On page 50 that is an implicit assumption, that it
13 would have to be the LTV modeled load time.

14 Q Okay. Would you refer to page 51 of your
15 testimony, please? Now on this page you introduce the
16 concept of a load time equation to find for groups of
17 homogenous stops, is that right?

18 A You're referring to line 6. Yes.

19 Q Now I am trying to understand what you mean by
20 homogenous stops in this conceptualization.

21 By that do you mean a homogenous group of stops is
22 a group in which all the stops have the same volume for each
23 and every one of the five volume terms that are found on the
24 right-hand side of the load time regressions?

25 Those five terms would be letters, flats, parcels,

1 accountables and collections.

2 A In this particular case, and this is explaining an
3 ideal situation, the groupings or the strata that we are
4 talking about -- sometimes I call it a route, sometimes it
5 is called a stratum -- would represent stops that have the
6 same non-volume characteristics, same receptacle type, the
7 same container types -- those sorts of things -- same number
8 of possible deliveries.

9 The example I have got here, the equality that I
10 have here assumes that those stops all have the same volumes
11 for each of the volume variables.

12 Now I understand that that is not a real
13 situation. We are trying to explain how the analysis should
14 be conducted.

15 In essence, in reality these stops even though
16 they have homogenous non-volume characteristics, would have
17 random, would have different volume levels on different
18 days, and if that were the case and they had different
19 volumes on different days, then again we would be working
20 with an inequality -- and I do understand that.

21 But that inequality would simply be that the true
22 value of the stop time, the true value would be less than
23 the estimated value.

24 Q Have you given any thought as to how you would
25 handle an uncovered stop? Would any of the homogenous

1 groups have any uncovered stops in them?

2 A What you would have to do is -- again this would
3 be what the Postal Service would have to do -- there would
4 be a couple of ways. I will just give you one.

5 You would have to take and look at these stops,
6 maybe identify a cross-section of homogeneous stops,
7 homogenous in the non-volume characteristics, and through
8 that cross-section, looking at the volumes on each of those
9 stops, assume that that was the volume distribution for
10 those stops over the year and separately estimate that stop
11 type model for each of those volumes.

12 Even then you are still going to get that
13 inequality. You are going to get a little bit more
14 precision but you still will get that inequality and the
15 inequality still will be that the true value will be less
16 than the estimated value.

17 Now you can continue to do this and continue to
18 disaggregate in terms of the types of stops and the volume
19 over time, the time effect of volume on the stops, and you
20 can continue to disaggregate this all you want. You will
21 get more and more precise, but you still will have that
22 inequality.

23 It becomes a question of how precise you want to
24 get versus the cost of getting to that level of precision.

25 I don't believe that it should stop us from using

1 the information that we do have. We have this information.
2 I have satisfied myself through doing sensitivity analyses
3 of the SDR model. I have satisfied myself that the
4 difference, the inequality is not much. And in every case
5 our estimate is always higher, meaning our volume variable
6 cost is always higher than the true volume variable cost. I
7 don't believe this should stop us from doing it. And in
8 fact I don't believe that this inequality is nearly as
9 severe and inappropriate as the inequality between the LTV
10 modeled time and the STS time.

11 Q Now back in Docket No. R90-1 Dr. Bradley outlined
12 how a disaggregated approach to calculating variabilities
13 might be performed. Are you familiar with that?

14 A No, I'm afraid I'm not. I am -- I am somewhat
15 familiar with Dr. Bradley's approaches. I don't exactly
16 recall that one, but I'm willing to talk about it if you
17 want.

18 Q Would you know or be able to confirm whether one
19 of the reasons to estimate separate variabilities by
20 group -- what that reason would be that he might have
21 alluded to?

22 A What modeling was he doing? Transportation or --

23 Q I guess what I'm asking is was one of the reasons
24 for his disaggregated approach -- was one of the reasons for
25 that to estimate separate variabilities by group?

1 A Yes.

2 Q Okay.

3 A Let me say I'm not sure that's what Dr. Bradley
4 was doing, but that is a legitimate thing to do.

5 Q Such a disaggregation would only be meaningful,
6 wouldn't it, if different regression coefficients were
7 estimated for each group?

8 A It would be equivalent to what you're doing now
9 with SDR, MDR, and business and mixed. The Postal Service
10 already stratifies by those three stop types.

11 Q But you'd only pursue that approach if you were
12 estimating regression coefficients for each group.
13 Otherwise there would be no reason to disaggregate the
14 groups, would there?

15 A For what purpose?

16 Q To calculate variabilities.

17 A I'm afraid I'm not quite following.

18 Q That's all right.

19 A If you want to get more precise, you would
20 disaggregate. And you could continue to disaggregate both
21 in terms of stop type and in terms of volumes -- daily
22 volumes on the stop type. You could continue to
23 disaggregate as long as you wanted. It's -- it will give
24 you more and more precision, but the extra precision is not
25 that much. And the extra cost to do that on the part of the

1 Postal Service could be considerable.

2 Q Okay. Let's move to a slightly different subject.
3 You would agree with me, wouldn't you, that an econometric
4 regression may be evaluated at a number of different points,
5 wouldn't you?

6 A It may be; yes. For what purpose?

7 Q Well, regardless of the purpose, the point at
8 which such a regression is evaluated wouldn't influence the
9 data that were used to estimate the equation, would it?

10 A Would you repeat that, please?

11 Q Well, I'm asking you to assume that we've
12 estimated an econometric regression and I asked you to
13 confirm that it could be evaluated at a number of different
14 points. I think you agreed with me.

15 Now the underlying data upon which the regression
16 was estimated doesn't depend upon where you evaluate the
17 equation, does it? The data comes first and then you
18 evaluate the equation; right?

19 A I guess it depends on what you are doing with that
20 model and maybe I need a concrete example. Let's do an LTV
21 model.

22 The Postal Service has an LTV model for single
23 delivery stops, single delivery residential stops. The data
24 used to develop that model come from the LTV data but in
25 this case you have taken the base year CCS data and used to

1 evaluate that model.

2 Because the CCS data, the average stop values for
3 the current year, base year CCS are not a whole lot
4 different than they were for LTV, I think it is perfectly
5 acceptable to do that.

6 Q I think I am just trying to establish a very
7 simple point, that when you are estimating an economic
8 regression you have certain data, and that's what you use to
9 estimate the equation.

10 A Yes, sir.

11 Q And that data does not change depending on where
12 you choose to evaluate the equation once it is estimated,
13 isn't that right?

14 A The coefficients don't change, no.

15 Q And the underlying data that was used to estimate
16 the equation wouldn't change?

17 A No.

18 Q Okay. Similarly, the method of evaluating an
19 econometric equation doesn't affect an underlying reality
20 reflected in that data, such as whether or not all stops
21 actually get a certain amount of volume?

22 A Would you repeat that, please?

23 Q Well, where you evaluate, the point at which you
24 choose to evaluate the econometric equation doesn't alter
25 the reality, the operational reality reflected in the data,

1 such as the distribution of volume in a particular way
2 across stops?

3 A No, you have already estimated the model. You
4 have already estimated the model.

5 Some of these models you can forecast, so what you
6 would be -- I mean people estimate models to do forecasting
7 of something that is going to happen in the future.

8 I guess I don't understand what you need from me.

9 Q I am not trying to get very deep with these
10 questions.

11 Could you confirm for me whether or not the Postal
12 Service or the Postal Rate Commission has used the LTV
13 equations to estimate total load time in the past?

14 A Actually, when you run the variabilities off those
15 LTV models, you are effectively calculating both the
16 marginal cost and the average stop cost for those models, so
17 every time you do a variability you have that average stop
18 cost embedded in that variability.

19 Q So you are saying there is an implicit accrued --

20 A There is implicit --

21 Q -- load time that corresponds to that equation?

22 A -- in there for each -- yes, sir.

23 Q Okay.

24 A You have that average stop cost regardless of what
25 volume level you want to put into the model.

1 When you evaluate variability at that volume level
2 that variability reflects the cost, the total cost, that
3 that model gives you -- the average cost, whatever you want
4 to call it. It does reflect that.

5 Q Okay. Now you are proposing a method for
6 calculating, explicitly calculating, accrued load time using
7 a particular econometric equation, the LTV equation, right?

8 A I think the word "accrued load time" may be
9 causing us a problem.

10 Accrued load time can be anything you want it to
11 be. The load time to which you apply the variabilities
12 needs to be the load time that is associated with those
13 variabilities and that is all I am proposing.

14 Q In your opinion would it be nonsensical to divorce
15 the accrued or the total load time from the variabilities?
16 Should they both be estimated using the same function? Is
17 that what you're saying?

18 A I'm saying for that particular volume level and
19 for that particular total cost for stop level that is the
20 appropriate variability. To take that variability and apply
21 it to a much larger stop cost when you don't know what the
22 volume is is not appropriate. It's not appropriate. You
23 need to match -- you need to match that total cost of the
24 stop to the variability that you get off that stop at that
25 particular volume level. And that's all I'm trying to get

1 out.

2 Q Is that because there's an internal inconsistency
3 to do it any other way?

4 A It's internally inconsistent if you apply the
5 variability to a much larger amount of cost that overstates
6 the marginal cost, it overstates the volume variable cost,
7 you have the wrong estimate. And this applies whether you
8 are talking about elemental variability or stops related
9 variability. It applies.

10 Q Now suppose we were to follow your advice and
11 estimate load time using the LTV equation. Would there be
12 any forecast error associated with that process?

13 A What -- okay, you need to explain to me which
14 testimony are you referring to? Are you referring to this
15 disaggregated approach, or are you referring to the LTV
16 model and it being estimated at the mean value of the
17 volume? Which one are we talking about?

18 Q Well, let's try to clarify that. Which -- how are
19 you currently proposing to calculate load time?

20 A I am currently proposing to calculate load time as
21 I've explained in my direct testimony.

22 Q Okay.

23 A And I have accepted the Postal Service's LTV model
24 and its mean value of volume approach, and all I am saying
25 is that if you're going to use the variability at that mean

1 value, then you also need to use the average and total cost
2 that's associated with that variability at that mean value.

3 Q Okay. So you would be using the LTV model to
4 predict a future amount of load time based on historical
5 data. Is that in essence what would be happening?

6 A We're talking about the base year and we're
7 talking about -- I don't know that there's a -- okay, I
8 understand what you're saying with prediction. Yes, you're
9 using the model for the base year volume to predict the LTV
10 load time for that stop. That is a model prediction. It
11 doesn't mean it's truly a forecast. It's just -- the model
12 says that this is the total stop cost, stop time, at this
13 level of volume for this stop type. It's a base year
14 prediction.

15 MR. COOPER: That's all I have.

16 CHAIRMAN GLEIMAN: Is there any followup?

17 Questions from the bench?

18 Mr. McLaughlin, would you like some time with your
19 witness to prepare for redirect?

20 MR. McLAUGHLIN: If we can just take five minutes.
21 I don't think we need ten minutes.

22 CHAIRMAN GLEIMAN: Sure.

23 [Recess.]

24 CHAIRMAN GLEIMAN: Mr. McLaughlin, you can sit
25 wherever you'd like.

1 MR. McLAUGHLIN: I'm engrossed.

2 CHAIRMAN GLEIMAN: You can even, you know, do it
3 from up here if you'd like.

4 REDIRECT EXAMINATION

5 BY MR. McLAUGHLIN:

6 Q In the cross-examination with Mr. Cooper there was
7 some talk I believe at the end about how you deal with the
8 STS and the LTV in terms of what's the load time. Can you
9 clarify that -- I believe you said that the proper approach
10 would be to apply the LTV variabilities to the LTV model
11 load time. Now if that were done, how would the excess of
12 STS over LTV time be dealt with? How would that be treated?

13 A In looking at the -- I spent quite a bit of time
14 trying to figure out where that excess may have come from,
15 and what makes the most sense to me is that that excess is
16 truly time at the stop, whether you want to call it load or
17 you want to call it access, it doesn't matter. It's -- it
18 was time that the carriers were spending at stops. But it
19 was not time that was included in the LTV time.

20 Since the LTV time includes all of the elemental
21 time, it seems appropriate to treat the rest -- the
22 difference between LTV and STS as load time, but just call
23 it fixed time at the stop.

24 Q And that would be treated as coverage-related load
25 time.

1 A And it would be treated as -- in the same way as
2 coverage-related for each of the three stop types. You
3 would want to attribute it to the same extent as stops,
4 attribute it on the basis of stops variability, stops
5 coverage variability, as opposed to deliveries coverage
6 variability. All three would be stops coverage variability.

7 Q Then the other alternative would be to treat STS
8 as the measure of the load time, in which case what would
9 you have to do with the LTV variabilities before you apply
10 them to the STS accrued costs?

11 A If instead you want to come up with an elemental
12 variability that applies to the total of STS load time, you
13 would have to adjust the LTV variability downward to match
14 the greater load time measured by the STS. That is I
15 believe in one of the -- in my response to one of those
16 propositions that the Commission presented to us earlier.

17 Q In terms of the final result, is the result
18 mathematically the same whichever approach you use?

19 A Effectively the result is the same, and the reason
20 for that is the elemental marginal cost needs to be what is
21 measured off of the LTV model. However you want to get to
22 that correct result is whatever you want to do, but we still
23 want to see that correct marginal cost translated into the
24 correct volume variable cost -- elemental volume variable
25 cost.

1 MR. McLAUGHLIN: Mr. Chairman, I have one last
2 question, which I was thinking Mr. Cooper might have asked.
3 It relates to cross-examination of Mr. Baron yesterday when
4 we were talking about his interpretation of Ms. Crowder's
5 testimony, and specifically an equation which the witness
6 stated that it was his interpretation of what Crowder had
7 done. Witness Crowder is here to clarify exactly what that
8 equation represents. If --

9 CHAIRMAN GLEIMAN: You're saying this is a
10 question that you thought somebody else was going to ask but
11 they didn't ask, so now you're going to offer us the
12 opportunity to have somebody clarify it? You know, I'd love
13 to have a clarified record, but on the other hand, it
14 doesn't sound to me as though this is proper redirect.

15 MR. McLAUGHLIN: It is not redirect based on the
16 questions that Mr. Cooper asked. However, it does deal with
17 an issue that Mr. Baron raised in his rebuttal testimony,
18 rebuttal to Witness Crowder, where he indicated that he
19 was -- it was his interpretation of what she was doing, and
20 I think the record would help -- would be aided by having
21 Witness Crowder's explanation of that.

22 CHAIRMAN GLEIMAN: Well, I always like to know
23 what it is that people meant rather than what people thought
24 other people meant. So I suspect unless the Postal Service
25 wants to lodge an objection to this effort to clarify our

1 record and make it more understandable, I'm going to let you
2 go ahead and try to do whatever you want, as long as it's
3 only --

4 MR. McLAUGHLIN: It's just going to be I believe
5 just one single question.

6 CHAIRMAN GLEIMAN: Okay.

7 REDIRECT EXAMINATION

8 BY MR. McLAUGHLIN:

9 Q In yesterday's transcript at page 17796 --
10 actually it's 17795 and 96 -- there was discussion
11 concerning your equation for the deliveries effect, equation
12 BV minus CV squared, that Witness Baron interpreted to not
13 include the effect of possible deliveries with respect to
14 actual deliveries. Can you explain whether that is in fact
15 the case?

16 A No. I believe that that's been misinterpreted.
17 That equation was found in Attachment C of my direct
18 testimony. In that attachment I describe three effects from
19 the possible deliveries variable. There is a fixed effect.
20 There is a marginal effect. And there is an indirect effect
21 on actual deliveries. That indirect effect was not
22 explicit, but in the BV minus CV squared, which equals
23 actual deliveries, the B coefficient does include the
24 possible deliveries effect.

25 The possible deliveries effect can be considered a

1 shift. If you have a graph that graphs actual deliveries
2 with respect to volume, you will have a curvilinear concave
3 down graph. The possible deliveries effect, which is
4 embedded in the B variable, shifts that curve up or down
5 given the number of possible deliveries. In other words,
6 greater numbers of possible deliveries will shift the curve
7 up. Lesser numbers of possible deliveries will shift the
8 curve down.

9 The B variable and the C variable also can be used
10 to develop the marginal volume effect on actual deliveries.
11 They are both in that equation. And in fact if you take
12 that equation with the rest of the material that is in
13 Attachment C, you can transform it to be exactly the LTV
14 model equation where D equals the possible deliveries, not
15 the actual deliveries. Volume and possible deliveries
16 explain actual deliveries. Volume and possible deliveries
17 are in the LTV model.

18 MR. McLAUGHLIN: I have no further questions.

19 CHAIRMAN GLEIMAN: Mr. Cooper, do you have any
20 follow-up to -- is it sur-sur-surrebuttal?

21 MR. COOPER: Just give me a couple minutes here.

22 CHAIRMAN GLEIMAN: I think that we owe that.

23 MR. COOPER: Mr. Chairman, I'm not sure we're ever
24 going to be able to fine-tune this econometric to the degree
25 we would like, but I think now is as good a stopping point

1 as any.

2 CHAIRMAN GLEIMAN: I had that feeling myself.

3 Well, if there is nothing further, then Ms.
4 Crowder, we appreciate your appearance here today, your
5 contributions to and clarifications of our record, and if
6 there's nothing further, you're excused.

7 THE WITNESS: Thank you.

8 [Witness excused.]

9 CHAIRMAN GLEIMAN: Our next witness is appearing
10 on behalf of the United States Postal Service. Dr. Panzar
11 is already under oath in this proceeding, and Mr. Cooper, if
12 you would introduce your witness and enter his rebuttal
13 testimony, and while he's making his way to the witness
14 table, just let me mention that I'm pleased he was able to
15 get here.

16 MR. COOPER: The Postal Service calls Dr. John C.
17 Panzar, who has just arrived from Chicago.
18 Whereupon,

19 JOHN C. PANZAR,
20 a rebuttal witness, was called for examination by counsel
21 for the United States Postal Service and, having been
22 previously duly sworn, was further examined and testify as
23 follows:

24 DIRECT EXAMINATION

25 BY MR. COOPER:

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1 document entitled "Rebuttal Testimony of John C. Panzar on
2 Behalf of United States Postal Service," marked for
3 identification as USPS-RT-13.

4 A Thank you.

5 Q Are you familiar with this document?

6 A Yes.

7 Q Was it prepared by you or under your direct
8 supervision?

9 A Yes, it was.

10 Q If you were to be giving testimony orally today,
11 is this the testimony that you would give?

12 A Yes, it is.

13 MR. COOPER: Mr. Chairman, I ask that this
14 document be entered into the evidentiary record and
15 transcribed.

16 CHAIRMAN GLEIMAN: Are there any objections?

17 [No response.]

18 CHAIRMAN GLEIMAN: Hearing none, Dr. Panzar's
19 testimony and exhibits are received into evidence, and I
20 direct that they be transcribed into the record at this
21 point.

22 [Rebuttal Testimony and Exhibits of
23 John C. Panzar, USPS-RT-13, was
24 received into evidence and
25 transcribed into the record.]

USPS-RT-13

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

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

REBUTTAL TESTIMONY
OF
JOHN C. PANZAR
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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1. QUALIFICATIONS

1 My name is John C. Panzar and I am the Louis W. Menk Professor of Economics
2 at Northwestern University, where I hold appointments in the Economics Department and
3 in the Transportation Center. I have testified on behalf of the United States Postal
4 Service previously in this proceeding. My qualifications may be found in my direct
5 testimony in this docket, USPS-T-11.

6 2. PURPOSE AND SCOPE OF TESTIMONY

7 I have two objectives for the present testimony. First, I want to explain why the
8 “weighted attributable cost” (WAC) concept presented by Witness Chown should play
9 no role in the postal rate-making process. It has no economic relevance and, as she
10 herself admits, is not grounded upon cost causation. Its use is unnecessary and would
11 only confuse matters. The reason is that cost measures can be relevant for rational rate-
12 making only to the extent that they are causally related to the firm’s decisions. Marginal
13 costs play an important role in rate-setting because they reflect the costs that are *caused*
14 by the (marginal) volume changes resulting from (marginal) rate changes. Incremental
15 costs are important for both equity and efficiency because they measure the costs that are
16 *caused by* the provision (of all units) of some service. The WAC concept proposed by
17 Witness Chown reflects neither notion of causality. On a per unit basis, WAC for a
18 subclass may be greater than, equal to, or less than the marginal cost of that subclass or
19 the average incremental cost of that subclass. In sum, Witness Chown’s attempts to
20 assign responsibility for certain institutional costs to particular classes of mail, while

1 having some superficial appeal, is in actuality an arbitrary allocation of the unallocable.
2 Her "metric," in essence, is a somewhat flexible variant of a fully distributed costing
3 scheme.

4 The second set of issues addressed in this testimony are Dr. Henderson's
5 "practical" reasons for using Postal Service estimates of average incremental cost in
6 developing his pricing recommendation instead of the unit volume variable cost estimates
7 dictated by economic theory. First, he argues that marking-up average incremental costs
8 for rate-making purposes is desirable because it provides a "margin for error" when
9 evaluating rates for cross-subsidization. I explain why such a margin for error is not
10 necessarily desirable and, even if it were, would provide no justification for using average
11 incremental costs as the cost basis to which mark-ups should be applied. Next, he
12 justifies marking-up average incremental costs because they are "longer run" costs than
13 the unit volume variable costs obtained from the Postal Service's costing methodology. I
14 explain that the incremental costs estimates provided by the Postal Service in this
15 proceeding are calculated using the same basic methodology as its volume variable cost
16 estimates. I also point out that the so-called "longer run" costs Dr. Henderson wants to
17 attribute *and* mark-up, should not form part of the cost basis to which mark-ups are
18 applied precisely because they do not vary with volume, even though they may be
19 variable during the relevant time period.

1 **3. WITNESS CHOWN'S "WEIGHTED ATTRIBUTABLE COSTS"**
2 **(WAC) HAVE NO ECONOMIC SIGNIFICANCE.**

3 As I explained in my Direct Testimony, there are two economic concepts of cost
4 causality that are important for postal rate-making: marginal costs and incremental costs.
5 The former measure the costs caused when an additional unit of subclass volume is
6 provided and the latter measures all the costs incurred as a result of the entire mail
7 volume of a subclass. (Equivalently, the incremental costs of a subclass are the Postal
8 Service costs that would be *avoided* if the subclass in question were no longer provided
9 by the Postal Service.) As I also explained in my Direct Testimony, each cost concept
10 has its unique role to play in an economically efficient rate-making process. Marginal
11 cost, as measured by unit volume variable cost, is the appropriate starting point to which
12 mark-ups should be applied. Incremental cost is the standard to which subclass revenues
13 must be compared in order to determine that the subclass is not receiving a subsidy.

14 The WAC proposed by Witness Chown involve combining marginal and
15 incremental costs in such a way that the usefulness of both concepts is destroyed. Unit
16 WAC are not an appropriate basis for mark-ups, as they may be greater than or less than
17 economic marginal costs. WAC also provide no useful information for subsidy analysis
18 because they may be greater than or less than incremental cost. More importantly, the
19 attempt to introduce cost measures not based upon cost causation into the rate-making
20 process reveals a fundamental misunderstanding of the role of that important policy
21 function. The purpose of rate-setting is to cover the costs of the enterprise. Any break-
22 even set of rates will necessarily allocate total costs among the various subclasses, but the

1 objective must always be a “desirable” set of rates, however that term may be defined or
2 interpreted. Concepts of “cost coverage” have economic (as opposed to statutory)
3 significance because economically desirable rates generally must exceed marginal costs
4 and revenues must be at least as large as incremental cost. This is why the ratio of
5 subclass revenues to its volume variable costs is of general interest to economists. There
6 is no similar reason why WAC should play any role in rate-setting. Put simply, the use of
7 WAC is not called for in the statute, and it has no basis in economic theory.

8 **3.1 Witness Chown's Weighting Scheme Obscures The Economic**
9 **Usefulness Of Postal Service Cost Measures.**

10 Witness Chown proposes that the volume variable costs attributed to each
11 subclass from any cost component be weighted by a factor equal to that component's
12 share of institutional costs divided by its share of total volume variable costs. These
13 weighted values would then be summed over all cost components to determine the
14 weighted attributable costs for each subclass. She then proposes that the Commission use
15 its judgment to apply to these WAC whatever mark-ups it thinks are warranted by the
16 statute. These mark-ups would then be added to *unweighted* unit volume variable costs to
17 determine subclass rates. Unfortunately, by attempting to mix two economically valid
18 cost measures, Witness Chown ends up creating a cost measure with no economic
19 usefulness.

20 The shortcomings of Witness Chown's proposal can be explained in terms of her
21 simplified example, first introduced on page 10 of her testimony. I begin by clarifying
22 and extending the example in three ways. First, I assume that the institutional costs

1 associated with each Function (cost component) are component fixed costs. These costs
2 must be incurred if the Function is provided at all, but do not vary with volume. This
3 greatly simplifies the calculations without affecting my conclusions. Second, I assume
4 that *one unit of volume* is provided for each Class of mail. It is impossible to analyze
5 costs for rate-making purposes without specifying service quantities. Here, it simplifies
6 the arithmetic and maximizes comparability with Witness Chown's discussion to assume
7 unitary volumes for Classes A, B, and C. Finally, I assume that the (implicit) "cost
8 drivers" for cost Function 1 and Function 2 are equal to the unweighted volumes of each
9 mail Class. This is consistent with the example, and, again, simplifies the arithmetic.

10 Let me now restate the cost structure of the hypothetical postal network
11 represented in the example. Three mail subclasses (Classes A, B, and C) utilize one or
12 both of two cost components (Functions 1 and 2). Each unit of Class A requires one unit
13 of service from Function 1 *and* one unit of service from Function 2. Each unit of Class B
14 mail requires one unit of service from Function 1, but does not utilize Function 2 at all.
15 Each unit of Class C mail requires one unit of service from Function 2, but does not
16 utilize Function 1 at all. The (component) total costs for Function 1 are assumed to be
17 given by

18
$$C_1 = \$30 + (\$75)(\text{Class A volume} + \text{Class B volume}).$$

19 Similarly, the (component) total costs for Function 2 are assumed to be given by

20

21
$$C_2 = \$120 + (\$50)(\text{Class A volume} + \text{Class C volume}).$$

1 As explained in my Direct Testimony, the costing methodology of the Postal
2 Service would assign \$75 of Function 1 costs as volume variable costs to each of Classes
3 A and B, while assigning \$50 of Function 2 costs as volume variable costs to each of
4 Classes A and C. The total volume variable costs assigned to each mail subclass is just
5 the (unweighted) sum of those assigned from Functions 1 and 2. Since I have assumed
6 that all subclass volumes are equal to one, the per unit volume variable cost is equal to
7 total volume variable costs. For Class A, these are both $\$125 = \$75 + \$50$. Class B's
8 unit (and total) volume variable cost is \$75 and Class C's unit (and total) volume variable
9 cost is \$50. Now, let us use this example to verify the point made in my direct testimony:
10 i.e., that unit volume variable costs are equal to marginal costs. Adding an additional unit
11 of Class A service in this example requires increasing driver activity from two to three in
12 both Functions 1 and 2. The Function 1 cost is \$75, and the Function 2 cost is \$50, so
13 that the total marginal cost of an additional unit of Class A service is, indeed, equal to the
14 (per unit and total) Class A volume variable cost of \$125. Adding an additional unit of
15 Class B service in this example requires increasing driver activity from two to three in
16 Function 1 only. The cost of this would be \$75, which equals the (per unit and total)
17 Class B volume variable cost. Adding an additional unit of Class C service in this
18 example requires increasing driver activity from two to three in Function 2 only. The
19 cost of this would be \$50, which equals the (per unit and total) Class C volume variable
20 cost. In this example, the total volume variable costs assigned to the three subclasses are
21 \$250.

1 The above discussion is reflected by the numbers in the middle column of Table 4
2 in Witness Chown's direct testimony. Since total system costs are $\$400 = [\$30 +$
3 $(2)(\$75)] + [\$120 + (2)(\$50)]$, this leaves institutional costs for the system of \$150 which
4 must be covered by marking-up rates above unit volume variable costs. (Of course, with
5 the cost structure in this example, system institutional costs are just the sum of
6 component fixed costs: $\$150 = \$30 + \$120$.) The final column of Witness Chown's
7 Table 4 is obtained by applying a break-even uniform mark-up to the volume variable
8 costs calculated earlier.

9 Next, consider the subclass-level incremental costs which would be calculated by
10 applying Postal Service methodology to this example. If Class A were eliminated, the
11 system would save \$75 of costs by reducing the level of driver activity in Function 1
12 from two units to one unit. Similarly, \$50 would be saved by reducing the level of driver
13 activity in Function 2 from two to one. The incremental costs of Class A in this example
14 are thus $\$125 = \$75 + \$50$; the costs that would be avoided if Class A mail service were
15 no longer provided. Notice that the fixed costs associated with Functions 1 and 2 are not
16 part of the incremental costs of Class A because those costs would continue to be
17 incurred (to serve Classes B and C), even if Class A were eliminated. It is even simpler
18 to calculate the incremental costs of Classes B and C. For Class B, these are just the \$75
19 of costs saved by reducing the level of driver activity in Function 1 from two units to one
20 unit. Class C incremental costs are just the \$50 of costs saved by reducing the level of
21 driver activity in Function 2 from two units to one unit. Again, the component fixed
22 costs are not part of the incremental costs of Classes B or C because they would be

1 incurred to serve Class A, regardless. Because of the rather simple structure of the
 2 example, incremental costs and volume variable costs are equal for all three subclasses,
 3 taken individually.

	Weighted Attributable Cost	Incremental Cost	Volume Variable Cost	Marginal Cost
Class A	\$125	\$125	\$125	\$125
Class B	\$25	\$75	\$75	\$75
Class C	\$100	\$50	\$50	\$50

4 **TABLE 1**

5 For the example in question, Table 1 presents the values of the cost measures
 6 derived above as well as Witness Chown's Weighted Attributable Cost. It is easy to see
 7 the problems which can result from her attribution scheme. In this example, it turns out
 8 that WAC, Incremental Cost, and Volume Variable Cost are all equal for Class A. But,
 9 for Class C, WAC is twice the level of Volume Variable Cost and Incremental Cost. This
 10 is because Class C utilizes the high fixed cost component (Function 1), but not the low
 11 fixed cost component (Function 2). Witness Chown argues that this accurately reflects
 12 Class C's intensive use of components with large institutional costs. This may be so, but,
 13 as she admits, there is no cost causative content to that interpretation. The institutional
 14 costs are "identified" with particular subclasses of mail solely because Witness Chown
 15 has chosen to use a metric which arbitrarily implies responsibility for such costs without

1 establishing any causal nexus whatever. Precisely the opposite difficulty emerges in the
2 case of Class B. Because it utilizes only the cost component with low fixed costs, its
3 WAC of \$25 is significantly lower than its marginal and incremental cost of \$75. Under
4 Witness Chown's metric, Class B is assigned relatively less responsibility for certain
5 fixed costs, despite the fact that no single class, whether it be Class C, or Class A, or
6 Class B, can be shown to have caused these costs to be incurred.

7 What is the significance of this exercise for rate-making purposes? None, that I
8 can see. Witness Chown has cleverly constructed a cost measure that is a *weighted* sum
9 of component volume variable costs. One could construct many other such weighted
10 sums, which would be equally arbitrary. The WAC weights in Witness Chown's
11 proposal reflect the relative level of institutional costs in the various components. These
12 weights appear meaningful, until one recalls that, by definition, the institutional costs in
13 question are *common costs*, which are not caused by any single subclass. Therefore, just
14 because a subclass incurs most of its volume variable costs in a cost component that has
15 large institutional costs does not mean it is any more or less "responsible" for those costs
16 than any other *single* subclass.

17 Suppose Witness Chown had gone further, and proposed, for example, that
18 institutional costs be distributed using a uniform mark-up over WAC. Then her scheme
19 would have been recognized as a (somewhat complicated) form of Fully Distributed Cost
20 rate-making, based on arbitrary allocations of costs common to two or more subclasses.
21 She avoids that charge by recommending that the Commission use its judgment in setting

- 1 varying subclass mark-ups over WAC to cover institutional costs. However, the arbitrary
- 2 allocation of common costs remains at the heart of the plan.

3 **3.2 Unbundling, Incremental Costs, And Cross-Subsidy Tests**

Despite the serious short comings of her WAC proposal, Witness Chown's testimony raises some important issues regarding the impact of unbundling on the analysis of cross-subsidization. Again, her simple example (as extended above) provides a useful framework in which to illustrate the issues. Table 2 presents figures for incremental costs, volume variable costs, and WAC for *groups* of services as well as individual services. The interesting feature to note is that the incremental costs of {A,B} and {A,C} are *greater* than the sum of the individual service incremental costs. With constant component marginal costs, this could not happen if all services utilized all cost components. Here, however, since Class C does not utilize Function 1, that component's fixed costs of \$30 must be included in the incremental costs of service group {A,B}. Similarly, since Class B does not utilize Function 2, that component's fixed costs of \$120 must be included in the incremental costs of service group {A,C}.

Service Group	Volume Variable Costs	Incremental Costs	WAC
Classes A and B	\$200	\$230	\$150
Classes A and C	\$125	\$295	\$225
Classes B and C	\$125	\$125	\$125
Classes A, B, and C	\$250	\$400	\$250

TABLE 2

1 The end result of these considerations is that a process of unbundling which
 2 results in a situation in which all subclasses do not utilize all cost components increases
 3 the importance of performing incremental cost tests on *groups* of service offerings as well
 4 as individual service offerings. In the present example, based on the individual
 5 incremental cost tests, any combinations of non negative mark-ups m_A , m_B , and m_C that
 6 summed to the total institutional costs of \$150 would seem to result in a rate structure
 7 that was free of subsidy. However, additional constraints emerge from the joint
 8 incremental cost test. For the service group {A,B} to cover its incremental cost of \$230,
 9 Class C must be charged no more than $\$170 = \$400 - \$230$. In other words, $m_C \leq \$120 =$
 10 $\$170 - \50 . Similarly, for the service group {A,C} to cover its incremental cost of \$295,
 11 Class B must be charged no more than $\$105 = \$400 - \$295$, which translates to $m_B \leq \$30$
 12 $= \$105 - \75 .

1 Thus, any subsidy-free rate structure must have mark-ups over volume variable
2 costs such that $m_A + m_B + m_C = \$150$; $m_A \geq 0$; $0 \leq m_B \leq \$30$; and $0 \leq m_C \leq \$120$.
3 Notice that even the constraints imposed by group incremental cost test leaves the
4 Commission considerable freedom to pursue statutory considerations in setting cost
5 coverages. The important point here is that Postal Service costing methodology provides
6 the framework within which mark-ups may be determined and rates tested for cross-
7 subsidization.

8 Now it possible to uncover why. Witness Chown's argument strikes a chord of
9 sympathy at first reading. Recall her description of the plight of Class B mailers under
10 equal mark-ups without WAC:

11 Class B, which uses only Function 1, is assigned \$45 of institutional costs
12 even though the institutional costs for Function 1 total only \$30. Thus, in
13 this example, Class B is assigned a share of the institutional costs of
14 Function 2 although the class makes no use of this function.¹

15 This may strike one as somehow "unfair." Whether or not this is the case, it is clear that
16 it is, at the very least, economically inefficient. Consider the incremental costs in Table
17 2. Because the mark-up assigned to Class B in this situation is \$45, and its price is \$120,
18 the revenue obtained from Classes A and C totals only \$280 ($= 400 - 120$), less than the
19 \$295 incremental cost of the two classes considered as a group. Thus, applying equal

¹ Chown Direct Testimony, pages 10-11.

1 mark-ups to unweighted volume variable costs violates the incremental cost test for the
2 {A,C} service group.² Thus Chown's dramatic example merely illustrates the need for
3 careful incremental cost testing when unbundling occurs. It does not demonstrate any
4 need for an arbitrary scheme for weighting volume variable costs. Nor is Witness
5 Chown's proposal a substitute for subsidy analysis. Since the Commission would be free
6 to select differing mark-ups for each subclass, basing those mark-ups on WAC rather than
7 volume variable costs does nothing to ensure that subsidy free rates are established.

8

9 **3.3 Unbundling And Work-Sharing Discounts**

10 Unbundling also raises the issue of work-sharing discounts. Witness Chown's
11 proposed WAC costing methodology complicates rather than clarifies the resulting rate-
12 making problem. Again, her example can be used to illustrate the difficulties caused by
13 her proposal. There, Class B can be viewed as a version of Class A in which Function 2
14 is provided by the mailer. Similarly, Class C can be viewed as a version of Class A in
15 which Function 1 is provided by the mailer. A glance at Table 1 reveals that Postal
16 Service costing methodology clearly reflects this fact. The (unit) volume variable costs
17 of Class A (\$125) exceeds the (unit) volume variable cost of Class B (\$75) by \$50, which

² Equivalently, one could say that the rate for Class B violates the *stand-alone* cost test because $\$120 > \30 (Function 1 Fixed Costs) + $\$75$ (Class B Volume Variable Costs).

1 is precisely the cost of the unit of Function 2 driver activity saved by work-sharing each
2 unit of Class B volume. Similarly, the (unit) volume variable costs of Class A (\$125)
3 exceeds the (unit) volume variable cost of Class C (\$50) by \$75, which is precisely the
4 cost of the unit of Function 1 driver activity saved by work-sharing each unit of Class C
5 volume.

6 There is considerable debate about the appropriate levels of work-sharing
7 discounts in a multi-layered network such as that operated by the Postal Service. It is not
8 my intention to take a position on that issue here. However, it is generally recognized
9 that a pricing policy that employs discounts equal to unit costs saved is required to ensure
10 that postal services are provided at minimum *social* cost. That is, only this policy will
11 provide the incentive for those mailers (and *only* those mailers) who can provide a
12 function more cheaply than the Postal Service to undertake that activity themselves.
13 There may be good reasons to depart from this Efficient Discount Policy when setting
14 rates. For example, as Witness Bernstein points out, Ramsey optimal prices may involve
15 *different discounts*.³ However, one result of a costing methodology should be to make it
16 easy to determine the magnitude of unit cost savings.

³ In other words, efficient "discounts" do not necessarily yield efficient "rates."
Logically, this is not surprising, as the scope of the inquiry involved in exploring efficient
discounts does not address the broader issue of the efficiency of the base rate to which the
discount is applied.

1 As indicated above, the methodology presented by the Postal Service in this
2 docket has the property that, when one mail subclass involves fewer cost components
3 than another, the difference in unit attributable costs measures the component costs saved
4 at the margin. All that is required to implement EDP is to set equal *absolute* mark-ups
5 for the subclasses in question. (*Not* equal percentage mark-ups!) A glance at Witness
6 Chown's Table 7 reveals that her proposed WAC methodology makes it very complicated
7 to implement EDP. The WAC for Class A (\$125) is \$100 greater than that of Class B
8 (\$25), while the Function 2 costs saved are only \$50. On the other hand, the WAC for
9 Class A (\$125) is only \$25 more than that of Class C (\$100), while the Function 1 costs
10 saved are \$75. Of course, since Witness Chown's proposal allows the Commission to set
11 any mark-ups it deems reasonable, it is still possible to implement EDP. However, it
12 would no longer be simple!

13 **4. WITNESS HENDERSON'S PROPOSAL TO MARK-UP**
14 **AVERAGE INCREMENTAL COSTS IS CONTRARY TO**
15 **ACCEPTED ECONOMIC THEORY.**

16 In his Direct Testimony, Dr. J. Stephen Henderson makes alternative pricing
17 recommendations for Express Mail, Priority Mail, and Parcel Post. These
18 recommendations are based upon applying existing mark-ups to the average incremental
19 cost estimates developed by the Postal Service, rather than unit volume variable costs. In
20 my Direct Testimony, I explained why unit volume variable costs correspond to
21 economic marginal costs and that marginal costs are the economically correct starting
22 point from which to apply mark-ups for rate-setting purposes. Rather than dispute the
23 economic principles upon which my testimony is based, Dr. Henderson offers two

1 supposedly practical reasons for using average incremental costs as the basis for mark-
2 ups: to guard against the effects of "measurement error" and because they are calculated
3 on a "longer run" basis than unit volume variable costs. In my opinion, neither argument
4 is correct.

5 **4.1 Marking-Up Average Incremental Costs Is Not The Correct Way To**
6 **Allow For A "Margin For Error" When Attempting To Prevent Cross-**
7 **Subsidization.**

8 On page 10 of his Direct Testimony, Dr. Henderson states: "Without some
9 markup over incremental cost, measurement error could lead to prices for some services
10 that are below their actual incremental costs." The situation he seems to have in mind is
11 one in which the revenues from some subclass *exactly* covers its *measured* incremental
12 cost. In the absence of systematic bias, measured incremental costs may be greater than
13 or less than "true" incremental costs. Dr. Henderson points out that, if rates were set to
14 cover measured incremental costs, but did not cover true incremental costs, entry into the
15 market in question would be inefficiently deterred. That is the potential *efficiency cost* of
16 an *underestimate* of the true incremental cost. Call this ECU. However, there are also
17 costs associated with applying an incremental cost floor that is above true incremental
18 costs. In that case, prices for some or all other subclasses may be increased above the
19 (initially) desired levels, leading to a loss of consumers' surplus and the encouragement
20 of inefficient entry into those markets. Such is the potential *efficiency cost* of an
21 overestimate. Call this ECO. Which expected costs are greater, those of the ECU or
22 those of the ECO? No general conclusion is possible without detailed analysis of the case

1 at hand. Most modeling approaches tend to lead to the result that the point estimate, or
2 "best guess," be used to implement constraints such as an incremental cost pricing floor.

3 However, should detailed study result in the conclusion that, as a practical matter,
4 subclass revenues should exceed subclass incremental costs by some "margin for error,"
5 that is no reason to use average incremental costs as the cost basis to which mark-ups are
6 applied. The correct way to implement such a policy would be at the subsidy testing
7 stage. That is, the Commission would determine rates based on marginal costs and
8 statutory considerations and then test them for cross-subsidy by comparing the resulting
9 revenues to estimated incremental costs plus any desired margin for error.

10 **4.2 Postal Service Estimates Of Incremental Costs Are Developed Under**
11 **The Same Assumptions As Those Used To Develop Volume Variable**
12 **Costs. They Are Not "Longer Run" Costs.**

13 On page 11 of his Direct Testimony, Dr. Henderson cites my Direct Testimony as
14 authority for his conclusion that "... the relevant cost basis for pricing decisions should
15 correspond to the time period during which the rates will be in effect." I could not agree
16 more. That is why the unit volume variable costs presented by the Postal Service are *not*
17 designed to be estimates of short-run marginal costs that "change[s] frequently as a result
18 of changes in volumes, usage mixes, overtime rates, input costs, organizational changes,
19 productivity improvements, general inflation, and other factors."⁴ Instead, they are

⁴ Direct Testimony of J. Stephen Henderson, UPS-T-3, at page 11.

1 designed to measure those additional costs required to provide a unit increase in subclass
2 volume which is expected to be sustained over a period of a few years.

3 There may be practical questions concerning exactly what productive inputs are
4 and are not allowed to vary in the operation of the Postal Service's costing methodology.
5 However, it must be pointed out that the incremental costing methodology presented in
6 Witness Takis's Direct Testimony is based on precisely the same costing system that is
7 used to develop Postal Service unit volume variable cost estimates. Incremental cost
8 calculations require estimating the effects on component costs of removing entire
9 subclass mail volumes, rather than one unit of subclass volume. Because of this, one
10 might argue that incremental cost estimates involve necessarily less accurate
11 extrapolations from current experience. But, though perhaps less precise, they are
12 calculated using the same cost models used in the calculation of volume variable costs.

13 In his discussion, Dr. Henderson seems to confuse the issues of whether certain
14 costs vary with volume with whether or not they are variable within a particular time
15 frame. Costs which do not vary with volume are *fixed costs*. Those fixed costs which
16 cannot be avoided during a particular time period are *sunk costs* with respect to that time
17 frame. The Postal Service costing methodology presented in this proceeding does not
18 include any component fixed costs or product specific fixed costs when developing
19 marginal (unit volume variable) cost estimates. But this is because those costs do not
20 vary with volume, not because the Postal Service has chosen to use short run costs
21 instead of long run costs. Dr. Henderson's example of advertising costs is instructive.
22 Advertising costs are not included in marginal cost calculations because they do not vary

1 with volume. However, they may or may not comprise part of subclass incremental costs
2 depending upon the time frame of the analysis. One could imagine advertising contracts
3 that irrevocably committed the Postal Service to a pattern of expenditures over the next
4 decade. In that case, these costs would be sunk with respect to the time period relevant
5 for rate-making and, therefore, would not be part of the incremental costs of any subclass.
6 Alternatively, suppose the Postal Service committed its advertising expenditures on a
7 monthly or annual basis. These costs would then clearly be incremental for rate-making
8 purposes. However, in neither case would advertising costs be included in the calculation
9 of marginal costs. This example illustrates precisely why average incremental costs
10 should not form the cost basis to which mark-ups are applied: *they include costs that do*
11 *not vary with volume.* To the extent possible, such costs should not be included in the
12 rates that determine consumer purchases because they are *not* caused by provision of the
13 marginal unit of service of the subclass in question.

14 One other point made by Dr. Henderson merits comment. During hearings on his
15 testimony, Dr. Henderson observed that the Postal Service and the Commission have no
16 choice but to rely upon available demand information (e.g., price elasticities) when
17 setting rates, and further stated that a Ramsey analysis does provide useful information
18 for consideration in a broader pricing process. Tr. 25/13669-70. Obviously, I agree. But
19 Dr. Henderson appears to fail to appreciate fully the consequences of his statements.
20 Specifically, if the mark-up process starts with incremental costs, it is impossible to
21 engage in a Ramsey analysis, much less derive any useful information content. There are

1 no means by which to analyze economically efficient mark-ups for comparison purposes
2 with other proposed mark-ups.⁵

3 That is why, as stated in my direct testimony, it is necessary to start the
4 mark-up process with marginal (i.e., volume variable) costs. Using this approach, for
5 each subclass, one can consider the minimum mark-up required over marginal costs to
6 cover incremental costs, one can consider the Ramsey mark-up, and, of course, one can
7 bring to bear all the other factors of the Act one wishes to rely upon in determining the
8 actual mark-up proposed. In contrast, if one starts with incremental costs, you can still
9 consider the other factors of the Act, but you have lost the ability to bring to bear
10 information on the economically efficient mark-ups. And as even Dr. Henderson
11 apparently agrees, you have therefore lost useful information.

12 **5. SUMMARY AND CONCLUSIONS**

13 My conclusions in this Rebuttal Testimony are easily summarized:

- 14 • The Weighted Attributable Cost concept proposed by Witness Chown is
15 without economic foundation and should play no role in the rate-making process. Even

⁵ I suppose that as a matter of semantics, one could argue that it is arithmetically possible to take marginal costs, calculate Ramsey rate levels, and convert the resulting rate levels into a mark-up over incremental cost for each subclass. While such an exercise could be conducted, I would not consider it one in which, in any meaningful sense, the true starting point has been incremental costs.

1 though it allows for substantial flexibility, it still unnecessarily introduces arbitrariness
2 into the rate-making process.

3 • The “practical” reasons offered by Dr. Henderson for basing his pricing
4 *recommendations on mark-ups of average incremental costs rather than marginal costs*
5 are not well founded, and certainly do not overcome the theoretical superiority of the
6 latter over the former as the proper basis for rate-making.

7 In this testimony, I have continued my efforts to emphasize that marginal costs
8 are the relevant cost basis to which any mark-ups should be applied. The costing
9 methodology used by the Postal Service is designed in such a way that unit volume
10 variable costs correspond to economic marginal costs. Therefore, these costs should be
11 used as the basis for mark-ups, even though the Postal Service has also reported estimates
12 of incremental costs in this proceeding. The latter should be used only to evaluate rates
13 for cross-subsidization. While incremental costs are, indeed, caused by the totality of the
14 mail subclass in question, they include costs which are *not* caused by the marginal unit of
15 subclass volume.

1 CHAIRMAN GLEIMAN: Three participants have
2 requested oral cross examination of the witness -- Florida
3 Gift Fruit Shippers, the Newspaper Association of America,
4 United Parcel Service.

5 Does any other party wish to cross examine?

6 [No response.]

7 CHAIRMAN GLEIMAN: If not, Mr. Wells, you may
8 begin when you're ready.

9 CROSS EXAMINATION

10 BY MR. WELLS:

11 Q Dr. Panzar, I'm Mike Wells of Florida Gift Fruit
12 Shippers, and I just have a couple of short questions.

13 Look at page 15 of your testimony, please.

14 A Okay.

15 Q On line 13, you use the terminology "efficient
16 discount policy." Would you define how you use that
17 terminology?

18 A I use that terminology to describe the situation
19 where the discount between a full-service sub-class of mail
20 and one for which work sharing provided is equal to the per
21 unit postal cost saved.

22 Q Do you support and recommend the utilization of
23 that policy?

24 A As I explained in the testimony, it's the starting
25 point for ensuring cost efficiency -- that is, ensuring that

1 mailers engage in work sharing only when they are at least
2 as efficient as the Postal Service at the margin in
3 providing that work.

4 So, in that sense, I recommend it, but there may
5 be demand side reasons or reasons in accordance with the
6 Postal Statute for deviating from that efficient discount
7 policy.

8 To further elaborate, I guess, if I could -- you
9 might want to rename it the cost-efficient discount policy,
10 because that's what the term "efficiency" should refer to.

11 Q Is the effect of this that, where there is work-
12 sharing, that it does not produce the piece contribution to
13 institutional costs?

14 A No. Under what I have called the efficient
15 discount policy, both services would be making a
16 contribution to incremental costs.

17 Q The same contribution.

18 A The same contribution, yes.

19 Q All right.

20 Then, on page 16, you say there all that is
21 required to implement EDP is to set equal absolute mark-ups
22 for the sub-class in question. What do you mean by that?

23 A I mean the same mark-up per unit, equal per-unit
24 mark-ups, as distinct from equal percentage mark-ups.

25 Q And you say it's not equal percentages, and you

1 would go with an equal unit contribution and not an equal
2 percentage contribution. Is that right?

3 A The efficient discount policy, as I've described
4 here, has equal per-unit contributions and not equal
5 percentage contribution.

6 MR. WELLS: Very good. Thank you.

7 That's all I have, Mr. Vice Chairman.

8 COMMISSIONER HALEY: Very good. Thank you.

9 Mr. Baker.

10 CROSS EXAMINATION

11 BY MR. BAKER:

12 Q Good afternoon, Dr. Panzar. Bill Baker for the
13 Newspaper Association of America.

14 A Good afternoon.

15 Q Just I wanted to follow up on Mr. Wells' question
16 when we talk about equal per unit contribution, did you mean
17 as measured in dollars and cents rather than in percentages?

18 A As measured as dollars and cents per piece.

19 Q Right, okay. Could you turn to page 11 of your
20 testimony -- I was directing your attention to lines 1 and 2
21 so you might want to flip back to page 10 to see where it
22 picks up -- do you see that?

23 A I am not sure my numbering lines up.

24 Q Okay. I am referring then to the last couple
25 sentences before your heading 3.2.

1 A Okay. Page 11, 1 and 2 -- is that your --

2 Q Of the copy of your testimony that I have, it is a
3 continuation of a sentence that begins on page 10.

4 A Okay.

5 Q And here you were discussing Witness Chown's
6 weighted attributable cost proposal and you state that --
7 well, you were discussing whether it's a form of fully
8 distributed costing, but you concluded by ending -- by
9 stating and the sentence I want to focus on is the sentence
10 that "The arbitrary allocation of common costs remains at
11 the heart of the plan."

12 Are you with me?

13 A Yes.

14 Q Okay. Let's assume for a moment that the Postal
15 Service proposed to mark up the attributable costs for each
16 subclass by an equal percentage amount.

17 Would you call that an arbitrary allocation of
18 common costs?

19 A No.

20 Q Why not?

21 A I'm sorry, let me -- repeat your question? You
22 say if the Postal Service --

23 Q -- had proposed to mark up the attributable costs
24 for each subclass by an equal percentage amount, would that
25 have been in your judgment an arbitrary allocation of common

1 costs?

2 A No, I don't think so.

3 MR. COOPER: So that the record is clear, Mr.
4 Baker, do you mean by the term "attributable costs" any
5 particular type of costs?

6 MR. BAKER: Well, I had not had any particular
7 definition in mind. I was referring to the concept of
8 marking up of whatever we consider attributable costs.

9 BY MR. BAKER:

10 Q Isn't in a sense the entire rate setting process
11 that we are going through here a form of allocating the
12 common costs to the subclasses so that they can be recovered
13 through rates?

14 A Very much so.

15 Q And is any allocation of common costs to the
16 subclasses of mail arbitrary by its very nature?

17 A Some are arbitrary in the sense that they don't
18 pay attention to the relevant economic measurements
19 available to the analysts or to the statutory provisions of
20 what should influence the Commission.

21 When I say that the whole rate setting process can
22 be viewed as an allocation of the common costs, that
23 allocation is a residual that comes about from cost
24 coverage.

25 Once the Commission takes into account the various

1 factors it considers in setting rates and if those rates
2 cover the costs of the Postal Service, then by construction
3 they result in a cost allocation, and that allocation will
4 not be arbitrary if the Commission doesn't set the rates in
5 an arbitrary way.

6 You could get to the cost coverage through what
7 economists tend to call arbitrary manipulations of
8 irrelevant cost data and those cost coverages would be
9 arbitrary in my opinion.

10 Q Are we then saying that the exercise of judgment
11 by the Commission in setting rates does not necessarily
12 render its result arbitrary?

13 A Well, I would say it differently. It's the
14 exercise of judgement by the Commission, which makes the
15 implicit cost allocation from approved rates non-arbitrary.

16 Q I'd like you to also turn to what I believe you'll
17 find on page 20 of your testimony, lines 1 through 4, and
18 this is a discussion of advertising costs that were, I
19 guess, initiated by Dr. Henderson. Have you found the page?

20 A Yes.

21 Q Okay. And looking at your sentence, where you
22 said that advertising costs are not included in marginal
23 cost calculations because they do not vary with volume, and
24 then you went on to say they or may not comprise part of
25 sub-class ^{incremental} ~~increment~~ cost, depending upon the time-frame of

1 the analysis, and I want to focus on that second sentence
2 with my question here.

3 Let's assume that the Postal Service committed to
4 an Express Mail advertising contract that had a duration of
5 10 years. Would those advertising costs be an incremental
6 cost to the Postal Service for Express Mail?

7 A Not in a time-frame of shorter duration. For
8 example, if the costs had been incurred already, say
9 yesterday, and could not be avoided even if the Postal
10 Service abandoned Express Mail service, then those costs
11 would not be incremental to any relevant decision in the
12 medium run of a few years.

13 Those would just be part of the overall sunk costs
14 of the enterprise. They would be irrelevant to the decision
15 whether or not the Postal Service should abandon Express
16 Mail, because they wouldn't be saved if it abandoned Express
17 Mail at this date.

18 Q Okay. Would the 10-year Express Mail advertising
19 contract, in your judgement, be a long run incremental cost?

20 A In the abstract sense that economists use long run
21 -- that is, in the sense that any expenditure can be avoided
22 in the long run -- then, yes, it could be considered a long
23 run incremental cost. It would be considered a long run
24 incremental cost in that sense.

25 Q Now I want to offer you a different hypothetical

1 situation.

2 Now I'd like you to suppose that the Postal
3 Service governors adopted a policy that, from now on, rates
4 would increase every two years by relatively small amounts
5 rather than less frequently at larger amounts, at larger
6 increments, and assume further that the Postal Service then
7 files a rate case and announces that it expected that the
8 new rates would be in effect only for two years, so we're
9 talking about a two-year rate cycle, clear, and we
10 understood two-rate cycle under this hypothetical.

11 Now, if the Postal Service has an Express Mail
12 advertising contract that has three years to go, should that
13 cost be considered an incremental cost of Express Mail for
14 purposes of that rate case?

15 A An existing contract that has three years to go at
16 the time rates are being decided for a period of two years.
17 Because those advertising costs could not be avoided if
18 Express Mail were dropped, they can't be viewed as
19 incremental to Express Mail for the purpose of that rate
20 case.

21 Q So that answer is no.

22 A I'll assume you're not trying to trick me.

23 Q That was a no.

24 COMMISSIONER LeBLANC: It's a leap of faith, isn't
25 it?

1 MR. BAKER: With that clear and candid no, I have
2 no more questions, Mr. Chairman.

3 CHAIRMAN GLEIMAN: Mr. McKeever?

4 COMMISSIONER LeBLANC: Excuse me, Mr. McKeever.
5 Let me just clarify something while we're right there.

6 Dr. Panzar, in that last question that Mr. Baker
7 asked you, in that case it becomes an institutional cost as
8 far as you're concerned, in its total concept?

9 THE WITNESS: Yes, it would be part of the overall
10 non-volume variable costs of the Postal Service, so
11 institutional in that sense, yes.

12 COMMISSIONER LeBLANC: Okay. Good. Thank you.

13 CROSS EXAMINATION

14 BY MR. McKEEVER:

15 Q Dr. Panzar, I'd also like to follow up a little
16 bit before I begin the questions I intended to ask.

17 Mr. Baker's questions about the 10-year Express
18 Mail contract were phrased in terms of whether they would be
19 -- that would be an incremental cost. Would that 10-year
20 contract be attributable to Express Mail, in your view?
21 This is a 10-year contract for Express Mail only. Go ahead.

22 A Not for the -- an existing 10-year contract for
23 Express Mail only, I wouldn't say they were attributable for
24 the purposes of the subsequent short-term rate case, because
25 the funds committed were not avoidable as a result of any

1 decisions that could be made at that time.

2 I am a little uncomfortable with classifying any
3 expenditures as attributable. I prefer the distinction
4 marginal or incremental.

5 But I would answer that they're not attributable
6 for the purpose of a subsequent rate case where the rates
7 are in effect for a period over which the expenditure
8 cannot, by assumption, be altered.

9 Q Well, since you're an economist, I understand your
10 hesitancy about attributable, but unfortunately, that's the
11 word we have to deal with, because that's what's in the
12 statute.

13 You say it would not be attributable for purposes
14 of that rate case, envisioning rates that would be in effect
15 for two years. Would the costs of that 10-year contract be
16 attributable to Express Mail in any other sense or for any
17 other purpose?

18 A Again, if you fall back to the notion of the long-
19 run, in which all expenditure decisions are up for renewal,
20 those expenditures on Express Mail alone would be
21 attributable to Express Mail in the long-run sense.

22 Q Okay.

23 A Assuming we define long-run attributable in the
24 same way we define long-run marginal or long-run
25 incremental.

1 Q And if you are not using that long-run concept
2 that you just mentioned but were back in the situation where
3 the rates are expected to be in effect for two years,
4 whether it is attributable or in fact let's use your
5 language -- whether it is incremental really depends on what
6 day you are looking at it, the day before the contract is
7 entered into or the day after?

8 A Any analysis of economic costs, in particular
9 whether or not they are incremental, has to hinge upon the
10 concept of avoidability, so in the hypothetical, which is a
11 little bit extreme, yes, it is the case that on one day
12 those costs are avoidable in the sense that you still have
13 the option not to sign the contract, but the next day they
14 are no longer avoidable and hence no longer incremental to
15 that service.

16 Q What is extreme about the hypothetical in your
17 view?

18 A The length of the commitment of resources relative
19 to the period under which rates are in effect.

20 Q Is it the 10-year length of the contract that you
21 think is extreme or the --

22 A Relative to the 2-year hypothetical rate period.

23 Q Okay. In fact, nobody really knows how often the
24 Postal Service is going to file rate cases, not even the
25 Postal Service -- is that correct?

1 A I certainly don't know.

2 Q Dr. Panzar, could you turn to page 3 of your
3 rebuttal testimony?

4 I would like to direct your attention there to
5 lines 16 through 18 and there you point out that ~~Dr.~~
6 ~~Henderson wants to attribute end mark-up yet you say~~ the so-
7 called longer run costs Dr. Henderson wants to attribute ~~end and~~
8 mark-up should not form part of the cost basis to which
9 mark-ups are applied precisely because they do not vary with
10 volume.

11 Do you see that?

12 A Yes.

13 Q Do you mean there do not vary with volume in the
14 short-run?

15 A They do not vary with volume in the short-run
16 relevant to rate setting in this case.

17 Q They do not vary with volume in the sense that
18 they do not vary when an additional unit of volume is
19 provided. Is that accurate?

20 A Yes.

21 Q Okay. But you go on to say, even though they may
22 be variable during the relevant time period, is that
23 correct? You go on on that page?

24 A Yes. Yes.

25 Q Okay. Dr. Panzar, could you please turn to page

1 17 of your testimony? And I would like to direct your
2 attention to lines 16 through 19. Could you take a look at
3 those lines?

4 A Yes.

5 Q Now, there you state there are -- beginning on
6 line 16. There are also costs associated with applying an
7 incremental cost floor that is above true incremental costs,
8 correct?

9 A Yes.

10 Q And you state there, in that case, prices for some
11 or all other subclasses may be increased above the initially
12 desired levels. Do you see that?

13 A Yes.

14 Q By the phrase "the initially desired levels," I
15 take it you mean prices where revenues cover true
16 incremental costs, is that right?

17 A No, what I meant is prices set at whatever levels
18 the Commission felt best and passed the true average
19 incremental cost subsidy test. Then, if you apply to those
20 prices an incremental cost, average incremental cost floor
21 subsidy test that was too high, you would have to raise them
22 above those hypothetically initially desired levels.

23 Q For the class where the incremental cost floor is
24 too high, right?

25 A For -- you may have to raise it for some which

1 would have passed the incremental cost test for the true
2 level, but fail it when the measured level is higher than
3 the true level.

4 Q Okay. Well, let me make sure I understand what
5 you are trying to say here by asking it this way. In your
6 second sentence -- well, in your first sentence you are
7 talking about an incremental cost floor that is above
8 incremental costs for a particular class of mail, aren't
9 you? The sentence, "There are also costs associated with
10 applying an incremental cost floor that is above true
11 incremental costs."

12 A Yes.

13 Q Okay. And then in the next sentence, you are
14 directing your remarks to some or all other subclasses.

15 A Right.

16 Q Okay. Now, in that context, with that in mind,
17 did you mean to say that the prices for some or all other
18 subclasses may be increased above the initially desired
19 levels or may be increased by less than the initially
20 desired levels? I am trying to make sure we have the --

21 A Oh, I see. They may be -- other subclasses would
22 be -- I seem to have two increases here, which is what you
23 are getting at. And one of them should be a decrease.

24 Q That was my question. Go ahead.

25 A So, presumably, if subclass A, the one where we

1 are questioning whether or not the incremental cost measure
2 is accurate, and that --

3 Q That is too high.

4 A Is too high. Then for breakeven, some or all of
5 the other subclasses may have to have their prices lowered
6 if that new incremental cost, that inaccurate incremental
7 cost floor is implemented, lowered relative to what they --
8 from their otherwise desirable level.

9 Q So that second sentence should be, in that case,
10 prices for some or all other subclasses may be below the
11 initially desired level, is that right?

12 A Yes.

13 Q Thank you. Dr. Panzar, could you turn to page 19
14 of your testimony?

15 A Yes.

16 Q And again I'd like to direct your attention in
17 particular to lines 9 through 11. And there you state,
18 quote, one might argue that incremental cost estimates
19 involve necessarily less accurate extrapolations from
20 current experience.

21 Do you see that?

22 A Yes.

23 Q Is it your belief that incremental cost estimates
24 involve necessarily less accurate extrapolations from
25 current experience?

1 A Yes.

2 Q Thank you.

3 Dr. Panzar, are you familiar with the term quasi
4 fixed costs?

5 A I've seen it, but I don't think I could give you a
6 precise definition.

7 Q Well, that was going to be my next question, so I
8 won't ask it.

9 A Okay.

10 MR. MCKEEVER: That's all I have, Mr. Chairman.

11 CHAIRMAN GLEIMAN: Is there any followup?

12 MR. TODD: Mr. Chairman, we have some.

13 CHAIRMAN GLEIMAN: I'm sorry. I apologize.

14 CROSS EXAMINATION

15 BY MR. TODD:

16 Q Dr. Panzar, I'm David Todd, appearing in behalf of
17 Mail Order Association of America. I have just a couple of
18 followup questions.

19 First, if I suppose from your point of view, God
20 forbid, you were to be transformed into a pricing witness,
21 and all you knew about costs in a multiproduct regulated
22 entity, you were given costs which were absolutely certain
23 that you knew what the marginal cost for each of the product
24 lines is, and you know what the incremental cost for each of
25 the product lines is -- that's all you know about costs,

1 nothing more -- and then you're given the godlike task of
2 marking up those marginal costs so as to equal total costs
3 of the enterprise, would you feel comfortable doing that,
4 not commenting on your godlike obligation, but merely that
5 this would be a starting point with which you would feel
6 comfortable?

7 A I certainly would want to start with estimates of
8 marginal and incremental costs if I were going to engage in
9 this pricing exercise.

10 Q And if you were given those marginal and
11 incremental costs, and that's all you knew about cost
12 behavior, would you feel comfortable using those costs as a
13 starting point?

14 A Yes.

15 Q Thank you. You had some discussion, answered some
16 questions from counsel earlier discussing efficient discount
17 policy and the prices which might flow from that. Am I --
18 and you acknowledge that there could be a difference between
19 efficient discount prices and efficient rates.

20 A Yes.

21 Q Would it be accurate to say that anytime there is
22 a divergence between the efficient discount policy rate and
23 the efficient rate, there's a tension between those two
24 concepts? There's a pricing tension.

25 A There's a pricing tension between demand-side

1 considerations, value of service, elasticity of demand, and
2 cost efficiency considerations. There's certainly a tension
3 there, anytime the rate is not consistent with the efficient
4 discount policy.

5 Q And would it not also be obvious that the greater
6 the difference between the efficient discount policy rate
7 and the efficient rate, the greater that tension would be?

8 A I really can't comment on that, the quantitative
9 notion you're trying to get across, without some way of
10 measuring tension.

11 Q Well, let me give you an example. Suppose the
12 efficient discount policy rate were five cents or ten cents
13 and the efficient rate were five cents. Would you say
14 that's a lot of tension?

15 A No. I couldn't say that was a lot tension.

16 Q One was twice as high as the other.

17 A I couldn't say that was a lot of tension
18 relative -- what I could say perhaps is relative to a
19 difference of one cent it would introduce more distortions
20 on the cost side -- that is mailers providing the work share
21 who shouldn't or mailers not providing the work share who
22 should.

23 In that sense, I guess I would agree with the
24 spirit of your discussion.

25 Q And in terms of pricing and determining prices,

1 would you agree that it is necessary to examine both the
2 efficient rate as well as the efficient discount policy rate
3 before making a final judgment?

4 A I would say that it would be desirable to examine
5 both in the following sense.

6 The "efficient" rate -- I would like to put the
7 term in verbal quotes -- in order to do that, let me use the
8 term Ramsey rate that comes from maximizing some
9 well-understood total surplus function.

10 That rate takes into account this trade-off
11 between the supply side and the demand side that I have been
12 discussing, so if I were charged with the task of maximizing
13 total surplus, I would want to know the Ramsey rate and that
14 rate would reflect -- in some cases it will depart from the
15 efficient discount rate, but that rate will reflect the
16 right trade-off between the cost considerations and demand
17 considerations.

18 But that is only -- now for the Commission's
19 purposes I would think that would be useful information, but
20 their statutory responsibility isn't as simple as maximizing
21 total surplus.

22 They may be willing to trade off demand side
23 considerations against cost side efficiencies as well, and I
24 would think they would want to know both numbers.

25 If they were just interested in Ramsey-like total

1 surplus calculations they wouldn't have to pay any great
2 attention to the efficient discount policy because the
3 Ramsey calculation has made that trade-off automatically.

4 So I guess that's saying yes, I would like -- if I
5 were in the position of setting the rates I would like to
6 see both numbers.

7 Q And you wouldn't simply by rote choose the
8 efficient discount policy rate over the efficient or Ramsey
9 rate?

10 A No.

11 MR. TODD: Thank you. I have no further
12 questions.

13 CHAIRMAN GLEIMAN: Follow-up?

14 FURTHER CROSS EXAMINATION

15 BY MR. McKEEVER:

16 Q Dr. Panzar, I am not sure I understood anything --
17 something -- but let me -- maybe I didn't understand
18 anything, but let me see if I understood something.

19 Judged from the standard of efficient rates as you
20 define the term, is it accurate to say that the bigger the
21 discount, the more the discounted rate departs from
22 efficient rates?

23 A I don't think so, but could you restate that
24 again, because you have to -- you have to be talking about
25 at least two rates in order to make a comparison about how

1 they might depart from one another.

2 Q Well, what prompted my question was you made that
3 point in one of your responses to Mr. Todd.

4 He gave you an example and I can't repeat the
5 exact example but it involved a five-cent differential and
6 you said, well, that is different from a one-cent
7 differential, and that is what I am thinking of. The bigger
8 the discount -- I thought what you were trying to suggest
9 was the bigger the amount of the discount, the greater the
10 disparity between the rate dictated by the efficient
11 discount policy and what you define as the efficient rate.

12 I misunderstood?

13 A No -- I think you misunderstood Mr. Todd's
14 hypothetical.

15 Q Okay.

16 A He was positing a unit postal cost saved, I
17 believe, of 5 cents and then he said, well, if there is a
18 discount -- I'm sorry, go ahead and let him --

19 MR. TODD: I'm sorry. I don't mean to interrupt
20 your answer, Dr. Panzar.

21 THE WITNESS: That's if the difference between the
22 efficient discount and the actual rate were 5 cents, isn't
23 that more of a tension than if that difference were 1 cent.

24 BY MR. McKEEVER:

25 Q Okay.

1 A And I said it would probably lead to more cost
2 distortions because there would be greater distortion of
3 incentives.

4 Q Okay. Well, I am not sure I helped the record and
5 I think I'll let it go there because I don't think I can
6 make it better.

7 CHAIRMAN GLEIMAN: Mr. Todd? -- before you do
8 that, did you understand --

9 MR. McKEEVER: Sufficiently to know that I don't
10 wish to pursue it any further.

11 [Laughter.]

12 CHAIRMAN GLEIMAN: Well, it's clear then,
13 especially given the answer that you just gave that you are
14 not qualified to be a Postal Rate Commissioner.

15 FOLLOW-UP CROSS EXAMINATION

16 BY MR. TODD:

17 Q Prompted to a degree by Counsel's question, in
18 determining marginal costs, you don't have to know whether a
19 given rate is a discounted rate or not, do you?

20 A No.

21 MR. TODD: Thank you.

22 CHAIRMAN GLEIMAN: Just so I can clarify the
23 record, you seem to have understood enough to know to stop,
24 and that is what disqualified you, and I'm going to prove
25 the point right now.

1 You were asked some questions earlier by Mr.
2 McKeever concerning costs associated -- the example he was
3 using was an Express Mail contract, and I just want to make
4 sure I understand the general principle that you were
5 espousing.

6 The cost of any contract that exceeds the term
7 --where the term of the contract exceeds the length of a
8 rate cycle and for which the funds are committed and not
9 avoidable cannot or should not be included in marginal cost,
10 if you will, in attributable cost.

11 THE WITNESS: Or incremental costs.

12 CHAIRMAN GLEIMAN: And that's a general principle
13 of economics.

14 THE WITNESS: Yes. Some costs are sunk.

15 CHAIRMAN GLEIMAN: Okay.

16 So, if there is a labor contract that exceeds the
17 term of a rate cycle and contains a no-layoff clause, the
18 costs are sunk costs and shouldn't be included in marginal
19 costs, incremental costs, or attributable costs. Is that
20 correct?

21 THE WITNESS: No.

22 CHAIRMAN GLEIMAN: Why not?

23 THE WITNESS: Because those costs vary with
24 volume.

25 CHAIRMAN GLEIMAN: I'm afraid that --

1 THE WITNESS: Maybe not in aggregate, but they
2 --but with usage among different sub-classes. You're
3 postulating the situation where all these workers are there
4 and have to be paid their full salary for 10 years
5 regardless of what they do.

6 CHAIRMAN GLEIMAN: Do you know that that's not the
7 case?

8 THE WITNESS: No, I don't know --

9 CHAIRMAN GLEIMAN: I don't know that the 10-year
10 figure --

11 THE WITNESS: Right.

12 CHAIRMAN GLEIMAN: We're using a hypothetical.
13 But my hypothetical to you was there's a labor contract, the
14 labor contract exceeds the terms -- the length of the rate
15 cycle --

16 THE WITNESS: Right.

17 CHAIRMAN GLEIMAN: -- and the labor contract has a
18 no-layoff clause.

19 So, when the contract is signed, there are X
20 hundreds of thousands of employees covered by the contract,
21 and they can't be laid off, and they have to be paid. They
22 have to be paid for 40 hours a week plus benefits.

23 Now, it may be that, if volume goes through the
24 roof in whatever this entity is that entered into this
25 contract, they have to hire some part-time people or they

1 have to pay overtime, but they're committed to base pay for
2 a certain number of people for a certain period of years,
3 and I don't understand what the difference between that
4 situation is and your situation with the contract for
5 advertising Express Mail.

6 THE WITNESS: Well, you've said it yourself.
7 They'd have to -- they have to make decisions about
8 additional staffing, overtime workers, etcetera, etcetera,
9 at the margin, depending on their margin of mail.

10 CHAIRMAN GLEIMAN: So, it's only the cost of
11 overtime and the cost of casual employees or new hires as a
12 consequence of volume growth that are part of marginal cost,
13 but there's a baseline of labor cost that's outside of the
14 margin?

15 THE WITNESS: No, because then there's an
16 opportunity cost that comes into play.

17 If you have variation at the margin, that's --
18 through the usual postal costing system, will give you
19 volume variable costs, and all of those -- a laborer who
20 provides the required effort to process the marginal volume
21 of mail is interchangeable -- who happens to be on overtime
22 or casual --

23 CHAIRMAN GLEIMAN: People are fungible?

24 THE WITNESS: Yes.

25 CHAIRMAN GLEIMAN: Okay.

1 THE WITNESS: He's interchangeable with a laborer
2 who is, in your hypothetical, sunk in terms of his total
3 salary. So, at the margin, these guys are substituted and
4 the costs do vary at the margin.

5 CHAIRMAN GLEIMAN: So, then, if the Postal Service
6 has a contract for \$150 million a year on advertising cost
7 and it initially designates \$50 million to be spent on
8 Express Mail but subsequently decides it doesn't want to
9 spend it on Express Mail, it wants to spend it on something
10 else, even though the length of the \$150 million-a-year
11 contract is 10 years, the fact that they can move the money
12 around -- money, like people, being now fungible -- it means
13 that maybe we should treat the advertising dollars the same
14 way as we treat the people dollars.

15 THE WITNESS: Not the same way, not as marginal.
16 In your second hypothetical, you would treat those as
17 incremental, because they have the ability to shift from one
18 service to the other, which is very different from the
19 hypothetical discussed earlier about advertising.

20 CHAIRMAN GLEIMAN: But your basic contention is,
21 then, that -- I don't mean to use the term in a cute manner,
22 but I'm not sure how else to describe it -- there's a pool
23 of bodies out there, the bodies are interchangeable, and the
24 fact that there is a baseline of X hundred thousand
25 employees who come in 40 hours a week and get paid even if

1 there's no volume of mail under the contract, which has a
2 no-cut clause, that those people are part of the marginal
3 cost from the get-go, from person number one to person
4 number X hundred thousand.

5 THE WITNESS: As long as it's necessary to incur
6 additional expenses at the margin, the fact that a whole
7 bunch of these marginal workers have iron-clad, inescapable
8 contracts doesn't change that --

9 CHAIRMAN GLEIMAN: Well, let's take another
10 hypothetical.

11 THE WITNESS: -- doesn't change that conclusion.

12 CHAIRMAN GLEIMAN: Let's modify the hypothetical
13 slightly, then, and then I'm going to try and be as smart as
14 Mr. McKeever was and quit, and that is that the Postal
15 Service is seriously concerned about a pending no-growth
16 situation as new technologies eat away at potential and
17 existing volumes.

18 They're locked into a labor contract that exceeds
19 the length of the rate cycle for a certain number of dollars
20 per hour for a certain number of employees who are on-board
21 at that particular time.

22 And volume doesn't increase. Let's say volume
23 doesn't increase because that makes it nice and simple. So
24 you have got X hundreds of thousands of employees, stagnant
25 volume. Now, how is it that those people are at the margin?

1 We are hiring any more people.

2 THE WITNESS: Well, you could design a
3 hypothetical where none of those people with the fixed
4 contract would be at the margin, in which case, their wages
5 would be a sunk cost. Now, you got part of the way there,
6 but then you would also have to get, well, you would also
7 have to take into account as to whether or not they were
8 substitutable for things which were variable at the margin.
9 They wouldn't be fungible with trucks, but they might be
10 substitutable.

11 But there is nothing wrong with the instinct that
12 if you push the margin of operation far enough away from
13 this committed work force, that their expenditures will be a
14 sunk cost. At some point, that, as a logical matter, that
15 could happen.

16 CHAIRMAN GLEIMAN: Thank you, I think.

17 Follow-up as a consequence of questions from the
18 bench?

19 MR. BAKER: I am not as smart as Mr. McKeever is,
20 I am going to prove now.

21 FURTHER CROSS-EXAMINATION

22 BY MR. BAKER:

23 Q Dr. Panzar, this forum has used, in the past, in
24 its attribution decisions, a concept called fixed costs, or
25 specific fixed costs. Are you familiar with that usage by

1 the Commission?

2 A Specific fixed costs applying to a single subclass
3 of mail or --

4 Q It did come -- well, it has come up in that
5 context, and perhaps others. You are familiar with that?

6 A Yes, that's the term I am -- that's the sense in
7 which I am familiar with it.

8 Q Would my Express Mail advertising contract, which
9 becomes a sunk cost when they decide not to do Express Mail
10 anymore, be a fixed cost?

11 A More than likely, because it doesn't vary with
12 volume.

13 MR. BAKER: Thank you, Mr. Chairman.

14 CHAIRMAN GLEIMAN: Anybody else?

15 COMMISSIONER LeBLANC: I am going to show you how
16 stupid I am, I am going to follow up with this.

17 CHAIRMAN GLEIMAN: He is not an economist, by the
18 way.

19 COMMISSIONER LeBLANC: If you forget about the
20 individuals for a minute, does the same thing apply to a
21 capital investment?

22 THE WITNESS: The same basic principles apply,
23 yes.

24 COMMISSIONER LeBLANC: I mean even if the
25 expenditure is a heck of an expenditure here. I mean you

1 are talking about something pretty substantial, not just one
2 or two. I mean that will change the whole effect, wouldn't
3 it?

4 THE WITNESS: Well, what specifically do you have
5 in mind with respect to a capital expenditure?

6 COMMISSIONER LeBLANC: An airplane.

7 THE WITNESS: An airplane.

8 COMMISSIONER LeBLANC: Something along those
9 lines.

10 THE WITNESS: An airplane is probably too fungible
11 for --

12 COMMISSIONER LeBLANC: Okay.

13 THE WITNESS: To work for your example. It could
14 be shifted back and forth among services, rented out. But
15 if you have committed to a lease on a building, or all the
16 buildings of the Postal Service, that you can't escape, the
17 same basic principles apply. If costs aren't avoidable,
18 they can't be incremental to anything.

19 COMMISSIONER LeBLANC: That's fine. Thank you,
20 sir.

21 CHAIRMAN GLEIMAN: Next?

22 [No response.]

23 CHAIRMAN GLEIMAN: Well, it appears that we are
24 ready for redirect, Mr. Cooper. Would you like a couple of
25 minutes?

1 MR. COOPER: It occurs to me that we are overdue
2 for our afternoon break, so this might be a good time to
3 take it now.

4 CHAIRMAN GLEIMAN: We were going to just plow
5 right through.

6 No, let's take ten.

7 [Recess.]

8 CHAIRMAN GLEIMAN: Mr. Cooper, I have one other
9 question I would like to ask, and I can ask it before you do
10 redirect or I can ask it after you do redirect, and we can
11 go around the bend a little bit on it again. It's up to you
12 whether you're primed and ready to go.

13 MR. COOPER: I'm perfectly happy to let you go
14 ahead.

15 CHAIRMAN GLEIMAN: Okay. And I apologize for
16 this, but I did a reality check and found that I haven't
17 created enough havoc yet today or gotten into enough
18 mischief. And it's something that has been bothering me for
19 a while.

20 Dr. Panzar, I know that efficient component
21 pricing is one of your areas of interest, and let me make
22 sure I understand something. Suppose we have a monopoly
23 that has a bottleneck function and also has functions which
24 are not bottleneck. And then suppose the marginal cost for
25 processing a transaction through its system is a dime, and

1 that the monopoly charges a markup of 50 percent or five
2 cents for a total rate for the transaction of 15 cents.

3 THE WITNESS: On its bottleneck or the whole
4 thing?

5 CHAIRMAN GLEIMAN: The whole -- the whole system.

6 THE WITNESS: Okay.

7 CHAIRMAN GLEIMAN: Now suppose someone only wants
8 to use the bottleneck function, and the bottleneck function
9 has a marginal cost of four cents. Am I right that
10 efficient component pricing would have me charge five cents
11 as a markup for the transaction that uses only the
12 bottleneck function, which in effect would be much higher
13 than the 50-percent markup for someone who uses the entire
14 system?

15 THE WITNESS: I may need a pencil to get that --

16 CHAIRMAN GLEIMAN: I apologize.

17 THE WITNESS: Hypothetical right.

18 Originally the -- we're charging 15 cents on 10
19 cents --

20 CHAIRMAN GLEIMAN: For somebody who uses the
21 entire --

22 THE WITNESS: Entire service.

23 CHAIRMAN GLEIMAN: All the functions.

24 THE WITNESS: Okay. Now -- and then --

25 CHAIRMAN GLEIMAN: We've got --

1 THE WITNESS: Somebody wants only the monopoly
2 component, and how much does that cost?

3 CHAIRMAN GLEIMAN: Marginal cost of four cents.

4 THE WITNESS: Okay. Now the efficient component
5 pricing rule would say that the difference in the rates
6 should be equal to the difference -- the unit postal costs
7 saved, so the rate on postal costs saved are six cents in
8 your example. So the efficient component pricing rule would
9 say charge nine for the bottleneck component service, and
10 that's a markup of 120 percent instead of 50 percent. Yes.

11 CHAIRMAN GLEIMAN: Now when I first saw Witness
12 Chown's proposal, I understood that it was what people have
13 come to call a different metric, and they've raised some
14 questions about it, but isn't it in effect an offshoot of
15 efficient component pricing? You've got mail x, which uses
16 processing, transportation, and delivery functions, and mail
17 y, which uses only the bottleneck or the delivery function.
18 And Chown is trying to give us a quantitative method to
19 arrive at a higher percentage markup on the mail that only
20 uses the bottleneck function, the delivery function.

21 And there have been assertions that her
22 methodology is flawed, and it may well be, but the question
23 I have is, assuming for the sake of discussion that the
24 strategy is flawed, that the methodology is flawed, is the
25 overall strategy that she proposes in the ballpark of

1 efficient component pricing?

2 THE WITNESS: No, no; not at all. The reason
3 her -- the basic reason her strategy is flawed is she's
4 trying to -- I won't say the word "attribute." Let's say
5 the vague term assign responsibility for costs that are
6 borne by -- that are not caused by any single subclass.
7 They're caused by two or more.

8 Each of her component's fixed costs or
9 institutional costs are caused by two or more subclasses,
10 and the basic problem with her approach is she's concocted a
11 metric that allows you to think you're assigning those costs
12 to individual subclasses separately. And they're only
13 caused by groups of two at a time.

14 CHAIRMAN GLEIMAN: So then a more correct approach
15 would just be -- just flat-out use efficient component
16 pricing.

17 THE WITNESS: In her -- it wouldn't be incorrect,
18 but it would lock you into equal markups, and you may not
19 want to be locked into equal markups. If you worked out
20 efficient component pricing in her example, in her example
21 she's got both components are bottleneck components. If you
22 followed efficient component pricing there, you wouldn't
23 have any discretion at all. That would tell you exactly how
24 much you had to charge for services A, B, and C. Now you
25 might like that, but, I mean, there's no reason.

1 CHAIRMAN GLEIMAN: I'd feel even worse about
2 collecting my paycheck. But thank you. And I apologize for
3 the digression and any confusion that I may have caused.

4 Mr. Cooper.

5 REDIRECT EXAMINATION

6 BY MR. COOPER:

7 Q Professor Panzar, we've been discussing of late
8 some hypothetical contracts, one of which was an employment
9 contract. I'm going to add my own employment contract to
10 the mix. Suppose you have an employment contract in place
11 for say four years with no layoff clause. Wouldn't it be
12 possible for the Postal Service to experience decreasing
13 labor costs during the term of that contract?

14 A Yes, because of typical attrition among its
15 workers.

16 Q Could they have not also experienced increased
17 labor costs under that contract?

18 A Yes, because of growth in volume.

19 Q And they would be free to hire additional workers.

20 A Presumably.

21 Q Would the -- would there be marginal costs of
22 labor in such a circumstance?

23 A In either circumstance and contrary to Chairman
24 Gleiman's hypothetical, the Postal Service would be varying
25 its work-force and its expenditures on labor at the margin

1 in the way that the postal cost system is designed to
2 measure.

3 Q Might there be incremental costs of labor in such
4 a regime?

5 A Incremental costs and marginal costs, yes.

6 Q So, does the existence of a no-layoff clause
7 necessarily imply that the costs of the contract are sunk?

8 A No, not usually.

9 Q Now, we've also had -- talked about an advertising
10 contract hypothetical. Let's again assume that there is an
11 advertising contract or that there are -- the Postal Service
12 does have long-term advertising contracts.

13 In this case, can you tell me -- in the current
14 proceeding, can you tell me whether Postal Witness Takis has
15 failed to include any advertising costs associated with
16 specific sub-classes in the incremental costs of those
17 sub-classes?

18 A I can't answer that one way or another. To my
19 knowledge, he's included what's appropriate. You'd have to
20 consult his testimony.

21 MR. COOPER: I have no further questions.

22 CHAIRMAN GLEIMAN: I think I owe people not only
23 follow-up from redirect but follow-up as a consequence of
24 the question I asked, if they choose to follow up.

25 Is there any follow-up as a consequence of

1 redirect?

2 I just -- did I understand you correctly to tell
3 Mr. Cooper that there could be labor costs that are
4 incremental costs?

5 THE WITNESS: Well, yes.

6 CHAIRMAN GLEIMAN: Can you tell me what they --
7 describe that situation to me?

8 THE WITNESS: Most simply, you could imagine -- or
9 you don't have to imagine, you could probably look in
10 Witness Bradley's testimony -- say something like mail
11 processing, which are analyzed using the volume variability
12 method.

13 All of the costs are not volume variable. There
14 is a residual of institutional costs left, is my
15 understanding.

16 Now, those costs wouldn't be incremental to any
17 particular service or subset of services, but they would be
18 overhead or institutional costs, and they would be labor
19 costs.

20 Now, suppose there was a component of labor
21 services which were only used by one sub-class of mail and a
22 volume variability analysis was carried out and, again, you
23 had economies of scale so that not all the costs of that
24 component were volume variable, yet only one sub-class used
25 that labor cost component.

1 Then, all of the costs of that component would be
2 incremental to that sub-class, some of them would be volume
3 variable, and some of them would be institutional.

4 I think that's the -- that's my interpretation of
5 what you -- of an example of what you were asking.

6 But it doesn't look like you think that's an
7 example of what you're asking.

8 CHAIRMAN GLEIMAN: Well, I'll accept what you say
9 and I'll go back and read the hearing record and read it
10 against the testimony of Dr. Christensen earlier today about
11 whether there can be shared cost or institutional cost as
12 part of incremental cost.

13 THE WITNESS: No, there can't --

14 CHAIRMAN GLEIMAN: They're incremental costs but
15 they're not incremental costs.

16 THE WITNESS: No. They are not shared -- in the
17 example I --

18 CHAIRMAN GLEIMAN: Specific fixed costs, one might
19 call them.

20 THE WITNESS: No. They need not be fixed. That
21 was the slippery distinction I was trying to come up with
22 per your request was an example of the classic costs which
23 are variable. They are not fixed costs.

24 CHAIRMAN GLEIMAN: But not with volume.

25 THE WITNESS: Not at the margin with volume but

1 labor costs that are incremental and it would have to be
2 labor costs that are only used by a single subclass or a
3 small subset of subclasses, and then you could have -- but
4 it doesn't contradict your quote of Christensen because they
5 are not shared.

6 Now even -- excuse me -- I seem to have confused
7 my attorney as well.

8 [Laughter.]

9 THE WITNESS: No? Okay.

10 MR. COOPER: No, there is no confusion here, but I
11 do have some questions that I would like to ask.

12 CHAIRMAN GLEIMAN: And just a comment about my
13 earlier hypothetical with the no layoff clause.

14 I suspect that I could construct if we sat here
15 long enough an iron-clad hypothetical that allowed no
16 variables, no attrition, or only a one-to-one replacement at
17 the same labor rate, because that is where you talked about
18 labor cost decreases.

19 When you talked about labor cost increases in
20 response to Mr. Cooper you talked about volume increases and
21 I thought that we had done away with volume increases but of
22 course you could have increases because people's wages go up
23 by seniority. They get cost of living adjustments and the
24 like I guess in addition to seniority raises in the Postal
25 Service, but my point here is that in theory you could

1 construct a hypothetical, it seems to me, that would have
2 all the labor costs being institutional costs to the Postal
3 Service.

4 I won't sit here and take up a lot of time trying
5 to prove my point on that.

6 Mr. McKeever?

7 RECROSS EXAMINATION

8 BY MR. MCKEEVER:

9 Q Dr. Panzar, do incremental costs consist of
10 marginal costs and specific fixed costs and no other costs,
11 or can there be incremental costs that are neither marginal
12 nor specific fixed?

13 A By neither -- by marginal you mean volume variable
14 to get the units comparable?

15 Q Well, no. I would like to stick with marginal if
16 you can answer it. If you can't, obviously you can't, but
17 when we get into what is volume variable then we talk about
18 is it marginal costs or what are the tests of volume
19 variable.

20 A The reason I tried to clarify the question is that
21 one foolproof way of calculating the incremental cost for a
22 single subclass is to take that first unit, go from zero to
23 the first unit. That will bring in all the specific fixed
24 costs because if you have zero you don't incur them.

25 As soon as you have some, you get those and then

1 you add up the marginal costs unit by unit and the sum is
2 incremental cost.

3 However, if marginal costs are decreasing or not
4 constant then you have costs which are neither marginal nor
5 specific fixed which are part of incremental cost.

6 MR. McKEEVER: Thank you.

7 CHAIRMAN GLEIMAN: I think I figured it out.

8 If you mail your mail at the end an accounting
9 period, the closer you get to the end of the accounting
10 period the less it should cost you to mail your First Class
11 letter because you are on the margin -- I don't know if
12 there is anything more.

13 Does anyone else -- Mr. Cooper, you had some more
14 redirect you wanted to do -- re-redirect?

15 MR. COOPER: Yes -- the clean-up hitter here.

16 CHAIRMAN GLEIMAN: Certainly.

17 FURTHER REDIRECT

18 BY MR. COOPER:

19 Q Professor Panzar, you are familiar with what have
20 been called single subclass delivery costs, aren't you?

21 A Yes.

22 Q And those are labor costs, are they not?

23 A Yes.

24 Q They are also part of incremental costs, are they
25 not?

1 A In fact, they are the incremental costs associated
2 with the subclass in the question.

3 MR. COOPER: I have no further questions.

4 CHAIRMAN GLEIMAN: Well, if there is nothing
5 further, Dr. Panzar, we appreciate your appearance here
6 today and your contributions to the record, and I always
7 enjoy having you come down to be a witness. Today I come
8 away hopefully a little smarter but also a little bit more
9 confused, but that will just make me think a little bit
10 more, so thank you again for your appearance here today.

11 If there is nothing further you are excused.

12 THE WITNESS: Thank you.

13 CHAIRMAN GLEIMAN: And I hope you are feeling
14 better -- sorry we had to drag you down here for this today.

15 THE WITNESS: Thank you.

16 [Witness excused.]

17 CHAIRMAN GLEIMAN: Our last witness today is
18 appearing on behalf of the Postal Service -- Mr. Taufique is
19 already under oath in these proceedings and I was going to
20 say Mr. Reiter, but I don't see Mr. Reiter in the room so I
21 guess it's still Mr. Cooper.

22 MR. COOPER: Still Mr. Cooper.

23 CHAIRMAN GLEIMAN: Still Mr. Cooper.

24 You can proceed to introduce your witness's
25 testimony.

1 MR. COOPER: The Postal Service calls Altaf
2 Taufique to the stand.
3 Whereupon,

4 ALTAF H. TAUFIQUE,
5 a rebuttal witness, was called for examination by counsel
6 for the United States Postal Service and, having been
7 previously duly sworn, was further examined and continued to
8 testify as follows:

9 DIRECT EXAMINATION

10 BY MR. COOPER:

11 Q Mr. Taufique, I am handing you two copies of a
12 document entitled "Rebuttal Testimony of Altaf H. Taufique
13 on Behalf of United States Postal Service," marked for
14 identification as USPS-RT-21. Are you familiar with this
15 document?

16 A Yes.

17 Q Was it prepared by you or under your direct
18 supervision?

19 A Yes, it was.

20 Q If you were to be giving rebuttal testimony orally
21 today, is this the testimony that you would give?

22 A Yes, it would be.

23 MR. COOPER: Mr. Chairman, I ask that this
24 testimony be admitted into evidence and transcribed.

25 CHAIRMAN GLEIMAN: Are there any objections?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, Mr. Taufique's testimony and exhibits are received into evidence, and I direct that they be transcribed into the record at this point.

[Rebuttal Testimony and Exhibits of Altaf H. Taufique, USPS-RT-21, was received into evidence and transcribed into the record.]

USPS-RT-21

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

REBUTTAL TESTIMONY
OF
ALTAF H. TAUFIQUE
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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AUTOBIOGRAPHICAL SKETCH

My name is Altaf H. Taufique. I currently serve as an economist in the office of Pricing at the United States Postal Service. Prior to joining the Postal Service in July 1996, I was employed by the Gulf States Utilities Company (GSU) in Beaumont, Texas from 1980 to 1994. At GSU, I served as an economic analyst in the Corporate Planning department and was subsequently promoted to Economist, Senior Economist and finally to the position of Director, Economic Analysis and Forecasting. My responsibilities at GSU included the preparation of the official energy, load and short-term revenue forecasts, and the economic forecasts for the regions served by the Company. I have testified before the Public Utility Commission of Texas in Austin and the Federal Energy Regulatory Commission in Washington, D.C. My testimony defended GSU's official energy and load forecasts. I have appeared before this Commission in two other Dockets as a rebuttal witness, and I presented testimony on behalf of the Postal Service previously in the current Docket (USPS-T-34). My rebuttal testimony in Docket No. MC96-3 dealt with the issue of Postal Service monopoly in the post office box market and other issues relating to pricing of post office boxes. In Docket No. MC97-5, I rebutted a claim of undue harm to Postal Service's competitors allegedly due to the proposed packaging service. In this Docket my testimony presented the rates for Regular Rate and Within County Periodicals.

1 I received a Master's Degree in Economics from Central Missouri State
2 University in Warrensburg, Missouri in 1976, and a Bachelor's degree in
3 Economics & International Relations from Karachi University in Karachi,
4 Pakistan. I have also completed thirty-three credit hours of coursework towards
5 a Ph.D. in Economics at Southern Illinois University. I taught economics at
6 Chadron State College in Chadron, Nebraska between 1978 and 1980, and
7 during my employment at GSU in Texas, I taught courses in economics at Lamar
8 University in Port Arthur, Texas.

1 I. PURPOSE OF TESTIMONY

2

3 The purpose of my testimony is to rebut the testimonies of NAA witness
4 Chown and UPS witness Henderson. Witness Chown proposes a method for
5 allocating institutional costs based on mail classes' utilization of various postal
6 functions and develops a new set of weighted attributable costs to which a
7 judgmental mark-up is applied. The institutional cost contributions produced by
8 the markup are then to be added to the unweighted attributable costs to meet the
9 overall revenue requirement.

10 I begin by demonstrating the economic weakness of Ms. Chown's
11 methodology through a simple example of a small business faced with a similar
12 issue. Subsequently, I present the results of using witness Chown's approach on
13 Within County Periodical rates. Depending on the Commission's exercise of
14 judgment, the resulting cost coverage for Within County Periodical mail may not
15 only be significantly higher, but also is virtually certain not to meet the
16 requirement of the law requiring the markup for preferred classes to be half the
17 markup of the comparable commercial class.

18 My testimony then challenges Dr. Henderson's approach to the allocation
19 of institutional costs, which results in a significant rate shock for Regular Rate
20 along with a substantial rate increase for preferred Within County Periodicals. I
21 present rate charts resulting from the application of witness Henderson's
22 proposed mark-up indices and attributable costs. Finally, I discuss the pricing
23 approaches proposed by both witnesses Chown and Henderson and their impact
24 on the logic and economics of worksharing discounts as adopted by the Postal

1 Service and the Commission. I conclude that the proposals of these witnesses
2 needlessly threaten the correct discount pricing signals developed by the Postal
3 Service in cooperation with the Postal Rate Commission and the mailing
4 community.

5
6 II. THE ARBITRARY ALLOCATION OF INSTITUTIONAL COSTS PROPOSED
7 BY WITNESS CHOWN DOES NOT MAKE ECONOMIC SENSE.
8

9 The problem with the allocation of institutional cost raised by witness
10 Chown's proposal can be understood with a simple example. A restaurant
11 owner decides to install a fifteen thousand dollar counter because this would
12 add to the ambiance of the restaurant, allow her the space for a cash register,
13 and also provide the space for customers who come in for a cup of coffee. After
14 the installation of the counter, she realizes this counter can also be used to
15 display some retail items such as candy, chewing gum, etc. for sale, which will
16 add to the bottom line for her business. The following question describes the
17 pricing dilemma : In pricing the retail items, should the cost of this new counter
18 be included in the cost of these items (based on some proportion of usage)
19 before a mark-up is applied for pricing purposes?

20 An accounting approach comparable to that proposed by witness Chown
21 would be to fully distribute the cost of the counter and make the buyers of the
22 retail items pay their proportional cost for the counter, plus a mark-up on these
23 items. Doing so would drastically increase the prices charged for the gum and
24 other retail items, and would result in buyers purchasing such items from another

1 establishment. In such case, the additional revenue that these items could have
2 contributed to the bottom line would be lost, and the cost of the counter,
3 nevertheless, must be fully recovered from the activity in the restaurant.

4 The sound economic approach would be to analyze whether the cost of
5 the counter that would have been assigned to the retail products would go away,
6 if the enterprise stopped selling the retail items. Since the cost of the counter is a
7 cost which would be there regardless of the sale of retail items, then this cost
8 should be treated as overhead and should not be used to burden the retail
9 products. The owner could add to her bottom line by selling the retail items at
10 competitive prices, i.e., by applying a mark-up to the additional (or marginal)
11 cost.

12 Within the context of the Postal Service's cost structure, the institutional
13 cost of the delivery network is like the restaurant's counter, which would have to
14 be paid for regardless of any one class of mail being offered. The institutional
15 cost of the delivery network is linked to the existence of the Postal Service, not
16 the existence of a particular class of mail. Burdening a particular class of mail
17 with this institutional cost, as proposed by witness Chown (through the use of
18 weighted attributable costs) does not make economic or business sense, and
19 would undermine the sensible approach to discount pricing followed to this point
20 by the Postal Service and the Postal Rate Commission.

1
2 III. WITHIN COUNTY MAIL WILL EXPERIENCE HIGHER RATES AND A
3 MARKUP ABOVE THE LEGAL LIMIT.
4

5 Witness Chown calculates the weighted attributable costs for Within
6 County mail to be 59 percent higher than the TYAR attributable cost used by the
7 Postal Service. Exhibit NAA-1D in witness Chown's testimony provides the
8 weighted attributable cost of \$129.401 million, compared to the Postal Service
9 TYAR cost of \$81.360 million (Exhibit NAA-1A). I use her weighted attributable
10 costs and the Postal Service cost coverage of 107 percent to calculate the dollar
11 amount of institutional cost to be recovered from the Within County Periodicals
12 subclass. The resulting markup as applied to the TYBR attributable cost is 4.6
13 percent, 59 percent above the 2.9 percent proposed by the Postal Service in this
14 Docket.

15 Witness Chown makes no judgment regarding the relative level of the
16 institutional costs contribution to be recovered from each of the subclasses and
17 thus does not recommend specific rates. The use of her proposed weighted
18 attributable costs for applying markups, though, would alter the contribution and
19 resulting rates for the preferred Within County subclass. It is clear that the
20 resulting rates would be higher and the actual markup would exceed the legal
21 requirement¹ (50 percent of comparable commercial subclass). In what follows, I

¹ Given the level of weighted attributable costs for Regular Rate and Within County Periodicals any non-zero markup for Regular Rate Periodicals would exceed the legal limit.

1 present an example using the USPS proposed markup of 7 percent for Regular
2 Rate Periodicals to calculate Within County rates.

3 I employ a three-stage process to derive the final rates for Within County
4 using witness Chown's weighted attributable costs. First, her proposed
5 attributable cost of \$129.401 million is divided by the TYAR volume of 901.870
6 million pieces to derive a per unit weighted attributable cost of \$0.143, which is
7 multiplied by the TYBR volume of 911.204 million pieces to derive the TYBR
8 weighted attributable cost of \$130.740 million. Second, the dollar amount of
9 institutional cost to be recovered from the Within County subclass is calculated
10 using 50 percent of the markup of the commercial class (as required by law). The
11 proposed markup for Regular Rate Periodicals is 7 percent, which leads to a 2.9
12 percent markup for Within County for step 5 applicable in the test year. The
13 dollar amount to be recovered based on Chown's proposed weighted attributable
14 cost and the markup required by law is \$3.791 million (.029 multiplied by
15 \$130.740 million). The actual TYBR attributable costs are \$82.273 million.
16 Therefore, the step 5 cost coverage turns out to be 104.6. As I have stated
17 earlier, this cost coverage, based on witness Chown's proposed methodology, is
18 59 percent higher than the Postal Service's proposed cost coverage of 102.9
19 percent in the test year.

20 Finally, I use this cost coverage in my spreadsheets (LR-H-205,
21 2c_wc_x1) to calculate the final rates for Within County. This process requires
22 me to assume an 11 percent $((4.6*(6/5)*2=11)$ cost coverage for Regular Rate
23 Periodicals, because, in my spreadsheets, the cost coverage for the preferred

1 classes is calculated using the Regular Rate cost coverage and the applicable
2 step for the test year². The results of this analysis are presented in Exhibit RT-
3 8A. The top table on the Exhibit provides a comparison of USPS proposed rates
4 to the current rates. The second table makes a comparison of rates based on
5 Witness Chown's methodology to the current rates.

6 Witness Chown's proposal to use the weighted attributable cost to
7 allocate institutional costs is not only economically unsound, but is certain to lead
8 to larger increases in all rate cells for the preferred subclass of Within County
9 Periodicals, and the resulting cost coverage (calculated on actual attributable
10 cost) is drastically higher than the legally required markup.

11

12 **IV. WITNESS HENDERSON'S PROPOSAL LEADS TO HIGHER INCREASES**
13 **FOR BOTH REGULAR RATE AND WITHIN COUNTY PERIODICALS.**

14

15

16 Dr. Henderson's proposal rests upon three major components.

17

- 18 1. He proposes to use 100 percent volume variability for mail processing.
- 19
- 20 2. He proposes to use the incremental costs rather than the attributable cost
21 proposed by the Postal Service and recommended by the Commission in
22 previous omnibus proceedings, or the volume variable cost proposed by the
23 Postal Service in this Docket.
- 24
- 25 3. He utilizes the markup indices recommended by the Commission in Docket
26 No. R94-1 to recommend his alternative markups, presented in his Exhibit
27 UPS-T-3B.
- 28
- 29

² My analysis can be replicated using the spreadsheets that were filed with my original testimony in LR-H-205 by changing the Regular Rate cost coverage in line 11 to 1.11 of the 'rate design input' sheet in 2c_wc_x1.

1 I use a similar approach in deriving the rates for Regular Rate and
2 Within County Periodicals based on Dr. Henderson's recommended markups.
3 This approach was used earlier when analyzing the effect of witness Chown's
4 weighted attributable cost proposal, with two exceptions. First, Dr. Henderson
5 provides TYAR volumes that result from his pricing recommendation, and I use
6 those volumes to calculate the TYBR costs used in my rate calculations. Second,
7 Within County rates are based on witness Henderson's attributable costs
8 adjusted for volume differences and 50 percent of his proposed mark-up index
9 for Regular Rate periodicals, but the resulting cost coverage is higher than
10 presented in his analysis. It appears that his mechanical use of R94-1 markup
11 indices neglects the fact that R94-1 rates were based on step 2 of RFRA while
12 the test year in the current Docket requires the use of step 5.

13 The TYBR costs of \$1,766.603³ million and \$89.437⁴ million are
14 calculated for Regular Rate and Within County respectively using Dr.
15 Henderson's TYAR cost and volume estimates. Once again, using the same
16 spreadsheets provided in LR-H-205 (2c_rr_x9 for Regular Rate & 2c_wc_x1 for
17 Within County), I have calculated the final rates for both Regular Rate and Within
18 County Periodicals as they would appear if Dr. Henderson's proposal were
19 adopted by the Commission. The top table on Exhibit RT-8B reflects the

³ Dr. Henderson estimates \$1,714 million for the incremental costs and the associated volume of 6959 million pieces which calculates to \$0.246 per piece. This is multiplied by TYBR volume of 7173 million pieces to derive the TYBR cost for Regular Rate Periodicals based on his proposal.

⁴ Dr. Henderson measures \$85 million for the incremental costs and the associated volume of 866 million pieces which calculates into \$0.098 per piece. This is multiplied by TYBR volume of 911 million pieces to derive the TYBR cost for Within County Periodicals based on his proposal.

(continued...)

1 comparison of USPS proposed rates with currently applicable rates. The second
2 table makes a similar comparison based on Dr. Henderson's proposal. Exhibit
3 RT-8C contains the same information for Within County Periodicals.

4 Although Dr. Henderson does not discuss the effect of his proposal on the
5 Periodicals class in the body of his testimony, his Exhibit UPS-T-3B shows a
6 hefty increase the rates for all Periodical subclasses. His proposal would lead to,
7 on average, a 25 percent increase for Regular Rate Periodicals and a 10 percent
8 increase for Within County mailers.

9 Periodicals in the recent year have experienced relatively large increases
10 in attributable costs, and the Postal Service is committed⁵ to objectively
11 evaluating the cause of these increases. The lower-than-historical cost coverage
12 proposed for Periodicals in this Docket reflects in part the concerns of the
13 Service to avoid major disruptions in this industry. The mechanical approach of
14 using the markup indices from Docket R94-1 proposed by Dr. Henderson will
15 lead to inappropriate increase for Periodical mailers, and I recommend that the
16 Commission reject his approach.

17 I recognize that witnesses Chown and Henderson may not have intended
18 such substantial increases in Periodical rates, and, in fact, may believe some
19 adjustments are in order. However, they neither have mentioned such

(...continued)

⁵ For instance, Witness Degan's testimony (USPS-RT-6, pages 40-45) notes several initiatives underway to address cost and service issues.

1 adjustments, nor have they provided a mechanism to make such adjustments.

2 As such, their analyses, are flawed.

3 V. WITNESSES CHOWN'S AND HENDERSON'S PROPOSALS WOULD
4 TURN THE CLOCK BACKWARD.

5
6 As a relative newcomer to the Postal Service, I was surprised to find the
7 degree to which the Postal Service has shifted mail preparation and processing
8 costs to the lower-cost providers by offering various worksharing discounts and
9 keeping its delivery network access price non-discriminatory. In many instances,
10 where the mailers can perform the work cheaper (or more efficiently), they have
11 been able to bypass those functions and enter the mail downstream. Critics
12 could argue that the process has not worked perfectly, but when we evaluate the
13 competing interests that are required to be balanced under the pricing criteria, it
14 has worked remarkably well, especially with mailers electing to do part of the
15 work themselves.

16 Witness Chown's proposal, which would indirectly lead to the allocation of
17 institutional cost, which as I have stated earlier, does not make economic or
18 business sense. It would also provide wrong pricing signals to the mailers that
19 bypass one or more postal functions, and enter their mail downstream. I strongly
20 recommend that the Commission reject the proposal.

21 Witness Henderson relies on mechanical use of the markup indices from
22 the previous omnibus case. This would severely limit the use of judgment used
23 by the Postal Service and the Commission in the allocation of institutional cost
24 given the changes that may have taken place (costs, market conditions, change

- 1 in technology etc.). I would recommend to the Commission to reject such a
- 2 mechanical approach.

USPS-RT-21
EXHIBIT RT-21A

WITHIN COUNTY USPS PROPOSED RATES vs. CURRENT RATES					
Rate Element	Type		Proposed Step 6	Current Rate Step 5	Percent Change
ZONED ADVRTSG DELIVERY UNIT	POUNDS		0.117	0.112	4.5%
GENERAL	POUNDS		0.130	0.122	6.6%
Level BASIC NON-AUTOMATION	PIECES		0.090	0.082	9.8%
Level BASIC AUTOMATION LETTERS	PIECES		0.062	0.082	-24.4%
Level BASIC AUTOMATION FLATS	PIECES		0.077	0.082	-6.1%
Level 3 DIGIT NONAUTOMATION	PIECES		0.079	0.082	-3.7%
Level 3 DIGIT AUTOMATION LETTER	PIECES		0.060	0.078	-23.1%
Level 3 DIGIT AUTOMATION FLAT	PIECES		0.066	0.067	-1.5%
Level 5 DIGIT NONAUTOMATION	PIECES		0.076	0.082	-7.3%
Level 5 DIGIT AUTOMATION LETTER	PIECES		0.058	0.065	-10.8%
Level 5 DIGIT AUTOMATION FLAT	PIECES		0.062	0.067	-7.5%
LEVEL CARRIER ROUTE	PIECES		0.044	0.044	0.0%
LEVEL HIGH DENSITY	PIECES		0.040	0.039	2.6%
LEVEL SATURATION	PIECES		0.038	0.037	2.7%
WKSHARING DISCNTDELIVERY OFFICE EN	Discounts		(0.004)	-0.003	33.3%
WKSHARING DISCNT SCF ENTRY	Discounts		na	na	
Editorial Percentage Piece Percentage	Discounts		na	na	

WITHIN COUNTY RATES BASED ON CHOWN'S PROPOSAL vs. CURRENT RATES					
Rate Element	Type		Chown Step 5	Current Rate Step 5	Percent Change
ZONED ADVRTSG DELIVERY UNIT	POUNDS		0.119	0.112	6.3%
GENERAL	POUNDS		0.132	0.122	8.2%
Level BASIC NON-AUTOMATION	PIECES		0.091	0.082	11.0%
Level BASIC AUTOMATION LETTERS	PIECES		0.063	0.082	-23.2%
Level BASIC AUTOMATION FLATS	PIECES		0.078	0.082	-4.9%
Level 3 DIGIT NONAUTOMATION	PIECES		0.080	0.082	-2.4%
Level 3 DIGIT AUTOMATION LETTER	PIECES		0.061	0.078	-21.8%
Level 3 DIGIT AUTOMATION FLAT	PIECES		0.067	0.067	0.0%
Level 5 DIGIT NONAUTOMATION	PIECES		0.077	0.082	-6.1%
Level 5 DIGIT AUTOMATION LETTER	PIECES		0.059	0.065	-9.2%
Level 5 DIGIT AUTOMATION FLAT	PIECES		0.063	0.067	-6.0%
LEVEL CARRIER ROUTE	PIECES		0.045	0.044	2.3%
LEVEL HIGH DENSITY	PIECES		0.041	0.039	5.1%
LEVEL SATURATION	PIECES		0.039	0.037	5.4%
WKSHARING DISCNTDELIVERY OFFICE EN	Discounts		(0.004)	-0.003	33.3%
WKSHARING DISCNT SCF ENTRY	Discounts		na	na	na
Editorial Percentage Piece Percentage	Discounts		na	na	na
Note: The above rates are based on a cost coverage of 104.58 calculated based on witness Chown's proposal. See USPS-RT-21, page 5, lines 12 thru 16					

Periodicals: Regular Rates

USPS-RT-21
EXHIBIT RT-21B

USPS PROPOSAL vs. CURRENT RATES				
Rate Element	Type	Rates USPS Proposal	Current Rates	Percent Change
ZONED ADVRTSG DELIVERY UNIT	POUNDS	0.158	0.169	-6.5%
ZONED ADVRTSG SCF	POUNDS	0.180	0.190	-5.3%
ZONED ADVRTSG ZONES 1&2	POUNDS	0.203	0.214	-5.1%
ZONED ADVRTSG ZONE 3	POUNDS	0.216	0.224	-3.6%
ZONED ADVRTSG ZONE 4	POUNDS	0.251	0.251	0.0%
ZONED ADVRTSG ZONE 5	POUNDS	0.305	0.292	4.5%
ZONED ADVRTSG ZONE 6	POUNDS	0.361	0.336	7.4%
ZONED ADVRTSG ZONE 7	POUNDS	0.416	0.388	7.2%
ZONED ADVRTSG ZONE 8	POUNDS	0.474	0.432	9.7%
NONADVERTISING	POUNDS	0.174	0.161	8.1%
BASIC NON-AUTOMATION	PIECES	0.263	0.240	9.6%
BASIC AUTOMATION LETTER	PIECES	0.182	0.194	-6.2%
BASIC AUTOMATION FLAT	PIECES	0.221	0.209	5.7%
BASIC NON-AUTOMATION 3 DIGIT	PIECES	0.217	0.202	7.4%
BASIC AUTOMATION 3 DIGIT LETTER	PIECES	0.166	0.173	-4.0%
BASIC AUTOMATION 3 DIGIT FLAT	PIECES	0.188	0.175	7.4%
BASIC NON-AUTOMATION 5 DIGIT	PIECES	0.214	0.202	5.9%
BASIC AUTOMATION 5 DIGIT LETTER	PIECES	0.162	0.173	-6.4%
BASIC AUTOMATION 5 DIGIT FLAT	PIECES	0.186	0.175	6.3%
CARRIER ROUTE BASIC	PIECES	0.128	0.119	7.6%
CARRIER ROUTE HIGH DENSITY	PIECES	0.116	0.111	4.5%
CARRIER ROUTE SATURATION	PIECES	0.102	0.095	7.4%
PERCENTAGE EDITORIAL DISCOUNT	PIECES	-0.059	-0.057	3.5%
WKSHARING DISCNT DELIVERY OFFICE ENTRY	PIECES	-0.023	-0.021	9.5%
WKSHARING DISCNT SCF ENTRY	PIECES	-0.012	-0.011	9.1%

HENDERSON PROPOSAL vs. CURRENT RATES				
Rate Element	Type	Henderson Proposed	Current Rates	Percent Change
ZONED ADVRTSG DELIVERY UNIT	POUNDS	0.224	0.169	32.5%
ZONED ADVRTSG SCF	POUNDS	0.250	0.190	31.6%
ZONED ADVRTSG ZONES 1&2	POUNDS	0.272	0.214	27.1%
ZONED ADVRTSG ZONE 3	POUNDS	0.286	0.224	27.7%
ZONED ADVRTSG ZONE 4	POUNDS	0.321	0.251	27.9%
ZONED ADVRTSG ZONE 5	POUNDS	0.374	0.292	28.1%
ZONED ADVRTSG ZONE 6	POUNDS	0.430	0.336	28.0%
ZONED ADVRTSG ZONE 7	POUNDS	0.485	0.388	25.0%
ZONED ADVRTSG ZONE 8	POUNDS	0.543	0.432	25.7%
NONADVERTISING	POUNDS	0.194	0.161	20.5%
BASIC NON-AUTOMATION	PIECES	0.298	0.240	24.2%
BASIC AUTOMATION LETTER	PIECES	0.217	0.194	11.9%
BASIC AUTOMATION FLAT	PIECES	0.256	0.209	22.5%
BASIC NON-AUTOMATION 3 DIGIT	PIECES	0.252	0.202	24.8%
BASIC AUTOMATION 3 DIGIT LETTER	PIECES	0.201	0.173	16.2%
BASIC AUTOMATION 3 DIGIT FLAT	PIECES	0.223	0.175	27.4%
BASIC NON-AUTOMATION 5 DIGIT	PIECES	0.249	0.202	23.3%
BASIC AUTOMATION 5 DIGIT LETTER	PIECES	0.197	0.173	13.9%
BASIC AUTOMATION 5 DIGIT FLAT	PIECES	0.221	0.175	26.3%
CARRIER ROUTE BASIC	PIECES	0.163	0.119	37.0%
CARRIER ROUTE HIGH DENSITY	PIECES	0.151	0.111	36.0%
CARRIER ROUTE SATURATION	PIECES	0.137	0.095	44.2%
PERCENTAGE EDITORIAL DISCOUNT	PIECES	-0.071	-0.057	24.6%
WKSHARING DISCNT DELIVERY OFFICE ENTRY	PIECES	-0.023	-0.021	9.5%
WKSHARING DISCNT SCF ENTRY	PIECES	-0.012	-0.011	9.1%

Note: The above rates are based on witness Henderson's proposed cost coverage of 115.6 - Exhibit UPS-T-3B

USPS-RT-21
EXHIBIT RT-21C

WITHIN COUNTY USPS PROPOSED RATES vs. CURRENT RATES					
Rate Element	Type		Proposed Step 5	Current Rate Step 5	Percent Change
ZONED ADVRTSG DELIVERY UNIT	POUNDS		0.117	0.112	4.5%
GENERAL	POUNDS		0.130	0.122	6.6%
Level BASIC NON-AUTOMATION	PIECES		0.090	0.082	9.8%
Level BASIC AUTOMATION LETTERS	PIECES		0.062	0.082	-24.4%
Level BASIC AUTOMATION FLATS	PIECES		0.077	0.082	-6.1%
Level 3 DIGIT NONAUTOMATION	PIECES		0.079	0.082	-3.7%
Level 3 DIGIT AUTOMATION LETTER	PIECES		0.060	0.078	-23.1%
Level 3 DIGIT AUTOMATION FLAT	PIECES		0.066	0.067	-1.5%
Level 5 DIGIT NONAUTOMATION	PIECES		0.076	0.082	-7.3%
Level 5 DIGIT AUTOMATION LETTER	PIECES		0.058	0.065	-10.8%
Level 5 DIGIT AUTOMATION FLAT	PIECES		0.062	0.067	-7.5%
LEVEL CARRIER ROUTE	PIECES		0.044	0.044	0.0%
LEVEL HIGH DENSITY	PIECES		0.040	0.039	2.6%
LEVEL SATURATION	PIECES		0.038	0.037	2.7%
WKSHARING DISCNTDELIVERY OFFICE E	Discounts		(0.004)	(0.003)	33.3%
WKSHARING DISCNT SCF ENTRY	Discounts		na	na	na
Editorial Percentage Piece Percentage	Discounts		na	na	na

WITHIN COUNTY RATES HENDERSON PROPOSAL vs. CURRENT RATES					
Rate Element	Type		Proposed Henderson	Current Rate Step 5	Percent Change
ZONED ADVRTSG DELIVERY UNIT	POUNDS		0.132	0.112	17.9%
GENERAL	POUNDS		0.146	0.122	19.7%
Level BASIC NON-AUTOMATION	PIECES		0.097	0.082	18.3%
Level BASIC AUTOMATION LETTERS	PIECES		0.069	0.082	-15.9%
Level BASIC AUTOMATION FLATS	PIECES		0.084	0.082	2.4%
Level 3 DIGIT NONAUTOMATION	PIECES		0.087	0.082	6.1%
Level 3 DIGIT AUTOMATION LETTER	PIECES		0.067	0.078	-14.1%
Level 3 DIGIT AUTOMATION FLAT	PIECES		0.073	0.067	9.0%
Level 5 DIGIT NONAUTOMATION	PIECES		0.083	0.082	1.2%
Level 5 DIGIT AUTOMATION LETTER	PIECES		0.065	0.065	0.0%
Level 5 DIGIT AUTOMATION FLAT	PIECES		0.070	0.067	4.5%
LEVEL CARRIER ROUTE	PIECES		0.051	0.044	15.9%
LEVEL HIGH DENSITY	PIECES		0.047	0.039	20.5%
LEVEL SATURATION	PIECES		0.045	0.037	21.6%
WKSHARING DISCNTDELIVERY OFFICE E	Discounts		(0.004)	(0.003)	33.3%
WKSHARING DISCNT SCF ENTRY	Discounts		na	na	na
Editorial Percentage Piece Percentage	Discounts		na	na	na
Note: The above rates are based on cost coverage of 106.5 - Step 5 and 50 percent of witness Henderson's proposed cost coverage of 115.6 - Exhibit UPS-T-3B					

1 CHAIRMAN GLEIMAN: Three participants requested
2 oral cross examination of the witness -- Florida Gift Fruit
3 Shippers, Newspaper Association of America, and United
4 Parcel Service.

5 Does any other party wish to cross examine?

6 [No response.]

7 CHAIRMAN GLEIMAN: I don't see Mr. Wells in the
8 room.

9 That being the case, Mr. Baker, if you're ready to
10 do your cross examination.

11 MR. BAKER: Thank you, Mr. Chairman.

12 CROSS EXAMINATION

13 BY MR. BAKER:

14 Q Good afternoon, Mr. Taufique.

15 A Good afternoon.

16 Q I'd like to start by directing your attention to
17 page 2 of your rebuttal testimony. On this page and the
18 next you provide an example of a restaurant owner and
19 discuss how that owner should price different products that
20 she offers. I want to modify your example a little bit.

21 I want you to assume that the owner sells coffee
22 at 75 cents a cup and there is a coffee shop down the street
23 that sells coffee at the same price, and then a Starbucks
24 restaurant opens across the street from our restaurant
25 owner, and to compete with the Starbucks, the owner decides

1 to expand her products and offer cappuccino and espresso, as
2 well, and so, the owner invests in a commercial
3 cappuccino-espresso maker at a cost of \$2,000.

4 Are you with me so far?

5 A There's a restaurant right next door that is
6 selling coffee for the same price and now there's a new
7 competitor that is selling something different and this
8 owner is going to introduce this new product to compete with
9 the --

10 Q That is correct.

11 A Okay.

12 Q How should the owner recover the \$2,000 cost of
13 the cappuccino-espresso machine?

14 A The cappuccino and espresso machine basically
15 would be related to the production of a certain product, and
16 if the cost of these machines would not exist if the product
17 is not sold, then this would be part of the cost of doing
18 business, and that cost would be included in the mark-up of
19 the product.

20 Q So, should the owner try to recover the costs of
21 the machine in her price for cappuccino and espresso?

22 A If you go back to my hypothetical, basically what
23 I am suggesting over there is that, if you have a sunk cost
24 and that is being used for a different product which is not
25 causing the cost to happen, in that particular case there is

1 no point in burdening this new product with the sunk cost.

2 I'm not making a pricing decision or giving you
3 mark-ups on any other products. Basically, I'm not making
4 -- all of my testimony I have not made a judgement on how
5 the cost should be recovered, the institutional costs should
6 be recovered. I'm not making a judgement on that.

7 But it's a hypothetical that is beyond what I had
8 presented.

9 Q Well, my question, coming back, if the owner
10 invests the \$2,000 in the cappuccino-espresso machine,
11 should the owner raise the price of a cup of coffee in order
12 to help recover that cost?

13 A And coffee is not related -- coffee is not using
14 those products at all.

15 Q That's right. Coffee is not using the cappuccino
16 maker, the espresso maker.

17 A The price of coffee would not recover the cost
18 --as far as I'm concerned, the price of coffee would not
19 recover --

20 Q Right. So, you would expect the restaurant owner
21 to try to recover the cost of the cappuccino-espresso
22 machine from the -- in the price of the cappuccino and
23 espresso that she sells.

24 A Since this is a specific fixed cost that is
25 related to the product itself, yes.

1 Q At page 3, lines 14 to 18, of your testimony, you
2 state that the institutional cost of the delivery network is
3 linked to the existence of the Postal Service and not the
4 existence of any particular class of mail. Then you go on
5 to say that burdening a particular class of mail with this
6 institutional cost, as proposed by Witness Chown, you say,
7 through the use of weighted attributable costs, does not
8 make economic or business sense.

9 My question is this, under the rates proposed by
10 the Postal Service in this case, does it recover the
11 institutional costs of the delivery network from the various
12 subclasses of mail?

13 A It does, and I am not making any judgment on the
14 allocation of institutional costs even in my testimony, I am
15 not capable of doing that.

16 Q Okay. Is the difference -- well, these costs must
17 be recovered from someone in order to --

18 A That is true.

19 Q Yes.

20 A That is true.

21 Q Is the difference between Ms. Chown's method and
22 the Postal Service's proposal a difference in which
23 subclasses might be burdened more or less by these costs?

24 A The process of allocating institutional costs is a
25 different subject altogether and I think you are going

1 beyond the scope of my testimony.

2 All that I am stating is that the marginal cost of
3 a product should be used for markup purposes, and what the
4 markup is, I am not making a determination on that at all.
5 Basically, I am saying is that if the cost of the delivery
6 network is a cost that is going to exist regardless of any
7 class of mail, then we should not be looking at the
8 attributable cost of any particular class of mail and
9 weighting it based on the percent of the function used.
10 That would give the wrong signals.

11 What we have done, I think, based on what I have
12 read, the Commission has made the judgment on the allocation
13 of institutional costs and I think that has worked in terms
14 of overall work-sharing discounts, folks doing a lot of work
15 and bringing the mail at the lowest downstream level. So it
16 does not add anything to the ratemaking process to have the
17 attributable cost burdened with this functional allocation
18 responsibility which is not being caused by these particular
19 classes.

20 Q Well, in the final analysis here, whether Ms.
21 Chown's method is used, or the Postal Service's approach is
22 used, will you agree with me that it is the Commission that
23 ultimately decides which subclasses are burdened, if you
24 will, with recovering the institutional cost to the Postal
25 Service?

1 A I would agree.

2 Q Okay. Now, at the end of the quote on page 3, to
3 which I just directed your attention, you state that Ms.
4 Chown's proposal, and now I am quoting, "would undermine the
5 sensible approach to discount pricing followed to this point
6 by the Postal Service and the Postal Rate Commission." My
7 question is, can you explain what this sensible approach to
8 discount pricing is that has been followed to this point?

9 A Let's first talk about how it would undermine.
10 Basically, what I am talking about is, as was described I
11 think in an earlier discussion, that the Postal Service, or
12 a monopoly that is providing a bottleneck process, which
13 provides an economy of scale. Basically, if the Postal
14 Service were to burden the delivery network cost and make it
15 discriminatory -- compare it to all the mail classes that
16 use all the other functions and then their mail is entered
17 into the delivery network, if that price is different than
18 the price that is charged to a customer that does all the
19 work, and enters at a downstream level, if that price is
20 different, then, basically, you have given a disincentive to
21 the mailer for not performing the work.

22 And I think basically -- my argument is that if
23 mailers can perform the work cheaper, more efficiently, and
24 the Postal Service has done a good job, and the Commission
25 has done a good job in essentially privatizing the whole

1 process, and by making the delivery network more expensive
2 through this process, wrong signals will be given and it
3 will undermine what has been done so far.

4 Q Well, let's go back, let me go back to my question
5 which was, what -- in line 19 here on page 3, you use the
6 phrase, "the sensible approach to discount pricing followed
7 to this point." I ask you to tell me what you mean by that?

8 A I think the process that has worked so far is
9 fairly sensible. It has worked in terms of providing
10 incentives to the mailers to do work where they were more
11 efficient in doing the work. So there is no reason to
12 change that by using the approach that is proposed by
13 Witness Chown.

14 Q Well, can you explain to me how Witness Chown's
15 approach changes that, what you have called the sensible
16 approach to discount pricing?

17 A Apparently when I read her testimony as I went
18 through it, essentially her argument is that the delivery
19 network is where there is highest institutional cost and
20 based on the use of different functions she decides that
21 those postal products that use delivery function
22 inappropriately or at a higher rate, their attributable
23 costs will be going up significantly higher and I think that
24 would give the wrong signal to folks who have done, who have
25 chosen to do a lot of work if they could do it cheaper and

1 more efficient, so I think it has worked so far, why --
2 there is no reason to change it.

3 It would not add anything to the whole ratemaking
4 process by using the institutional function costs and using
5 her approach to allocating the costs differently.

6 Q How would Ms. Chown's weighting of the
7 attributable costs for purposes of determining the
8 appropriate cost coverage for the commercial classes of mail
9 change the discount signals that are set in discount rates?

10 A First of all, if you look at the changes in the
11 attributable costs that she has proposed, they are
12 significantly higher for those classes that use the delivery
13 network exclusively, so if that is the case then you are
14 giving a signal to the mailers that even though they can do
15 the work more efficiently we will charge you a higher price
16 for this -- for this bottleneck process so that you cannot
17 provide and it would be providing wrong signals to the
18 mailers.

19 Q Does Ms. Chown's -- is it your understanding of
20 Ms. Chown's testimony that she is changing the actual
21 attributable costs of any subclass in any way other than a
22 weighting metric used in determining cost coverages?

23 A The weighting metric that she is proposing is
24 causing her weighted attributable cost that will be used for
25 markup purpose -- suppose we -- and this is difficult to

1 discuss because she did not propose any markups, but
2 regardless, if you use the same markups on both sets of cost
3 numbers, the cost as proposed by the Postal Service and the
4 cost that she is proposing to be used for markup purposes,
5 you would find that the classes that use delivery function
6 at a higher rate, their costs have gone up significantly and
7 if you use the same markups the allocation of institutional
8 costs to those classes would be significantly higher also.

9 Q Is it your understanding that Ms. Chown proposed
10 that the Commission use the same markups to weighted
11 attributable costs as it would use to unweighted
12 attributable costs?

13 A No, she does not say that.

14 Q Okay. But it sounded to me like you just said
15 that that would be a problem if she did.

16 A What I am suggesting essentially is that the
17 Commission has looked at various factors, noncost factors,
18 in allocating the institutional costs.

19 It has worked from my perspective as a relative
20 newcomer to the Postal Service, it has worked amazingly in
21 terms of privatizing a lot of postal functions, and there is
22 no need to change that particular process to take into
23 account the institutional cost that is not caused by the
24 different classes of mail.

25 Q Could the Commission arrive at the same target

1 revenue for a subclass, if you will, using both Ms. Chown's
2 metric or the Postal Service's approach?

3 A If they did, what would be the point of this whole
4 thing?

5 Q Well, my point is they could. Could they? Could
6 they not?

7 A They could, yes.

8 Q Yes, okay. Has Ms. Chown made any recommendations
9 regarding how discounts are established for the subclasses?

10 A No, she has not.

11 Q Okay, so then how would Ms. Chown's approach
12 undermine the approach to discount pricing followed to this
13 point by the Postal Service and the Rate Commission?

14 A In evaluating a proposal, the way I looked at it,
15 the changes in the attributable costs that she has proposed
16 is a good signal of where if you would apply the same
17 markups, the results would be significantly different, so if
18 you come back to the same numbers in terms of allocation of
19 institutional costs then there is no point in having this
20 whole cycle of weighted attributable costs.

21 Q Are you suggesting that your understanding of Ms.
22 Chown's proposal is that the Commission would look at
23 weighted attributable costs in setting the discounts for
24 rates?

25 A No. All that I'm saying is that using the

1 weighted attributable cost in -- for the sake of argument,
2 if you used the same mark-ups, the signals would be wrong.
3 The signals would be to suggest that it does not pay to
4 provide or privatize the postal functions that the mailers
5 are doing.

6 Q In your direct testimony, you were a rate design
7 witness, correct?

8 A Yes.

9 Q And the policy has been to set a discount based on
10 estimates of avoided attributable costs, correct?

11 A A general policy?

12 Q Is that the general policy when one -- when you're
13 setting a discount, you look at an estimate of the avoided
14 costs that the Postal Service avoids when the mailer does a
15 work-sharing activity, correct?

16 A I wish I could agree with you, because the whole
17 process of rate-making is a lot more than just looking at
18 the cost savings and discounts, because in order to avoid
19 the rate shock to the customers that affects the
20 marketplace, it is not as simple -- I would not agree with
21 you that that is a general policy.

22 Q Well, when we set discounts for work-sharing
23 activities, are you suggesting that we should not use
24 estimates of avoided cost?

25 A That's the starting point.

1 Q That is the starting point.

2 A Right.

3 Q Okay. And if you were setting your discount to
4 give the proper economic signal to the mailer as to whether
5 it should engage in particular work-sharing activity or
6 whether it should let the Postal Service do that particular
7 work, should the discount be set at the 100 percent of the
8 estimated avoidable costs to give the best price signal?

9 A The judgement of how much the discount should be
10 is based on balancing the efficiency aspect and the other
11 aspects of the pricing criteria.

12 Q And back to Ms. Chown's approach, it still is not
13 clear to me how her proposal changes the approach to
14 discount pricing that the Postal Service and the Commission
15 have followed to this point.

16 A Again, like I said, if you compare the
17 attributable costs proposed by the Postal Service and
18 compare those to the weighted attributable costs proposed by
19 Witness Chown, you find major increases in those classes of
20 mail where delivery function is utilized proportionately
21 more.

22 Q Well, I understand that, but Ms. Chown uses the
23 weighted attributable costs only in -- or would suggest that
24 the Commission use weighted attributable costs in
25 determining the institutional costs to be recovered by a

1 particular sub-class. You understand that?

2 A I agree.

3 Q Okay. And she does not use weighted attributable
4 costs in setting discounts. Is that correct?

5 A That is true.

6 Q Now, I'd like you to turn to pages 4 through 6 of
7 your testimony, where you discuss your view of how one might
8 calculate a cost coverage for in-county mail under the Chown
9 proposal, and in particular, I think the gist of this is on
10 page 5 of your testimony.

11 A What line?

12 Q Well, in the paragraph beginning on page 3 -- line
13 3, rather, of page 5, you go through what you call a
14 three-stage process to derive the final rates for in-county
15 mail using Chown's weighted attributable costs. Are you
16 with me so far?

17 A Yes.

18 Q Okay.

19 Now, in this example, you start with her weighted
20 attributable costs for in-county mail, which you find on
21 Exhibit NAA-1D.

22 A Right.

23 Q Okay. And then you come up with a test year
24 before rate weighted attributable cost on line 8, right?

25 A Uh-huh.

1 Q Then you take the -- you look at the mark-up for
2 regular-rate periodicals, which is your 7-percent figure.

3 A Right.

4 Q Now, is that a weighted or an un-weighted mark-up?

5 A That's an un-weighted mark-up.

6 Q That's an un-weighted mark-up. Okay.

7 A Right. But essentially --

8 Q I understand. Okay. You've got the un-weighted
9 there and you take 50 percent and you phase it.

10 A Uh-huh.

11 Q So, you come up with a 2.9-percent mark-up for
12 in-county for step five.

13 A Right.

14 Q Then you determine, in your testimony, the dollar
15 amount to be recovered based on her proposed weighted
16 attributable cost by multiplying the 2.9 percent by the
17 weighted attributable costs.

18 A Uh-huh.

19 Q Correct? Is that how you did it?

20 A Yes.

21 Q Okay. Can you show me where in Ms. Chown's
22 testimony or interrogatory responses that she says that is
23 how one would determine the appropriate institutional cost
24 contribution?

25 A On page 19, lines 14 through 16, essentially it

1 reads -- and I'm reading from Ms. Chown's testimony -- "My
2 proposal is simply to substitute this measure of weighted
3 attributable costs for total attributable costs when
4 assigning institutional cost."

5 So, I could have used any number. Seven percent
6 was just one number. I could have used any number, and if I
7 had used the weighed attributable cost to assign the
8 institutional cost, my results would have been very similar.

9 Q Now, is it your understanding, then, that, in the
10 page and lines from her testimony that you cite, that she is
11 intending to refer to the specific case of how one sets the
12 mark-ups or the cost contributions for revenue foregone
13 sub-classes?

14 A If anything that I understood from her testimony
15 was that she wanted the Postal Service, according to her
16 proposal, to use the weighted attributable cost to assign
17 mark-ups, and that's exactly what I did.

18 Q In preparing your testimony, did you review Ms.
19 Chown's interrogatory responses?

20 A Most of them, I think.

21 Q Do you have an understanding of whether the NNA in
22 general terms participates in these proceedings on behalf of
23 the in-county mailers?

24 A Yes.

25 Q Okay. I'm going to distribute to you Ms. Chown's

1 response to NNA Interrogatory -- NNA/NAA-T-1-6 and ask you
2 to take a look at that.

3 A Sure. I think I've seen that before.

4 MR. BAKER: For the record, Mr. Chairman, I've
5 handed the witness a page which appears in the transcript of
6 this proceeding at page 13345, and I've asked the witness if
7 he's had a chance to review this answer.

8 THE WITNESS: Yes, I've reviewed the answer, but
9 my premise in doing the analysis was that -- my proposal to
10 be followed the way she has proposed it in her testimony
11 would require that we apply the markups to the -- otherwise
12 there's no point, because the within-county attribution
13 level increases significantly compared to all the other
14 classes of periodical mail. And that is what I wanted to
15 present, that if you want to use a proposal and use the
16 weighted attributable cost, then under no condition except
17 for a zero markup we would meet the requirement of the law.

18 BY MR. BAKER:

19 Q Does her answer to this Interrogatory
20 NNA/NAA-T-1-6 suggest that in the instance of a -- in the
21 instance of a subclass where we have one rate is defined by
22 all in a particular way, that perhaps the way she would
23 recommend you apply the proposal is to apply a markup to its
24 actual unweighted attributable costs?

25 A See, that was the problem that I was trying to

1 point out, too, that if you're going to use weighted
2 attributable cost, then either you would have to shift away
3 from her proposal or do something that will not be allowed
4 by the law. So I see what you've said over there, but I
5 still maintain that the use of weighted attributable costs,
6 that is why it does not make sense.

7 Q Well, is it possible that the calculation that you
8 provide on pages -- page 5 of your testimony, where your
9 understanding of Ms. Chown's proposal is that the markup
10 would be applied to the weighted attributable costs of
11 in-county mail, is based on a misunderstanding of how she
12 would apply her markup, how she would apply her proposal to
13 in-county mail?

14 A See, that is the inconsistency that I was trying
15 to point to, that either you use the weighted attributable
16 cost or you don't. If you start using it for some classes
17 and not for some other classes -- because if you look at her
18 proposal, the sum of her weighted attributable cost should
19 be equal to the sum of the attributable cost that we have
20 proposed.

21 Q And is that true?

22 A And I think Witness Hardy proves that in his
23 testimony that he adds the two totals, and if you don't use
24 all of it, then you're adding an inconsistency in there.

25 Q So let me ask you again, is the sum of the

1 weighted attributable costs in her testimony the same as the
2 total attributable costs?

3 A In her testimony; right.

4 Q Okay. And, just to maybe -- when -- let's forget
5 about the preferred classes for a moment. Let's go to a
6 regular commercial class. Under Ms. Chown's proposal -- I
7 want to ask you about your understanding of how her proposal
8 works for a regular commercial subclass with no revenue
9 forgone issues. She has her -- you take a commercial
10 subclass, let's call it First Class mail, she -- and the
11 weighted attributable costs are calculated, and the
12 Commission then, based on that, applies its judgment and
13 determines the institutional cost contribution to be
14 recovered from First Class mail. Then -- and that's a
15 dollar figure of institutional costs.

16 A Right.

17 Q And your understanding to what is that dollar
18 figure of institutional costs added to determine the target
19 revenue to be recovered from the subclass under Ms. Chown's
20 proposal.

21 A Based on Witness Chown's testimony it should be
22 added to the attributable cost to original number.

23 Q The unweighted actual?

24 A Exactly. Exactly.

25 MR. BAKER: Mr. Chairman, I have no more

1 questions.

2 COMMISSIONER HALEY: Mr. McKeever.

3 MR. MCKEEVER: Mr. Commissioner, we have no
4 questions.

5 COMMISSIONER HALEY: No questions.

6 Is there any followup cross-examination?

7 If not, Commissioners?

8 You have no questions.

9 You may take over, Mr. Chairman.

10 CHAIRMAN GLEIMAN: Mr. Cooper?

11 MR. COOPER: Could we take five?

12 CHAIRMAN GLEIMAN: Sure.

13 [Recess.]

14 CHAIRMAN GLEIMAN: Mr. Cooper?

15 REDIRECT EXAMINATION

16 BY MR. COOPER:

17 Q Mr. Taufique, Ms. Chown includes in her testimony
18 calculations of weighted attributable costs for the
19 preferred categories.

20 A Yes, she does.

21 Q Can you think of any reason why she would have
22 bothered to include them in her testimony if she didn't
23 intend them to be used?

24 A No, I don't know.

25 MR. COOPER: I have no further questions.

1 CHAIRMAN GLEIMAN: Is there any recross?

2 RECROSS EXAMINATION

3 BY MR. BAKER:

4 Q Mr. Taufique, is it possible Ms. Chown might have
5 included the weighted attributable costs for completeness?

6 A I beg your pardon?

7 Q Would it be possible she might have included them
8 in her testimony as a matter of completeness?

9 A As a matter of --

10 Q -- being complete?

11 A -- completeness. It could be, but it does not add
12 much to the record in terms of applying the cost numbers.

13 CHAIRMAN GLEIMAN: Anybody else?

14 [No response.]

15 CHAIRMAN GLEIMAN: If there isn't anything more,
16 then Mr. Taufique, we want to thank you. We appreciate your
17 appearance here today and your contributions to our record.
18 If there's nothing further, you're excused.

19 THE WITNESS: Thank you.

20 [Witness excused.]

21 CHAIRMAN GLEIMAN: That concludes today's hearing.
22 We'll reconvene tomorrow morning, March the 19th, at 9:30,
23 to receive testimony from Postal Service Witnesses Porras,
24 Pickett, Young, McGrane, Lewis, Rios, and Ellard and CTC
25 Witness Clark.

1 I suspect it has the potential to be a long day,
2 although I haven't checked the cross examination requests
3 yet.

4 Have a good evening, everyone.

5 [Whereupon, at 5:01 p.m., the hearing was
6 recessed, to reconvene at 9:30 a.m., Thursday, March 19,
7 1998.]

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