

ORIGINAL

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

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MAILING ONLINE SERVICE

Docket No. MC98-1

RESPONSE OF UNITED STATES POSTAL SERVICE
WITNESS PLUNKETT TO INTERROGATORIES OF
THE OFFICE OF THE CONSUMER ADVOCATE (OCA/USPS-T5-52-53),
AND FILING OF MISSING ATTACHMENT TO WITNESS PLUNKETT'S RESPONSE
TO INTERROGATORY PB/USPS-T5-5

The United States Postal Service hereby provides the responses of witness Plunkett to the following interrogatories of the Office of the Consumer Advocate: OCA/USPS-T5-52-53, filed on January 25, 1999. Each interrogatory is stated verbatim and is followed by the response.


In addition, the Postal Service omitted a one-page attachment from witness Plunkett's response to interrogatory PB/USPS-T5-5, filed January 29, 1999. That attachment is included at the end of this filing (preceding the declaration and certificate of service).

Respectfully submitted,

UNITED STATES POSTAL SERVICE

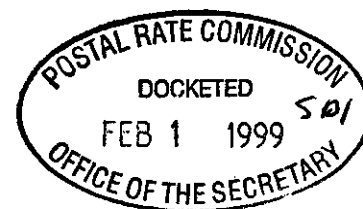
By its attorneys:

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**RESPONSE OF POSTAL SERVICE WITNESS PLUNKETT TO INTERROGATORIES
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OCA/USPS-T5-52. Please refer to your revised response to interrogatory OCA/USPS-T5-10, filed January 14, 1999.

- a. When OCA asks you whether the "fixed information systems costs" of MOL "will become institutional, rather than attributable," are you applying the definition of "attributable" articulated by the Commission in PRC Op. R97-1, paras. [4016-4018], i.e.,

[4016] In analyzing witness Panzar's position, the Commission first considers whether it is reasonable to limit the concept of attributable cost to marginal cost. The Commission has recognized since Docket No. R71-1 that marginal costs are the most important element of attributable cost. Over the years both the Service and the Commission have also included specific fixed costs under the rubric of attributable. Further, the Commission has analyzed costs caused by the classes of mail and found other nonvariable costs to be attributable (the fixed portion of special delivery messengers, the fixed portion of the Eagle Air Network, and the single subclass stop portion of access, among others). The Commission has even deleted marginal costs from attributable costs as in the case of the air transportation of parcel post to the Alaskan bush. In the latter case, the Commission found that the primary cause of those costs was the Service's universal service obligation, even though the cost varied with the volume of parcel post being transported to the bush.

[4017] The Commission is not prepared to depart from the position that attributable cost means costs which can be said to be reliably caused by a subclass of mail or special service. Marginal costs, by definition, include only the additional costs caused by the last unit of output. Marginal costs are an important subset of attributable costs, but the Commission cannot agree that marginal cost is all that is meant by the term "attributable." Unlike incremental costs, marginal costs have been central to microeconomic theory for a long time. The framers of the Act knew about and could have used the concept of marginal costs, but they did not. The language of the Act requires the Commission to set rates for each subclass so that it covers its attributable cost and makes a reasonable contribution to all other costs. In interpreting this language the Commission continues to believe that the authors of the Act intended "attributable" to

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mean more than just marginal cost. If they had meant marginal cost, they would have said so.

[4018] Marking up attributable cost is the means by which the Commission makes its determination of a reasonable contribution to all other costs. All other costs are the difference between total cost and attributable costs. All other costs are not the difference between total cost and marginal cost. When the Commission determines the reasonableness of a subclass's contribution to all other costs, it must use attributable cost as a base and *mark-up*.

....

[4024] The Commission's calculation of attributable costs by subclass and service does not precisely conform to witness Panzar's definitions of either marginal cost or incremental cost. However, they come closest to being the incremental costs associated with the subclasses and services taken one at a time.

- b. Do you agree with the Commission's view that attributable costs should include the volume variable costs of a subclass plus the specific fixed costs of that subclass?
- i. If you disagree, state whether you reject the Commission's articulated view of attributable costs.
 - ii. If you disagree with the Commission's view of attributable costs, then state your definition of attributable costs. Include in your discussion whether attributable costs must include the specific fixed costs of a subclass.
 - iii. Is the definition given in subpart ii. of this interrogatory the one you applied in determining the costs to be marked up for the purpose of recovering Information Systems costs in MOL's premailing, per impression fee?
 - iv. If your answer to subpart iii. is negative, then state the definition of attributable costs you applied in determining the costs to be marked up for the purpose of determining the premailing, per impression fee for MOL.
 - v. Did you include any of the fixed Information Systems costs in the cost base you marked up to determine the premailing, per impression MOL fee?
 - vi. If you excluded the specific fixed Information Systems costs from the cost base you marked up to determine the premailing, per impression MOL fee, didn't you deviate completely from the Commission's articulation of attributable costs?

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- c. Do you agree with the Commission that incremental costs come closer to being the attributable costs of a subclass than do marginal costs?
- i. If you agree with this view, did you apply it in determining the costs to be marked up for the purpose of determining the premailing, per impression MOL fee?
 - ii. If you disagree with this view, then state whether you marked up only the marginal costs of MOL to calculate the premailing, per impression MOL fee.
- d. Do you agree with the Commission that the volume variable plus the specific costs of a subclass best approximate attributable costs and that both should be added together and marked up to determine the rate for the subclass?
- i. If you agree with this view, did you apply it in determining the costs to be marked up for the purpose of determining the premailing, per impression MOL fee?
 - ii. If you disagree with this view, then state whether you marked up only the marginal costs of MOL to calculate the premailing, per impression MOL fee.
- e. Please review a relevant holding of the Commission in PRC Op. MC97-5, at page, 47 concerning the recoupment of start-up costs of a proposed, new Packaging Service:
- The Commission has adjusted packaging service costs to recover all start-up costs during the two-year life of the provisional service. . . . Reliance on the packaging service's contribution to institutional costs for recovery of these direct costs is also an unacceptable approach, for two reasons. First, it would be inappropriate in principle to recover an attributable cost from revenues that have been earmarked for contribution to the Postal Service's institutional costs. Second, doing so in this instance would reduce the institutional cost contribution of packaging service to an unacceptably low level.
- i. Have you applied this approach in your method for setting rates in MC98-1? Please explain.
 - ii. Specifically, have you included the start-up costs for MOL in the attributable cost base to be marked up for the purpose of establishing MOL rates? Please explain.
 - iii. If you have not done so, have you rejected the Commission's holding in PRC Op. MC97-5? Please explain.
 - iv. Is there any way to reconcile your answer to interrogatory OCA/USPS-T5-10 (revised January 14, 1999) with the Commission's holding in Docket No. MC97-5? Please explain.

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- v. What is the true cost coverage of MOL if start-up costs are included in the attributable costs to be marked up?
- vi. Isn't the true cost coverage far less than the 125 percent you have proposed if start-up costs are included in the costs to be marked up?
- f. Please compare your answer to question 1, POIR No. 2, that, "[T]he Postal Service considers that fees should be based on a markup of the volume variable costs of the service. Exhibits A and B were developed in conformity with this view," with the view articulated by the Commission at paras. [4016-18, and 4024] of PRC Op. R97-1, quoted in part a. above. Include in your comparison whether your view can be reconciled with the Commission's.

OCA/USPS-T5-52 Response:

a. In my revised response I was not applying any particular definition of attributable cost. I was simply pointing out that the fixed information systems costs will not become institutional, at least in the sense that institutional costs are paid for by all classes of mail.

b. In general, I agree with the Commission's view of attributable costs insofar as it describes the Commission's current definition of the term. However, I disagree with the notion that such attributable costs, which include fixed costs, provide the best basis for setting prices in all instances. See Tr. 2/641-43; Tr. 5/1115, 1181-84. I would instead suggest that in many cases, particularly when dealing with new products and services, the use of fixed costs as part of the base to be marked up may produce problematic results.

For instance, most new services incur some startup costs. While the categories are not precisely analogous, these costs are, among the categories posited in this interrogatory, most closely akin to specific-fixed costs, and may constitute a large portion of the costs of the service, especially during early, low volume periods.

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Depending on the nature of demand for the service, using fixed costs of this kind as a basis for ratemaking will produce one of two results. If demand is price elastic, basing prices on an all-inclusive definition of costs will result in higher prices, and may sufficiently dampen demand such that the service appeals only to the least price-sensitive users. For the Postal Service, which views Mailing Online as an extension of its mandate to provide universal access to its customers, such an approach is inappropriate. If demand is inelastic, the product will more quickly recover its startup costs. However, once startup costs have been recovered, prices will be higher than statutory criteria would otherwise warrant.

The foregoing highlights a somewhat arbitrary distinction between costs attributable to the Mailing Online experiment and costs attributable to Mailing Online in general. If Mailing Online becomes a permanent service, the one-time costs referred to by witness Seckar will in effect be sunk and will have no ongoing effect on future fees for Mailing Online. It is unnecessary and unfair to burden experimental users of Mailing Online with costs that will provide benefits to future users of a permanent service. In this regard, the GAO recently recognized that "it may not be reasonable to expect all new products to become profitable in their early years, because new products generally take several years to become established and recover their start-up costs¹." Of course, the Postal Service cannot, in every case, alter the design of a service to defer infrastructure costs required for a permanent service until after an experiment required to determine

¹GAO Report on U.S. Postal Service - Development and Inventory of New Products, at 4,20 (November, 1998)(GAO/GCD-99-15)

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the service's viability. In the instant case, the alternative would be to develop a system architecture on a smaller scale that would serve the needs of the experiment, but that would be replaced if a permanent classification were sought. This would obviously increase the total development costs of the product. Instead, the Postal Service chose a system architecture which will be scalable to a capacity greater than will be needed for the experiment.

A too-rigid adherence to the pricing dictum articulated in the question could have a chilling effect on development of otherwise beneficial experimental services. The Postal Service could present every new product as a candidate for permanent classification. As these products by definition lack empirical cost and revenue data, litigation of such cases would be problematic at best. Instead, the Postal Service has attempted to make use of the alternative ratemaking procedures that allow for consideration of the unique circumstances that pertain to new products.

In determining the costs to be marked up, and the resulting fee structure, I sought an approach that would satisfy the Postal Service policy goal of universal low cost access to services, while meeting a stringent cost threshold.

c. While I am not an expert in Postal Service costing, my understanding is that the relationship between attributable, incremental, and marginal costs varies considerably across subclasses. Thus I can provide neither an unqualified assent nor an unqualified dissent.

i. See my response to part b.

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- ii. My fee proposal marks up printer costs, which are similar to marginal costs, and variable information systems costs, which are roughly equivalent to average marginal costs.
 - d. See my responses to parts b and c.
 - e.
 - i-ii. My approach for setting fees in this docket is presented in my testimony. As it relates to the issue of attributable costs, my response to part b of this interrogatory is also relevant.
 - iii-iv. My testimony reflects what is, in my opinion, the most appropriate approach in the circumstances of this case. Thus I did not let this quote determine my approach in this case. See also my response to subpart v.
- Witness Lim estimates start-up costs to be \$11.1 Million during the experiment. If these costs are somehow included in Mailing Online unit costs prior to markup, then revenues would increase by \$13.9 Million. Cost coverage would not change.
- Furthermore, I do not believe that the cost contribution of Mailing Online would be unacceptably low if start-up costs are included using my projected revenues. I estimate that the cost coverage would be 118.2 percent in those circumstances.
- i. No. See my response to subpart v.
 - f. See my response to part b.

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OCA/USPS-T5-53. Please refer to part a. of your revised answer (January 14, 1999) to interrogatory OCA/USPS-T5-10.

- a. Are the one-time costs of \$11.1 million you refer to merely a rounding of the \$11,120,030 set forth in Table 2, column 3 ("One Time Cost"), at page 2 of USPS-ST-9?
- b. Are the one-time costs of \$11.1 million the start-up costs of MOL?
- c. Are the start-up costs of a service that are uniquely caused by offering that service incremental costs of that service? If your answer is negative, please explain.
- d. Are the start-up costs of MOL part of the incremental costs of MOL? If your answer is negative, please explain.
- e. Are the incremental costs of a service (including its unique start-up costs) attributable to that service?
 - i. If your answer is negative, please explain your position.
 - ii. If your answer is negative, reconcile it with the views articulated by the Commission in paras. [4016-18, and 4024] of PRC Op. R97-1.
- f. Are the incremental costs of MOL (including its unique start-up costs) attributable to MOL?
 - i. If your answer is negative, please explain your position.
 - ii. If your answer is negative, reconcile it with the views articulated by the Commission in paras. [4016-18, and 4024] of PRC Op. R97-1.

OCA/USPS-T5-53 Response:

- a. Yes.
- b. Witnesses Lim and Seckar describe them as "one-time" costs.
- c. Yes.
- d. To the extent that any costs of Mailing Online could reasonably be said to conform to the definition presented in part c, they would be incremental to Mailing Online.

Because Mailing Online shares equipment with Post Office Online, and generates Standard Mail (B) and First-Class Mail revenue, I would not agree that much of the costs identified as Mailing Online startup costs are "uniquely caused" by Mailing Online.

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- e. While I am not an expert in costing, my understanding is that, to the extent such costs can be measured, incremental costs are caused by the existence of a service, and, in that sense, attributable. However, attributable cost, as mentioned in my response to interrogatory OCA/USPS-T5-52, is a term of art with no precise economic meaning.
- f. See my response to parts d and e.

Revenues Including Variable Information Systems Costs

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	Note	1999	2000	Total 1999-2000
Impression Costs				
(a) Total Impression Costs	Attachment to witness Seckar's updated response to hearing question Tr. 7/1733-34, Worksheet 1 line 25	\$ 50,881,909	\$ 84,974,709	\$ 135,856,618
(b) Fixed Info Systems Costs (BW, 8.5x11 & 8.5x14)	Attachment to witness Seckar's updated response to hearing question Tr. 7/1733-34, Worksheet 1 line 7	\$ 1,845,942	\$ 3,221,664	\$ 5,067,605
(c) Fixed Info Systems Costs (BW, 11x17)	Attachment to witness Seckar's updated response to hearing question Tr. 7/1733-34, Worksheet 1 line 15	\$ 518,211	\$ 904,417	\$ 1,422,628
(d) Fixed Info Systems Costs (Spot Color, 8.5x11 & 8.5x14)	Attachment to witness Seckar's updated response to hearing question Tr. 7/1733-34, Worksheet 1 line 23	\$ 1,686,464	\$ 2,943,333	\$ 4,629,797
(e) Total Impression Costs excl. fixed info systems costs	=(a) - (b) - (c) - (d)	\$ 46,831,292	\$ 77,905,296	\$ 124,736,588
Paper Costs				
(f) 8.5x11 B&W pages	USPS T-2A page 9 line 45	541,001,192	944,192,341	1,485,193,533
(g) 8.5x11 Spot Color pages	USPS T-2A page 10 line 71	433,424,586	756,442,279	1,189,866,865
(h) Pages printed on 8.5x11 paper	=(f) + (g)	974,425,778	1,700,634,620	2,675,060,398
(i) 8.5x11 paper - Price per piece	USPS T-2A page 28	\$ 0.0049	\$ 0.0050	
(j) 8.5x11 paper - Total cost	=(h) * (i)	\$ 4,762,993	\$ 8,578,708	\$ 13,341,702
(k) 8.5x14 B&W pages	USPS T-2A page 9 line 49	60,416,029	105,442,192	165,858,221
(l) 8.5x14 Spot Color pages	USPS T-2A page 10 line 75	48,402,467	84,475,301	132,877,768
(m) Pages printed on 8.5x14 paper	=(k) + (l)	108,818,496	189,917,493	298,735,989
(n) 8.5x14 paper - Price per piece	USPS T-2A page 28	\$ 0.0053	\$ 0.0055	
(o) 8.5x14 paper - Total cost	=(m) * (n)	\$ 580,568	\$ 1,045,672	\$ 1,626,240
(p) 11x17 B&W pages	USPS T-2A page 9 line 53	84,417,856	147,331,826	231,749,682
(q) 11x17 Spot Color pages	USPS T-2A page 10 line 79	67,631,597	118,035,295	185,666,892
(r) Pages printed on 11x17 paper	=(p) + (q)	152,049,453	265,367,121	417,416,574
(s) 11x17 paper - Price per piece	USPS T-2A page 28	\$ 0.0102	\$ 0.0105	
(t) 11x17 paper - Total cost	=(r) * (s)	\$ 1,552,851	\$ 2,796,666	\$ 4,349,717
(u) Total Pages	=(h) + (m) + (r)	1,235,293,727	2,155,919,234	3,391,212,961
(v) Total Paper Cost	=(j) + (o) + (t)	\$ 6,896,412	\$ 12,421,246	\$ 19,317,658
Envelope Costs				
(w) First-Class Letters	USPS T-2A page 6 line 92	77,672,143	135,558,745	213,230,888
(x) Standard Mail (A) Letters	USPS T-2A page 6 line 94	172,640,919	301,304,758	473,945,677
(y) Total letter size pieces	=(w) + (x)	250,313,062	436,863,503	687,176,565
(z) # 10 Envelope no window and logo - Price per piece	USPS T-2A page 28	\$ 0.0272	\$ 0.0281	
(aa) Envelope Costs - letter size pieces	=(y) * (z)	\$ 6,820,530	\$ 12,284,574	\$ 19,105,104
(bb) First-Class flats	USPS T-2A page 6 line 93	14,072,713	24,560,663	38,633,376
(cc) Standard Mail (A) flats	USPS T-2A page 6 line 95	31,279,247	54,590,685	85,869,932
(dd) Total flat size pieces	=(bb) + (cc)	45,351,960	79,151,348	124,503,308
(ee) Flat sized envelope no window and no logo - Price per piece	USPS T-2A page 28	\$ 0.0468	\$ 0.0483	
(ff) Envelope Costs - flat size pieces	=(dd) * (ee)	\$ 2,122,000	\$ 3,821,971	\$ 5,943,971
(gg) Total Envelopes	=(y) + (dd)	295,665,022	518,014,851	811,679,873
(hh) Total Envelope Cost	=(aa) + (ff)	\$ 8,942,530	\$ 16,106,544	\$ 25,049,075
Transportation Costs				
(ii) First-Class Letters	USPS T-2A page 6 line 92	77,672,143	135,558,745	213,230,888
(jj) First-Class Letters - Transportation cost per piece	USPS T-2A page 7 line 140	\$ 0.00055	\$ 0.00054	
(kk) Total First-Class letter transportation costs	=(ii) * (jj)	\$ 42,594	\$ 73,423	\$ 116,017
(ll) First-Class flats	USPS T-2A page 6 line 93	14,072,713	24,560,663	38,633,376
(mm) First-Class flats - Transportation cost per piece	USPS T-2A page 7 line 141	\$ 0.00083	\$ 0.00082	
(nn) Total First-Class flats letter transportation costs	=(ll) * (mm)	\$ 11,717	\$ 20,198	\$ 31,915
(oo) Standard Mail (A) Letters	USPS T-2A page 6 line 94	172,640,919	301,304,758	473,945,677
(pp) Standard Mail (A) Letters - Transportation cost per piece	USPS T-2A page 7 line 142	\$ 0.00120	\$ 0.00119	
(qq) Total Standard Mail (A) letter transportation costs	=(oo) * (pp)	\$ 207,925	\$ 358,421	\$ 566,347
(rr) Standard Mail (A) flats	USPS T-2A page 6 line 95	31,279,247	54,590,685	85,869,932
(ss) Standard Mail (A) flats - Transportation cost per piece	USPS T-2A page 7 line 143	\$ 0.01586	\$ 0.01567	
(tt) Total Standard Mail (A) flat transportation costs	=(rr) * (ss)	\$ 496,104	\$ 855,185	\$ 1,351,289
(uu) Total Transportation Costs	=(kk) + (nn) + (qq) + (tt)	\$ 758,340	\$ 1,307,227	\$ 2,065,567
(vv) Insertor Costs	Attachment to witness Seckar's updated response to hearing question Tr. 7/1733-34, Worksheet 3	\$ 8,593,250	\$ 14,882,676	\$ 23,475,926
(ww) Total Printing, Transportation, and Insertor Costs	=(e) + (v) + (hh) + (uu) + (vv)	\$ 72,021,825	\$ 122,622,990	\$ 194,644,814
(xx) 25% Markup on printing and transportation costs	=(ww) * 25%	\$ 18,005,456	\$ 30,655,747	\$ 48,661,204
(yy) Total Revenue including Markup	=(ww) + (xx)	\$ 90,027,281	\$ 153,278,737	\$ 243,306,018
(zz) Net Contribution	=(yy)-(ww)	\$ 18,005,456	\$ 30,655,747	\$ 48,661,204

DECLARATION

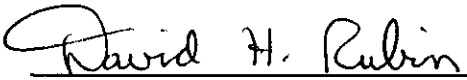
I, Michael K. Plunkett, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

Michael K. Plunkett

Dated: 2/1/99

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.



David H. Rubin

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February 1, 1999