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Before the

UNITED STATES POSTAL RATE COMMISSION

In the Matter of: MAILING ONLINE SERVICE

Docket No. MC98-1

VOLUME 11

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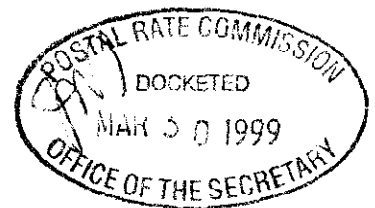
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BEFORE THE
POSTAL RATE COMMISSION

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In the Matter of: Docket No. MC98-1
MAILING ONLINE SERVICE :
- - - - - X

Third Floor Hearing Room
Postal Rate Commission
1333 H Street, N.W.
Washington, D.C. 20268

Monday, March 29, 1999

The above matter came on for hearing, pursuant to
notice, at 9:30 a.m.

BEFORE: EDWARD J. GLEIMAN, Chairman
W. H. "TREY" LeBLANC, III, Commissioner
DANA COVINGTON, Commissioner
GEORGE OMAS, Commissioner
RUTH GOLDWAY, Commissioner

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4 BY MR. RUBIN 2631

5 BY MR. COSTICH 2667

6 BY MR. WIGGINS 2720

7 BY MR. BUSH 2755

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10 DOCUMENTS TRANSCRIBED INTO THE RECORD: PAGE

11 Rebuttal testimony and Exhibits of

12 William M. Takis, USPS-RT-2 2632

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15 E X H I B I T S

16 EXHIBITS AND/OR TESTIMONY IDENTIFIED RECEIVED

17 Rebuttal testimony and Exhibits of

18 William M. Takis, USPS-RT-2 2632 2632

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1 PROCEEDINGS

2 [9:30 a.m.]

3 COMMISSIONER LeBLANC: On the record, please.

4 Good morning, gentlemen, ladies. Today we will
5 begin to receive rebuttal testimony in Docket Number MC98-1,
6 considering the Postal Service request to initiate a
7 nationwide Mailing Online service experiment. Scheduled to
8 appear this morning is Postal Service Witness Takis. I hope
9 I got that one right. Did I say that right?

10 MR. TAKIS: You did, sir.

11 COMMISSIONER LeBLANC: I still like your hairline,
12 like I said last time.

13 The procedural schedule in this case has become
14 quite complex. I urge participants to carefully familiarize
15 themselves with the schedule appearing as Attachment B to
16 Commission Order Number 1234 -- 1, 2, 3, 4, as they say. It
17 is the Commission's expectation that certain materials in
18 the nature of admissions or stipulations may have to be
19 added to the evidentiary record very shortly before the
20 Commission hopes to issue a recommended decision.
21 Additionally there may be a few final responses to discovery
22 requests that are ripe for admission.

23 My current intention is to admit miscellaneous
24 evidentiary material during the hearing tentatively
25 scheduled for April 26. Participants seeking to have such

1 materials admitted into the record should file appropriate
2 motions on or before -- on or before -- April 19.

3 If there is no need for a hearing on April 26, I
4 will rule on outstanding motions for admissions by that date
5 so that the evidentiary record can be closed in a timely
6 fashion. Thus, any objections or comments to motions for
7 admissions must be filed within seven days or by April 23,
8 whichever comes first.

9 On Friday, March 26, the Office of the Consumer
10 Advocate filed a motion to compel production along with
11 suggestions for expediting consideration of that motion.
12 This morning I believe the attorneys in question have had a
13 conversation or two as of Friday afternoon.

14 Mr. Hollies, will you be able to respond to that
15 orally right now at this particular time?

16 MR. HOLLIES: Certainly, Mr. Presiding Officer.

17 The OCA filed a motion seeking what appear to be
18 attachments to the memorandum that appears as Exhibit 1A to
19 the rebuttal testimony of Witness Garvey, USPS-RT-1. The
20 Postal Service is prepared to provide those attachments.
21 They consist of several pages of what started out as
22 Powerpoint slides. As such, there are a number of slides,
23 and that's why the reference in the exhibit is to the
24 plural, "attachments." We will be providing those later
25 today.

1 My understanding is that the OCA may be prepared
2 to withdraw its motion upon being furnished an opportunity
3 to review that material. It is physically in my office. I
4 did get permission from the Deputy Postmaster General to put
5 that in play, and we will do so later today.

6 I have one other procedural matter that doesn't
7 really affect anything here today. As a consequence of last
8 week's technical conference on the AP reports, the Postal
9 Service has gone back and reexamined its data. We will be
10 filing updated reports I hope later today. That will
11 reflect some costs that were not previously included.

12 COMMISSIONER LeBLANC: Let me take it one at a
13 time.

14 First of all, I'll take it on the back end, Mr.
15 Hollies. I do want to tell everybody I appreciate very much
16 the seemingly good manner in which everybody seems to be
17 again cooperating in these conferences that you're holding.
18 If there is any problem that comes up, if you will please
19 notify the Commission as soon as possible. Therefore we can
20 make any changes in scheduling or whatever we may have to do
21 on our particular end. But again I do want to thank all the
22 participants in those conferences for the seemingly good
23 nature with which these have been held.

24 Mr. Gerarden, you look like you want to make a
25 comment. Do you need to make a comment on that statement,

1 or can we move on?

2 Grab a mike if you can, please, sir.

3 And if you'll state your name so the record's
4 clear.

5 MR. GERARDEN: Thank you. Ted Gerarden for the
6 Office of the Consumer Advocate.

7 I wonder if I might ask the Presiding Officer if
8 Mr. Hollies can give a time certain as to when those
9 documents will be provided to OCA for review. In our
10 motion, of course, we had requested that they be available
11 in the hearing room tomorrow, and if the ruling was
12 favorable, that we would have an opportunity to review them
13 before proceeding with the cross-examination. Obviously in
14 preparation for cross-examination tomorrow it would be
15 helpful to OCA's staff if the documents are available with
16 adequate time for review. So I hope that they would be
17 available early in the afternoon rather than at the very end
18 of the day.

19 COMMISSIONER LeBLANC: By early this afternoon,
20 would that would give you adequate time to have your cross
21 ready?

22 MR. GERARDEN: Yes.

23 COMMISSIONER LeBLANC: Mr. Hollies, it's back to
24 you. Now where do we stand as far as that goes?

25 MR. HOLLIES: Well, as soon as Mr. Takis is done

1 and off the stand, I will personally be hightailing it back
2 over to the office and will fax those back over here to the
3 OCA.

4 COMMISSIONER LeBLANC: I will ask both parties,
5 and if there is a problem with you not receiving that, if
6 you could let us know, then again we can take it under
7 advisement and do whatever we feel is necessary under the
8 circumstances.

9 MR. HOLLIES: It's roughly 15 pages. It's fairly
10 quick to take a look at. It won't take that long. So I
11 think that we will more than meet the deadline envisioned by
12 the OCA's motion.

13 COMMISSIONER LeBLANC: Mr. Gerarden, any further
14 comments?

15 MR. GERARDEN: No. We'll look forward to
16 receiving them at an early hour this afternoon.

17 COMMISSIONER LeBLANC: Thank you.

18 Any other participant have any comment on those
19 matters?

20 Moving right along, as they say, one more comment
21 on our procedural schedule. It is the Commission's hope and
22 expectation that all participants will work cooperatively as
23 I've talked about to allow the extraordinary procedures to
24 success, and I think you've already made an effort to that,
25 and again, thank you.

1 I notice that the first contemplated conference
2 was duly scheduled, so let me just say that if there is a
3 problem on these next ones that come up as I talked about
4 earlier, let us know. I want to make sure that everybody
5 understands that.

6 So after we've said all of that now, does any
7 other procedural matter need to be raised at this point?

8 Yes, Mr. Wiggins.

9 MR. WIGGINS: Mr. Presiding Officer, thank you.

10 In the course of preparing to examine Mr. Takis, I
11 was looking at some of the data that we've received from the
12 Postal Service, and it came to me to wonder just what the
13 formal evidentiary status of that stuff is.

14 COMMISSIONER LeBLANC: What stuff?

15 MR. WIGGINS: Of the data reports, all three
16 varieties of them, the weekly reports, the biweekly reports,
17 and the soon-to-be-amended accounting-period reports.
18 There's not been any formal mechanism for putting them into
19 the record. It certainly seems to me that the Commission's
20 October 7 order authorizing the market test contemplated
21 that they'd be part of the record here.

22 The Commission said, and I'm reading from page 42
23 of that decision, after review of the record concerning the
24 data collection plan, the Commission recommends that the
25 following information be provided during the market test for

1 use during consideration of the proposed experiment. In
2 other words, we ought to be able to make use of that.

3 I had taken that sentence as sort of implying that
4 they were going in some fashion to be part of the formal
5 record. If that's not the contemplation of the Commission
6 or if it's objectionable to the Postal Service or anybody
7 else, it seems to me that sooner rather than later is the
8 time for disposing of any questions that there might be of
9 the formal evidentiary status of those data.

10 COMMISSIONER LeBLANC: Mr. Hollies, would you care
11 to comment on that?

12 MR. HOLLIES: Yes. I do believe the Presiding
13 Officer has already indicated, if my recollection serves me,
14 in the February 5 hearing that those reports are to be
15 treated as part of the evidentiary record, and my
16 understanding based on that discussion was therefore there
17 was no need for any further formal procedures to make them a
18 part of the evidentiary record. They are de facto becoming
19 part of the record as they are filed.

20 MR. WIGGINS: If that is the Commission's
21 impression as well, I have nothing more to say about that,
22 except --

23 COMMISSIONER LeBLANC: Well -- go ahead, Mr.
24 Wiggins. I'm sorry.

25 MR. WIGGINS: Well, except to note that in the

1 weekly reports and the biweekly reports, there have been a
2 number of corrections made over time, and as I was looking
3 at my collection of those documents over the weekend, I had
4 a fair level of confidence that I had the most up-to-date
5 documents, but I don't have real certitude on that. And I
6 guess I would suggest that the Commission request that the
7 Postal Service provide a definitive set of those documents
8 that are reflective of all the changes that have been made.

9 MR. HOLLIES: Mr. Presiding Officer, we could
10 perhaps provide a list of the final ones to clarify
11 anybody's questions about what exactly is in --

12 COMMISSIONER LeBLANC: By a list, are you
13 specifically stating the pages? I think that's what -- is
14 that what you're asking for, Mr. Wiggins?

15 MR. WIGGINS: Sure. If we --

16 COMMISSIONER LeBLANC: To make sure that the
17 pages and therefore the numbers are as per what you have
18 then? Is that what we're talking about?

19 MR. WIGGINS: That would work just fine, if we had
20 a list that said in AP 2, week 4, there are revised pages
21 boom boom boom, so that I could just look at what I've got
22 and make sure that I had the right date of revision.

23 COMMISSIONER LeBLANC: I would think that's in
24 order, Mr. Hollies, unless that's some major problem for the
25 Postal Service at this point.

1 MR. HOLLIES: If I could comment briefly. We
2 anticipated this very problem, and that is why at each --
3 when the occasion rose each time to update or revise a
4 report, we filed the whole report, we didn't file just
5 revised pages. Which is why I believe a list really ought
6 to be sufficient. If we identify, for example, the date on
7 which the final version of the AP report from AP 4 was
8 filed, I believe that ought to clarify things quite
9 sufficiently.

10 COMMISSIONER LeBLANC: I think that's fair, Mr.
11 Wiggins. Is there any problem with that?

12 MR. WIGGINS: No, that will work just fine for me.

13 COMMISSIONER LeBLANC: That will be fine.

14 Any other comments? OCA? MASA?

15 Okay. Having said all that and cleaned up the
16 record, we hope, are there any further comments?

17 Okay. Mr. Hollies, can you identify -- oh, I'm
18 sorry, who's going to -- okay. I'm always behind the power
19 curve here. Time to identify our witness so we can swear
20 him in.

21 MR. RUBIN: The Postal Service calls William M.
22 Takis as its next witness.

23 Whereupon,

24 WILLIAM M. TAKIS,
25 a witness, was called for examination by counsel for the

1 U.S. Postal Service and, having been first duly sworn, was
2 examined and testified as follows:

3 COMMISSIONER LeBLANC: Mr. Rubin?

4 DIRECT EXAMINATION

5 BY MR. RUBIN:

6 Q Mr. Takis, I provided you with two copies of a
7 copied entitled, "Rebuttal Testimony of William M. Takis on
8 behalf of United States Postal Service" and designated as
9 USPS-RT-2.

10 Was this testimony prepared by you or under your
11 supervision?

12 A Yes, it was.

13 Q And do you have any changes to make to your
14 testimony at this time?

15 A Yes, I do. In the course of preparing for today's
16 hearing I noted two small editorial changes, which I would
17 like to read into the record.

18 On page 4, line 3, of my testimony the word "and"
19 has been inserted between the words "component" and "their".

20 The second change is on page 18, in the second
21 line of the Footnote Number 16, the word "which" and the
22 comma preceding it has been deleted between the number 0330
23 and the word "give".

24 Q Thank you, and if you were to testify orally here
25 today, would this be your testimony?

1 A Yes, it would.

2 MR. RUBIN: I would request that the rebuttal
3 testimony of William M. Takis on behalf of the United States
4 Postal Service be entered into the record in this
5 proceeding.

6 COMMISSIONER LeBLANC: Are there any objections?

7 Hearing none, Mr. Takis's testimony and exhibits
8 are received into evidence, and I direct that they be
9 transcribed into the record at this point.

10 [Rebuttal testimony and Exhibits of
11 William M. Takis, USPS-RT-2, was
12 received into evidence and
13 transcribed into the record.]

14

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USPS-RT-2

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

MAILING ONLINE SERVICE

Docket No. MC98-1

REBUTTAL TESTIMONY
OF
WILLIAM M. TAKIS
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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1 **REBUTTAL TESTIMONY**

2 **OF**

3 **WILLIAM M. TAKIS**

4
5
6 **AUTOBIOGRAPHICAL SKETCH**

7
8 My name is William M. Takis. I am a Partner in PricewaterhouseCoopers' (PwC)
9 Washington Consulting Practice, located at 1616 North Fort Myer Drive, Arlington, VA
10 22209.

11
12 I am responsible for directing many of PwC's projects in the areas of cost analysis and
13 rate design for regulated utilities. My work has focused on cost of service studies, cost
14 of capital studies, rate design analyses, and other related financial and economic
15 studies for utilities in the electric, natural gas, telecommunications, and water supply
16 industries. I have performed these studies for numerous utilities in the United States
17 and abroad.

18
19 I am also a leader of PwC's Postal Industry Market Team, comprised of over 200 full-
20 time professionals providing consulting services to the U.S. Postal Service and
21 numerous foreign postal administrations. Over the past thirteen years, I have directed
22 numerous cost analysis projects for the U.S. Postal Service, focusing on the following
23 areas:

- 24
25 • incremental costs
26 • mail processing
27 • surface transportation
28 • air transportation
29 • window service
30 • recovery of prior years losses
31 • new product introductions.
32

1 I have also written several papers and articles concerning my work in regulated
2 industries which have been published in various journals and presented at industry
3 conferences.

4
5 I have a B.A. in Economics from Williams College and an M.A. in Economics from the
6 University of Maryland. In addition, I have completed most of the requirements for a
7 Ph.D. in Economics at Maryland, including core coursework and comprehensive theory
8 exams. I have also passed the Ph.D. field exam in Industrial Organization.

9
10 I have appeared before the Postal Rate Commission on three separate occasions. In
11 Docket No. MC95-1 (USPS-T-12), I presented testimony concerning a variety of costing
12 issues, concentrating on Standard Class letter-shaped mail processing costs. In that
13 same docket, I presented rebuttal testimony (USPS-RT-4) concerning costing issues for
14 Standard Class Enhanced Carrier Route mail. In Docket No. R97-1 (USPS-T-41), I
15 presented estimates of the Postal Service's incremental costs.

1 **I. PURPOSE AND SCOPE OF TESTIMONY**

2

3 The purpose of my testimony is to comment on several positions that have been taken
4 by participants in this Docket. First, I respond to various arguments made by the Office
5 of the Consumer Advocate (OCA) in its response to Notice of Inquiry (NOI) No. 1, Issue
6 5 (*OCA Response*), concerning the allocation of advertising costs, including the
7 following:

8

- 9 • the OCA's assertion that advertising costs for POL are volume variable (*OCA*
10 *Response*, pages 2 through 4);
- 11 • the OCA's belief that even if advertising costs are not volume variable, they
12 should still be distributed to products sold through the POL channel, including
13 MOL (*OCA Response*, pages 4 through 10);
- 14 • the OCA's use of the testimony of past witnesses appearing before the
15 Commission in previous Dockets to support its position in this case (*OCA*
16 *Response*, pages 6 through 7);
- 17 • the OCA's use of past Commission treatment of the costs associated with
18 Special Delivery Messengers to support its position in this case (*OCA*
19 *Response*, pages 8 through 10).

20

21 I believe that the conclusions drawn by the OCA about the volume variability of
22 advertising costs are incorrect, and that the approach proposed by the OCA for
23 allocating these costs to individual products may be harmful to the Postal Service,
24 competitors, and the mailing public. Moreover, the OCA's arguments are inconsistent
25 with both sound economic costing principles and with Commission precedent.

26

27 Second, I also comment on the testimony of Witness Prescott (MASA/PB-T-1),
28 concentrating on two specific issues:

29

- 1 • his conclusion that advertising costs should be allocated to products using a
- 2 "distribution key" based on the relative number of MOL and POL transactions
- 3 (Tr. 9/2135-37);
- 4 • his statements about vertical integration and the supposed negative effects of
- 5 the Postal Service's contracting with companies in the printing market (Tr.
- 6 9/2117-22).

7

8 As with my criticisms of the OCA's similar recommendation, I believe Witness Prescott's

9 proposal concerning the distribution of advertising costs will result in an arbitrary

10 allocation that violates sound economic costing principles. Such an allocation of costs

11 may be harmful to the Postal Service, its competitors, and mailers. Furthermore, I

12 believe his concerns about the potential harmful effects of vertical integration are

13 unjustified and should not affect the Commission's decision to recommend the Mailing

14 Online service.

15

16 In the following section of my testimony (Section II), I provide an overview of the

17 importance of *cost causality* in developing product costs, concentrating on Postal

18 Service and Commission precedent. In Section III, I show how the OCA's and Witness

19 Prescott's proposals concerning the allocation of advertising costs violate cost causality

20 criteria and will result in an arbitrary allocation of costs to products sold through the

21 POL channel with potentially harmful consequences. I then provide my

22 recommendations for the proper treatment of advertising costs in Section IV. Section V

23 addresses Witness Prescott's concerns about the supposed harmful effects of vertical

24 integration. Section VI concludes and summarizes my testimony.

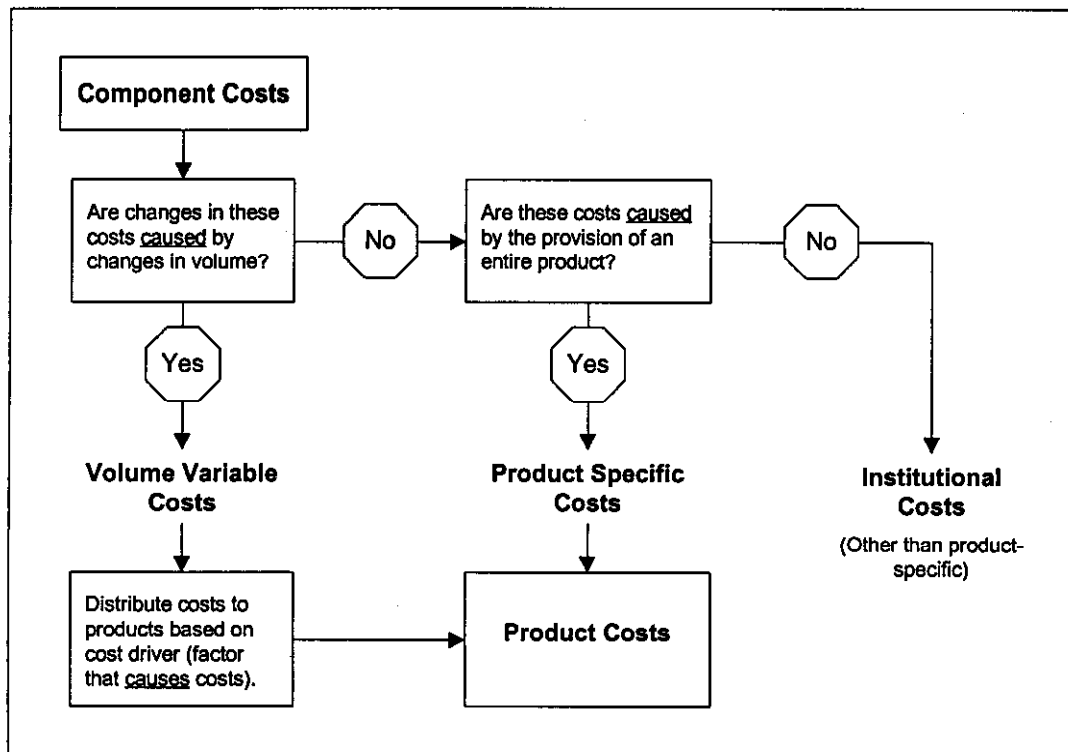
II. THE IMPORTANCE OF COST CAUSALITY IN POSTAL COSTING

In its Notice of Inquiry No. 1, Issue No. 5, the Commission asks interested parties to comment on the proper treatment of joint marketing costs. As I noted briefly in Section I, I believe that the proposals made by both the OCA and Witness Prescott for treating these costs are inconsistent with the Commission's precedent, not to mention sound economic costing principles. My belief is based on the fact that both the OCA and Witness Prescott ignore or misunderstand the critical concept of *cost causality* in their proposals and its important place in Commission precedent. Before I begin my discussion of the specific proposals made by the OCA and Witness Prescott in this area, it would first be helpful to review the important place the principle of cost causality has in postal costing, thus laying a framework for my subsequent discussion.

A. Allocating Costs to Products on a Causal Basis

The concept of cost causality has served as the foundation of both the Postal Service's and the Commission's costing systems since the Postal Reorganization Act was passed. While the Postal Service and the Commission do not always agree about what constitutes attributable costs, treatment of specific segments/components (*e.g.*, variabilities for mail processing costs in Docket No. R97-1), as well as what to do with those costs (*i.e.*, whether volume variable alone or a broader definition of attributable costs should serve as the basis for markups, as was debated in Docket No. R97-1), both the Postal Service and the Commission have consistently held that costs should be allocated to individual products and groups of products on a causal basis.

Exhibit USPS-RT2-A: Conceptual Overview of Postal Product Cost Development



1
 2 The diagram presented in Exhibit USPS-RT2-A provides a simplified overview of the
 3 development of postal costs for a generic cost component¹ and their allocation to individual
 4 products given my understanding of the Postal Service's and Commission's
 5 approaches.¹ As illustrated in the exhibit, causality is the key consideration for the
 6 development of product costs. For example, if changes in costs for a particular
 7 component are caused by changes in volume at the margin, then that portion of the
 8 component cost is termed *volume variable*. Volume variable costs within a particular
 9 component are distributed to individual products or subclasses based on *cost drivers* for
 10 that component; these cost drivers are also related to those elements that actually
 11 cause costs to accrue. If a cost is not caused by marginal changes in volume, but is

¹ There are many additional nuances in the Postal Service's costing system, particularly when allocating product-specific costs to groups of products. I discuss several of these nuances in Section IV with regard to the POL case.

1 caused by the provision of an entire product or subclass, then the cost is *product-*
2 *specific* to that product or subclass.² If costs are not caused by a specific product or
3 subclass, then they are part of *institutional* costs that are not product-specific.
4 Therefore, at every step of the cost development process, *cost causality* is the critical
5 determinant for allocation to products.

6
7 The important role of cost causality in both the Postal Service's and the Commission's
8 development of product costs can be illustrated by examining a particular cost segment
9 in greater detail. For example, Cost Segment 14 (Purchased Transportation) contains
10 volume variable, product-specific, and institutional costs in the various categories of
11 transportation, as discussed below.

12
13 **B. Example 1: Volume Variable/Marginal Costs and Causality**

14
15 *Volume variable costs* for commercial air transportation are determined by examining
16 how changes in volume *cause* changes in contract costs.³ For example, increases in
17 volume for different classes of mail traveling via commercial air transportation cause the
18 Postal Service to purchase additional transportation (*i.e.*, incur additional costs) to
19 transport additional pound-miles. These volume variable costs are then distributed to
20 individual subclasses of mail using a distribution key based on a specific cost driver that
21 *causes* transportation costs to accrue (*i.e.*, pound-miles).⁴ These causal relationships

² The term *product-specific* was introduced by the Postal Service in Docket No. R97-1. It corresponds roughly (but not exactly) to the Commissions' use of the term *specific-fixed*. Please see Tr. 9/4733-36 in Docket No. R97-1 for a complete discussion of these terms. In either case, the concept for the present discussion remains the same – these costs are *caused* by the provision of the entire subclass.

³ Please see Witness Bradley's testimony in Docket No. R97-1 (USPS-T-13) for a complete discussion of the development of volume variable costs for purchased transportation, including the important role of cost causality.

⁴ Please see Witness Nieto's testimony in Docket No. R97-1 (USPS-T-2) for a complete discussion of the distribution of volume variable costs for purchased transportation, including the important role of cost causality.

1 are at the heart of the purchased transportation planning and operational processes
2 and are mirrored in the Postal Service's and the Commission's development of volume
3 variable cost estimates.

4
5 **C. Example 2: Product-Specific/Specific-Fixed Costs and Causality**
6

7 Purchased transportation costs also include *product-specific costs*, such as the
8 premium costs associated with the Eagle Network. The Eagle Network is a dedicated
9 nighttime hub-and-spoke air network that is operated to permit next-day delivery of
10 Express Mail. The premium costs for the network (*i.e.*, the costs over and above
11 standard commercial air transportation costs) are not considered volume variable by the
12 Postal Service or the Commission, but are specific to Express Mail because they are
13 *caused* solely by the provision of this entire product (*i.e.*, these costs would not be
14 incurred if Express Mail were no longer offered).⁵ As I discussed in my testimony in
15 Docket No. R97-1, the Eagle Network serves Express, Priority, and First-Class Mail, but
16 it is necessary only for Express Mail.⁶ According to the Postal Service's operating
17 practices, if Express Mail were eliminated, then the Eagle Network would not be
18 needed, and Priority and First-Class Mail would be diverted onto commercial flights
19 without impinging on service standards. These premium costs are therefore *caused* by
20 the existence of Express Mail. Mirroring this causal relationship, the product-specific
21 costs associated with the premium costs of the Eagle network are included in the
22 incremental costs of Express Mail. As with volume variable commercial air
23 transportation costs discussed above, the causal relationships that drive operations are

⁵ Please see my testimony in Docket No. R97-1 (USPS-T-41) for a complete discussion of the development of product-specific costs for the Eagle Network, with special emphasis on causality concepts.

⁶ At the time of development of product costs for Docket No. R97-1, Priority and First-Class Mail were considered "filler" on the Eagle Network, and could have met their service standards if they traveled on standard commercial flights.

1 used throughout the development of product costs for the product-specific (incremental)
2 costs of the Eagle Network.

3
4 **D. Differences Between Causality and Correlation**
5

6 In discussing the importance of causality-based costing, it is important to note that
7 *correlation* does not necessarily imply *causality*. Simply because a change in cost is
8 *correlated* with a change in volume does not necessarily mean that it is *caused* by a
9 change in volume. Furthermore, using correlation as a substitute for causality in the
10 cost development process can result in inaccurate product costs.

11
12 The current treatment of Eagle Network costs by the Postal Service and the
13 Commission is an example of causality-based costing that goes beyond correlation.
14 Although the network is designed to carry Express Mail, a large portion of the volume
15 on the Eagle Network is First-Class Mail and Priority Mail. As I described above,
16 however, Express Mail bears all of the premium costs of the network – First-Class Mail
17 and Priority Mail do not bear any of the responsibility for these premium costs because
18 they are simply filling empty space that exists on the network.

19
20 A simple *correlation* analysis would find First-Class, Priority, and Express Mail volume
21 along with the network premium costs and might mistakenly allocate the network
22 premium to all products on the network. By contrast, a *causality* analysis (as was
23 performed by the Postal Service and adopted by the Commission in Docket No. R97-1)
24 shows that these premium network costs are incurred entirely for Express Mail, and,
25 therefore, should be treated as product-specific (*i.e.*, included in incremental costs) to
26 Express Mail and to no other product.

1 This example shows the potential "correlation trap" that can arise if an analyst equates
2 *correlation* with *causation* when developing volume variable or product-specific costs.⁷ I
3 believe that the OCA falls into this trap (as does Witness Prescott, to a certain extent)
4 when analyzing advertising costs, as I will discuss in greater detail in the next section of
5 my testimony.

6

7 **E. "Benefits" vs. "Causality"**

8

9 Just as it is important not to confuse *correlation* with *causality*, it is also important not to
10 confuse *benefits* with *causality*. The notion that a particular cost *benefits* a product is
11 not necessarily equivalent to the notion that a product *causes* the cost to accrue. For
12 example, First-Class Mail may benefit from being transported on the Eagle Network, but
13 it does not cause the premium costs associated with the network. Therefore, the
14 incremental cost of First-Class Mail should not include these premium costs, as I
15 discuss above. As another example, each individual product benefits from the activities
16 of the Postmaster General, but the costs of his salary are not caused by any specific
17 product. Therefore, the Postal Service and the Commission do not allocate the PMG's
18 costs to specific products. Any costing methodology that relies on *benefits* to allocate
19 costs to products instead of *causality* should be viewed with suspicion.⁸

20

21 **F. Fully Distributed Costing (FDC)**

22

⁷ I do not want to leave the impression that statistical/econometric analyses cannot be used to help identify causal links. For example, the econometric analyses that the Postal Service uses to investigate cost variabilities are firmly rooted in causality principles, as they are accompanied by operational analyses of causality. I am trying to distinguish between "spurious" correlation studies and causality-based studies here.

⁸ Witness Prescott and the OCA use the notion of *benefits* as a distribution mechanism inappropriately in allocating POL advertising costs to MOL, as I discuss in Section III below.

1 The problems associated with allocation mechanisms not based on causation can be
2 readily seen when one examines the effects of fully distributed cost (FDC) approaches,
3 which often rely on correlation analyses rather than causation analyses to distribute
4 costs. Under a generic FDC system, all of an organization's costs are distributed to
5 individual products, even though they may not be caused by those products. Direct
6 costs are first allocated to products where causal relationships can be found. Fixed and
7 common costs are then distributed to individual products using a variety of allocation
8 methods that might sound reasonable on the surface, but are not reasonable when the
9 underlying causality is examined. An individual product's share of fixed and common
10 costs could be determined by the product's share of total volume, its share of total
11 revenue, or some other measure. FDC approaches can often result in significant
12 under- or over-statements of product costs, which can lead to disastrous pricing results.
13 As I argue in greater detail in Section III below, the approach proposed by the OCA
14 borders on fully distributed costing. Therefore, an example of the potentially harmful
15 effects of FDC is illustrative.

16

17 The following example demonstrates how an FDC system might work within the context
18 of C/S 7, City Delivery Carriers, Street Activity. For the purposes of this example, I
19 assume that an FDC system would allocate direct costs to individual products in the
20 same way that the Postal Service determines a product's volume variable cost.
21 However, to mimic an FDC system, the fixed and common (institutional) costs from this
22 segment must then be distributed to individual products using a potentially arbitrary
23 allocation factor. I demonstrate how an FDC costing approach might look for C/S 7 with
24 the following three different allocation methods for the common costs in C/S 7:

25

- 26 • Method A: Distribute fixed and common costs in proportion to product volume
- 27 • Method B: Distribute fixed and common costs in proportion to product revenue
- 28 • Method C: Distribute fixed and common costs in proportion to product volume
- 29 variable costs

Exhibit USPS-RT2-B: Illustration of FDC Approach for Cost Segment 7 (City Carriers)

	C/S 7 Costs ¹	Percent of Total VVC ²	Revenue ³	Percent of Total Revenue ⁴	Pieces ⁵	Percent of Total Pieces ⁶
First-Class Mail	\$ 983,200	42.7%	\$ 33,397,582	57.7%	99,659,943	52.2%
Express Mail	\$ 21,530	0.9%	\$ 824,698	1.4%	63,633	0.0%
Other Products & Services	\$ 1,295,223	56.3%	\$ 23,663,392	40.9%	91,164,484	47.8%
Other (Fixed & Common)	\$ 5,854,978		N/A		N/A	
Total	\$ 8,154,931		\$ 57,885,672		190,888,060	

Method A: Distribute Fixed and Common Costs Based on the Proportion of Pieces

	VVC/Piece ⁷	Piece Allocation of Other Costs ⁸	Piece Alloc./ Piece ⁹	FDC Total Cost ¹⁰
First-Class Mail	\$ 0.0099	3,056,801	\$ 0.0307	\$ 0.0406
Express Mail	\$ 0.3383	1,952	\$ 0.0307	\$ 0.3690

Method B: Distribute Fixed and Common Costs Based on the Proportion of Revenue

	VVC/Piece ¹¹	Revenue Allocation of Other Costs ¹²	Rev. Alloc./ Piece ¹³	FDC Total Cost ¹⁴
First-Class Mail	\$ 0.0099	3,378,074	\$ 0.0339	\$ 0.0438
Express Mail	\$ 0.3383	83,416	\$ 1.3109	\$ 1.6492

Method C: Distribute Fixed and Common Costs Based on the Proportion of VVC

	VVC/Piece ¹⁵	VVC Allocation of Other Costs ¹⁶	VVC Alloc./ Piece ¹⁷	FDC Total Cost ¹⁸
First-Class Mail	\$ 0.0099	2,502,927	\$ 0.0251	\$ 0.0350
Express Mail	\$ 0.3383	54,809	\$ 0.8613	\$ 1.1996

^{1,3,5} Data Obtained from USPS 1997 Cost Segments and Components Report. Costs for First-Class Mail, Express Mail, and "Other Products and Services" represent volume variable costs.

² VVC divided by sum of First-Class Mail, Express Mail, and Other Products & Services VVC.

⁴ Revenue divided by sum of First-Class Mail, Express Mail, and Other Products & Services Revenue.

⁶ Pieces divided by sum of First-Class Mail, Express Mail, and Other Products & Services Pieces.

^{7,11,15} VVC divided by Pieces.

⁸ Other (Fixed and Common) C/S 7 Costs multiplied by Percent of Total Pieces.

⁹ Piece Allocation of Other Costs divided by Pieces.

¹⁰ VVC/Piece plus Piece Alloc./Piece.

¹² Other (Fixed and Common) C/S 7 Costs multiplied by Percent of Total Revenue.

¹³ Revenue Allocation of Other Costs divided by Pieces.

¹⁴ VVC/Piece plus Rev. Alloc./Piece.

¹⁶ Other (Fixed and Common) C/S 7 Costs multiplied by Percent of Total VVC.

¹⁷ VVC Allocation of Other Costs divided by Pieces.

¹⁸ VVC/Piece plus VVC Alloc./Piece.

- 1
- 2 The results in the above table show that there is a relatively small difference between
- 3 the three allocation methods for First-Class Mail – the FDC delivery unit cost only
- 4 ranges from \$0.035 to \$0.0438. The FDC unit delivery cost for Express Mail, however,

1 ranges between \$0.369 and \$1.6492 – a difference of \$1.2802. On the surface, both
2 product volume and product revenue would appear to be reasonable methods of
3 allocating common costs – product volumes may serve as a proxy for the workload that
4 needs to be performed and revenue represents a product's "ability to absorb" the
5 organization's fixed and common costs. However, neither measure captures causality.
6 The sizable difference in these allocation methods makes it impossible to determine the
7 true cost of the product in this example. Furthermore, this example shows that the cost
8 of one product (First-Class Mail in this example) may not be affected much by the
9 allocation mechanism, while another product's cost (Express Mail in this example)
10 varies wildly.

11

12 The problem with choosing an allocation factor for common costs is that there is no
13 cause-and-effect relationship between *individual products* and a pool of *common costs*
14 – if a causal relationship to individual products existed, these costs would not be
15 classified as common. This example shows that FDC estimates are unreliable and the
16 allocation methods underlying them are arbitrary. The resulting product costs can vary
17 widely depending on the selected allocation method.

18

19 Furthermore, the effects of using cost estimates developed through FDC approaches
20 for pricing can be disastrous. For example, if an FDC approach based on one set of
21 allocation factors results in an artificially low product cost, the prices may be set too low,
22 thereby harming both the Postal Service and its competitors. If, on the other hand,
23 another set of allocation factors results in a product cost and price that are artificially
24 high, then consumers may be harmed. In either case, with an FDC approach, one is
25 never quite sure that prices are set accurately, and one never quite knows who is being
26 harmed.

27

28 Both the Commission and the Postal Service have long recognized the serious
29 problems associated with FDC approaches, and have consistently stated their

1 disapproval for such methodologies.⁹ As I argue in greater detail below, however, the
2 OCA's and Witness Prescott's proposals in this case contain certain elements of FDC
3 frameworks, and should be avoided in this and other cases.

⁹ See, for example, PRC Op., R87-1, vol. 2, Appendix J, CS IX, p.9. The Commission has shown its discomfort with FDC approaches for many years. In PRC Op., R74-1, the Commission stated:

In the prior case, we expressed statutory reservations regarding a fully distributed costing method under which costs are first assigned to the classes and services on the basis of causation, and the remainder mathematically apportioned on a uniform basis. See PRC Op. 1-280, n. 1. We now believe those reservations were well taken; and that fully distributed costs, as defined above, would not satisfy the standards of § 3622. We reject a fully distributed costing method here in favor of the concepts of variability and demand discussed throughout this opinion (PRC Op., R74-1, vol. 1, p.124, n.3).

1 **III. ANALYSIS OF THE OCA'S AND WITNESS PRESCOTT'S ARGUMENTS**
2 **CONCERNING THE TREATMENT OF ADVERTISING COSTS**
3

4 It is against this backdrop of the critical nature of causality in postal product cost
5 development that I now analyze the specific proposals made by the OCA and Witness
6 Prescott. The OCA makes two related points:

- 7
- 8 • advertising costs for MOL/POL are volume variable;
 - 9 • these costs should be distributed to the individual products sold through the
10 POL channel (e.g., MOL) based on a distribution key determined by relative
11 transaction counts.
- 12

13 Witness Prescott does not argue that advertising costs are volume variable, but he
14 does propose that they be distributed using an approach similar to the OCA's. I believe
15 that the OCA's and Witness Prescott's points are wrong because their analyses ignore
16 important cost causality principles in both the development of volume variable costs and
17 their distribution to products.

18

19 **A. Are MOL Advertising Costs Volume Variable?**
20

21 The OCA asserts that advertising costs in general are volume variable (marginal)
22 because "... each extra unit of advertising cost is expended to induce a purchase by
23 an additional buyer" (*OCA Response*, p.2). The OCA's assertion is wrong on several
24 levels, but most importantly it misrepresents the role of causality in determining
25 marginal costs. The textbook definition of marginal costs is the change in a firm's total
26 costs *caused* by a marginal change in volume. The OCA's notion of marginal cost turns
27 this definition on its head – instead of changes in volume causing changes in
28 advertising costs, the OCA asserts that changes in advertising costs cause changes in
29 volume. This may be true (assuming the advertising is successful), but it misses the
30 point in defining marginal costs. From a marginal-cost/volume-variable cost

1 development standpoint, the OCA's position is akin to the "correlation trap" discussed
2 above. Simply because changes in advertising costs may be *correlated* with changes
3 in volume (through a reverse causality process), it does not mean they are *caused* by
4 them. In this case, it is clear that changes in advertising costs are not caused by
5 subsequent changes in volume, and therefore, cannot properly be treated as volume
6 variable.

7
8 The OCA's blanket assertion that advertising costs are designed to "induce purchases
9 by an additional buyer" further erodes its argument that these costs should be
10 considered volume variable. Although I am not an expert in advertising, it seems to me
11 that advertising expenditures can be made for any number of reasons, including the
12 following:

- 13
14 • to induce purchases by a new customer;
15 • to induce new purchases by an existing customer;
16 • to increase brand awareness among new and existing customers;
17 • to increase customer loyalty.¹⁰

18
19 Not all of these reasons can be directly tied to increases in sales volume, as the OCA
20 attempts to do through its blanket assertion. Companies often undertake advertising
21 campaigns to increase brand awareness, and not necessarily to increase sales of any
22 one particular product. Consider, for example, the advertising campaign currently

¹⁰ In its response to USPS/OCA-6, the OCA questions "the wisdom of an enterprise going to the expense of advertising a non-competitive, monopoly product." This statement illustrates the OCA's fundamental lack of understanding of both advertising and monopolies. I can cite numerous examples of "monopolies" advertising their products (e.g., electric utilities, cable television, etc.). They do so for many reasons, including the ones I discuss above. Furthermore, the Postal Service faces competition in First-Class Mail from a variety of sources (including the telephone, electronic mail, fax, and messenger services), despite the Private Express Statutes.

1 underway for my firm, PricewaterhouseCoopers. Through a variety of media, we have
2 a campaign designed to increase PwC's brand awareness among the general public,
3 particularly in light of our recent merger and name change. This advertising is not
4 caused by any particular service within our firm and is not meant to drive (directly)
5 increases in sales. Similarly, it is my understanding that POL advertising is meant to
6 increase the public's awareness of the POL channel, and not necessarily to promote
7 any specific product. It is also my understanding that as a convenient channel, POL
8 promotes use of Express Mail, Priority Mail, First-Class Mail, and Standard (A) Mail.

9

10 **B. How Should Advertising Costs be Distributed?**

11

12 In my discussion of the distribution of volume variable costs, I noted the Commission's
13 longstanding practice of distributing volume variable costs to individual products based
14 on a cost driver chosen for causality reasons. In contrast to this precedent, the OCA
15 and Witness Prescott propose to use the relative number of transactions for products
16 sold through the POL channel to allocate POL advertising costs to specific products.

17 The OCA claims:

18

19 advertising and promotion of PostOffice Online is undoubtedly for the purpose of
20 increasing public awareness of MOL, which, in turn, is intended to stimulate MOL
21 usage....Consequently, the relative usage of POL for access to the various
22 services available at the site is the logical distribution key.

23

24 *OCA Response*, p.10. Similarly, Witness Prescott suggests:

25

26 advertising for POL is designed to attract customers to the USPS' Mailing Online
27 and Shipping Online services. A potential customer who responds to the USPS'
28 advertisements is not tied to a specific revenue level or size of the transaction
29 that occurs (*i.e.*, number of pieces). Therefore, the advertising is designed to
30 attract transactions and the advertising costs should be allocated on that basis.

31

32

1 Tr. 9/2136. However, as I have discussed previously, the notion that advertising costs
2 are incurred for the purpose of attracting transactions is irrelevant from a cost allocation
3 standpoint, because it turns the causality relationship on its head. Changes in the
4 number of transactions do not cause changes in advertising costs (nor are they claimed
5 to by the OCA or Witness Prescott). Therefore, the relative number of transactions is
6 not a "cost driver" and consequently is not an appropriate distribution key for POL
7 advertising costs.

8
9 As I demonstrated above, when one ignores causality in the development of cost
10 drivers/distribution keys, one gets arbitrary results. Although transactions clearly do not
11 cause advertising costs, using the relative number of transactions as a distribution key
12 generates one specific distribution of costs to the individual products sold through the
13 POL channel. However, following the OCA's and Witness Prescott's apparent belief
14 that a distribution key does not have to have a causal relationship to the cost in
15 question, a case could be made for any number of different (arbitrary) distribution keys
16 (e.g., total revenues from each product; the contribution from each product; etc.), each
17 resulting in a different (arbitrary) distribution of costs. The fundamental problem with
18 the OCA's and Witness Prescott's approach is that, because it ignores causality, it
19 opens itself to arbitrariness. Any approach to cost development which does not include
20 *at its heart* the notion of causality is inappropriate for postal costing.¹¹

21
22 Witness Prescott and the OCA also appeal to the notion of *benefit* to justify their
23 distribution of POL advertising costs to MOL (OCA Response, p.9; Tr. 9/2136, 2155).
24 As I discussed in Section II above, the concept of *benefit* does not always correspond

¹¹ It is interesting to note that the OCA and Witness Prescott advocate similar, but not identical allocation/distribution factors (compare the OCA's response to USPS/OCA-5 to Witness Prescott's response to USPS/MASA/PB-T1-28). Each approach will result in somewhat different cost distributions. Neither approach is correct, because they are not based on causality. This example demonstrates the arbitrariness of non-causality based cost allocation methods.

1 to *causality*, and therefore, approaches which rely on *benefits* to distribute costs should
2 be viewed suspiciously. In this case, MOL may benefit from POL advertising, but MOL
3 does not cause these costs, and therefore, these costs should not be allocated to MOL.
4

5 **C. OCA's Analogy to Special Delivery Messengers**
6

7 The OCA tries to draw analogies between the Commission's treatment of the costs
8 associated with Special Delivery Messengers in Docket No. R87-1 and POL advertising
9 costs in this case (*OCA Response*, pp.8-10). The OCA, however, misses the point by
10 ignoring the Commission's reliance on cost causality in its treatment of Special Delivery
11 Messengers. The Commission's treatment of Special Delivery Messengers is not
12 analogous to POL advertising costs, as I argue below.
13

14 The Commission's allocation in Docket No. R87-1 of the fixed and common costs of
15 Special Delivery Messenger costs was based on its view that the fixed and common
16 costs in question are "causally related to a unique service characteristic of Express Mail
17 and Special Delivery."¹² The Commission found that the cost-causative relationship for
18 the fixed and common costs in Special Delivery Messengers was not product volume,
19 but the provision of an "output characteristic."¹³ In the case of Special Delivery
20 Messengers, the output characteristic is expeditious delivery for Express Mail and
21 Special Delivery, and it is this characteristic that causes the fixed cost to accrue.
22

23 The Commission described in detail its rationale for distributing the fixed and common
24 costs associated with Special Delivery Messengers to distinguish its approach from
25 Fully Distributed Costing (FDC).¹⁴ In order to distribute a fixed and common cost to
26 products, the Commission put forth the following guidelines,

¹² PRC Op., R87-1, vol. 2, Appendix J, CS IX, p.2.

¹³ PRC Op., R87-1, vol. 1, p.122.

¹⁴ Please see PRC Op., R87-1, vol. 1, p. 121 and PRC Op., R87-1, vol. 2, Appendix J, CS IX, pp.8-9.

1
2 Where there are (i) a well-defined cost element, (ii) a well-defined output
3 characteristic serving, by its presence or absence, to distinguish among classes,
4 and (iii) a causal relationship between these two, it may be possible to attribute
5 even a fixed common cost element on the basis of relative responsibility.
6 (emphasis added)¹⁵
7

8 In the case of POL advertising costs, it is difficult to discern what "well-defined output
9 characteristic" is provided to MOL by POL advertising. It would be difficult to claim that
10 advertising provides a "unique service characteristic" in the same way that Special
11 Delivery Messengers provide expeditious delivery for Express Mail and Special
12 Delivery.¹⁶ In addition, condition (iii), the causal relationship between the fixed cost and
13 the unique characteristic, is clearly not met – the Postal Service has stated that there
14 are no plans for advertising MOL only, and if MOL did not exist, the advertising plan for
15 POL would not be affected (Tr. 4/881).
16

17 The Commission further summarized its reasoning for making this cost part of the
18 attributable cost base of Express Mail and Special Delivery by saying,
19

20 Put differently: we can say that the fixed cost in question could be eliminated by
21 abolishing the special entitlement to expeditious delivery rather than the classes
22 as a whole.¹⁷
23

24 POL advertising costs would not be eliminated by abolishing the entire MOL product, as
25 the Postal Service has stated. This result stands in clear contrast to the OCA's claim

¹⁵ Id. At p. 122.

¹⁶ Please see PRC Op., R87-1, vol. 2, Appendix J, CS IX, p. 2. PRC Op., R80-1 at ¶ 0330, which gives examples of characteristics such as speed, reliability, or protection from theft.

¹⁷ PRC Op., R87-1, vol. 1, p.123.

1 that "the marketing costs for MOL would appear to meet every condition established by
2 the Commission in Docket No. R87-1."¹⁸
3
4 The Commission also discussed how to handle cost distribution to products, such as
5 First-Class Mail, that were handled by Special Delivery Messengers, but did not require
6 expeditious handling. The Commission determined that the handling of First-Class Mail
7 on Special Delivery Routes was "incidental" to the activities undertaken on behalf of
8 Express Mail, Special Delivery, and their international counterparts.¹⁹ The Commission,
9 therefore, did not distribute any of the fixed and common costs of Special Delivery
10 Messengers to products such as First-Class Mail. Again, the same claim can be made
11 for MOL. MOL is not causing POL advertising costs to accrue – it is incidental to POL
12 advertising plans (Tr. 4/881). Therefore, no advertising costs are caused by MOL, and
13 none should be allocated to MOL, contrary to the OCA's assertions.

14

15 **D. Should Institutional Costs be Distributed to Subsets of Products?**

16

17 The OCA states that "it becomes clear that the most equitable treatment for fixed costs
18 incurred by only a small subset of classes is to make that cost part of the attributable
19 cost base and mark it up" (*OCA Response*, p.7). The approach to cost allocation that
20 the OCA is proposing represents a fundamental departure from causality-based cost
21 analysis, and resembles a proposal for fully distributed costing (FDC), despite its
22 protestations that it does not want to employ FDC.

23

24 The OCA's costing approach, when taken to its logical conclusion, could lead to absurd
25 results. Consider the fixed costs associated with Postal Service delivery. City delivery
26 street activities contain over \$5 billion in fixed and common costs.²⁰ City delivery

¹⁸ *OCA Response*, p.9.

¹⁹ PRC Op., R87-1, vol. 2, Appendix J, CS IX, p.10.

²⁰ FY 97 CRA.

1 activities also serve only a subset of the Postal Service's total products – Money Order
2 costs, for instance, are not incurred for city delivery routes. The OCA proposal for
3 allocating costs, therefore, would imply that all institutional costs associated with city
4 delivery street activity be distributed to individual products.²¹
5
6 Relying on costing rules that are not grounded in cost causality represents a
7 fundamental departure from Postal Service and Commission precedent. City Carrier
8 costs are clearly not all attributed to products – nor should they be. Only those costs
9 which are caused by specific products should be allocated to those products, as is
10 currently done by the Postal Service and the Commission through their respective
11 approaches. The OCA's recommendation to start allocating institutional costs misses
12 this critical point.

²¹ The OCA may argue that it was only talking about cases involving “small” subsets of classes. This begs the question, however, “how small is ‘small’?” I question the validity of any costing system which must rely on one set of rules when the subset is “small” and another when the subset is “larger.” Furthermore, this concept of “small” subsets contradicts its response to USPS/OCA-4.

1 IV. THE PROPER TREATMENT OF ADVERTISING COSTS

2
3 In the preceding discussion, I have argued that advertising costs generally should not
4 be considered volume variable. My conclusions are based on long-standing
5 Commission precedent concerning the important nature of causality in the cost
6 development process and on common sense regarding the direction of causality
7 between volume and advertising costs. I do not, however, want to leave the impression
8 that advertising costs should never be included in product costs. On the contrary, as I
9 presented in several instances in my testimony in Docket No. R97-1, advertising costs
10 should be included in incremental costs for an individual product when they are incurred
11 to promote that product solely. In other words, they should be included in a particular
12 product's incremental cost when these costs would not be incurred if the product did not
13 exist.²² In these instances, advertising costs fit the definition of product-specific costs,
14 as I have described above. Advertising costs are not volume variable, but some
15 advertising costs are incurred solely to promote a particular product (e.g., Express Mail)
16 and therefore should be allocated to that product on a causal basis as product-specific
17 costs.²³

18
19 However, sometimes advertising costs are intended to promote a group of products,
20 and not any one individual product.²⁴ In that case, the advertising costs should be
21 considered specific to the group of products, but not to any one product within the
22 group. If advertising costs are incurred for a group of products, then they should be
23 allocated to the group as a whole for incremental cost test purposes, but not to any
24 specific product within the group for either product pricing or incremental cost test

²² Again, this statement illustrates the important nature of causality in the cost development process.

²³ Please see Witness Panzar's Rebuttal Testimony in Docket No. R97-1 (USPS-RT-13) for a more detailed discussion of this point regarding the nature of advertising costs.

²⁴ It is my understanding that POL advertising expenses are designed to promote the POL channel, which supports a number of different products.

1 purposes.²⁵ Any attempt to allocate advertising costs to individual products within the
2 group in this case would necessarily have to rely on arbitrary allocation mechanisms
3 (such as the relative number of transactions) that are not based on causal principles.²⁶
4
5 Perhaps the OCA's confusion on this point stems from a misreading of the intent of
6 Professor Baulmol's and Professor Sherman's quotes included in OCA's response to
7 NOI No.1. I agree wholeheartedly with the conclusions these two economists present.
8 Their statements clearly imply that advertising costs incurred for POL are incremental to
9 the group of products sold through the POL channel and should be included in any
10 incremental cost test for the group of products sold through POL as a *whole*. However,
11 their comments also support the conclusion that since these costs cannot be causally
12 linked to any individual product sold through the POL channel (such as MOL), they
13 should not be attributed or allocated to any individual product sold through POL (such
14 as MOL).
15
16 I believe this point illustrates the fundamental difference between my testimony and the
17 proposals put forth by the OCA and Witness Prescott – *because there is no causal*
18 *relationship between the individual products sold through the POL channel and these*
19 *common advertising costs, they should not be allocated to individual products such as*
20 *MOL*. The Postal Service has stated that if MOL were to be eliminated, the advertising
21 costs for POL would remain unchanged (Tr. 4/881). As I stated above, the only time
22 advertising costs can be allocated to individual products is when these costs would not
23 be incurred if the product did not exist (*i.e.*, when they are incremental or product-

²⁵ Please see Witness Panzar's Testimony in Docket No. R97-1 (USPS-T-11) for a complete discussion of the cost bases for product pricing and incremental cost tests in both single product and appropriate group settings.

²⁶ Such an approach would be tantamount to fully distributed costing approaches, which, as the OCA states, are contrary to Commission practice (*OCA Response*, p.8).

1 specific). This situation is clearly not present in this case. There is causality at the
2 group level, but not at the individual product level.
3
4 The Postal Service should allocate, for the purpose of an incremental cost test, general
5 advertising costs for the POL channel to the group of products sold through this
6 channel as a *whole*, and not to any particular products sold through the POL channel.
7 These costs are caused by the POL channel as a whole, and not by MOL or any other
8 product specifically. The Postal Service should ensure that the revenues (including
9 postage) for the group of products sold through the POL channel cover all costs
10 (including POL advertising costs), but the revenues of any particular product sold
11 through the POL channel should not necessarily have to cover any arbitrarily allocated
12 POL advertising costs.

1

2 **V. VERTICAL INTEGRATION ISSUES**

3

4 I have also been asked to provide a few brief comments on Witness Prescott's
5 statements about vertical integration and the supposed negative effects of the Postal
6 Service's contracting with private printing companies to provide MOL services. Like
7 Witness Prescott, I have not performed a complete analysis of the short- and long-run
8 dynamics of the Postal Service's presence in this market. However, even a cursory
9 review of Witness Prescott's assertions reveals shortcomings in his analyses and
10 conclusions, which I highlight below.

11

12 **A. "Potential" Harms versus "Actual" Harms**

13

14 Witness Prescott discusses at length the *potential* harms associated with vertical
15 integration. These include the following:

16

- 17 • vertical integration in the presence of a monopoly may raise barriers to entry (Tr.
18 9/2117);
- 19 • vertical integration may place competitors at a relative disadvantage (Tr. 9/2118-
20 19);
- 21 • certain printers may enjoy competitive advantages by contracting with the Postal
22 Service (Tr. 9/2119-20);

23

24 Witness Prescott provides a list of *potential* harms, but his testimony provides little
25 empirical evidence to support his opinion that MOL will harm some firms that will
26 compete with MOL and its printing contractors. While listing potential harms may be
27 useful as an academic exercise, Witness Prescott does nothing to prove actual harm by
28 the MOL experiment.

29

30

B. Specific Competitive Concerns

Witness Prescott presents a series of unsubstantiated claims about the effects of MOL on the printing industry and MOL's competitors, and then draws several broad conclusions from these claims. As I discussed above, I have not performed a detailed analysis of the printing industry or MOL competitors either. However, it is relatively easy to come up with plausible alternative assumptions that are no less justified than his assertions in these areas. These alternatives cast doubt on his conclusions. In the following section, I present four of his unsubstantiated claims and a set of alternative assumptions to rebut his broad conclusions.

Witness Prescott claims that the Postal Service's rate proposal provides MOL with a pricing advantage relative to its competitors (Tr. 9/2119). Specifically, he expresses concern that MOL will have an unfair advantage by being able to offer delivery services at discounted rates even if the volume minimums are not met in a given mailing. In fact, Witness Prescott presents only half of the story since he fails to consider that competing services may be able to receive additional discounts based on finer presort. By contrast, MOL, as proposed, would not be eligible for any additional discounts based on volume.²⁷ This fact seems to indicate a competitive disadvantage for the Postal Service.

Witness Prescott is also concerned with MOL's effect on competition in the printing industry. He argues that the presence of sunk capital costs will provide incumbent printers with an unfair advantage in subsequent bidding for MOL printing contracts (Tr. 9/2119-20, 2122). However, Witness Prescott does not give enough weight to the practice of equipment leasing, and how it would affect his conclusion that sunk costs could place some bidders at a competitive disadvantage (see Tr. 9/2167). The potential

²⁷ See Witness Plunkett for a discussion of pricing discounts associated with MOL (USPS-T-5, pp.11-12).

1 for equipment leasing reduces the incumbent advantage, as production levels with or
2 without MOL can be smoothed to a certain extent by leasing the necessary capacity.
3
4 Witness Prescott also claims that the selection of printers by geographic area will
5 prevent competition and favor certain printers (Tr. 9/2109, 2120, 2122). To support this
6 opinion, he points out that the second lowest bid in one region may be lower than the
7 winning bid in another region (Tr. 9/2120). Witness Prescott does not appear to have
8 considered that just because a bidder provides the second lowest bid in one region that
9 does not demonstrate that this bidder would have entered the same bid for the right to
10 service the second region, especially if costs are higher in that region.
11
12 It may also be helpful to put the volume of printing that is projected for MOL into
13 perspective. Although I am not an expert in the printing industry, I performed some
14 simple analysis of it in preparing my testimony. Revenues in the on-demand digital
15 printing industry for 1999 are projected to be approximately \$17 billion, and revenue is
16 expected to reach well over \$20 billion for 2000 with continued rapid growth into the
17 future.²⁸ By contrast, annual revenues for MOL for 1999 are projected to be \$90 million
18 or just over 0.5 percent of the projected industry revenues for 1999.²⁹ Obviously, there
19 will be geographic differences in the level of competition of the printing market, but to
20 presume that the modest revenues projected for MOL will have substantial effects on
21 the printing market seems unrealistic.
22
23 While Witness Prescott's concerns about the effects of vertical integration may be valid
24 in other cases, with regard to his specific concerns for the competitive effect of MOL on
25 its competitors or the printing industry, he fails to consider factors that would appear to
26 alleviate those concerns.

²⁸ CAP Ventures, Inc., *U.S. Print On Demand Market Forecast 1996 – 2001* (CAP Ventures, Inc. 1997), p.27; See Tr. 6/1495.

²⁹ Attachment to Response to PB/USPS-T5-5 (Tr. 8/1767, as corrected in Presiding Officer's Ruling No. MC98-1/24).

1
2 **C. Potential Benefits to Consumers and Industry**
3

4 Witness Prescott also appears to ignore the potential economic benefits that may arise
5 from MOL. In fact, MOL will likely create benefits for printers, other firms and
6 consumers. For instance, demand for printing services may increase due to the MOL
7 service. Such an increase in demand will come from mailings that had previously been
8 printed by the sender and from mail that did not exist prior to the MOL service. As noted
9 by Witness Garvey, MOL will promote the growth of direct mail and newsletter
10 publishing among small businesses by providing convenient and easy-to-use access to
11 sophisticated digital printing technology to small- and home-based businesses, who
12 would not otherwise have such access (USPS-T-1, p.1,12). MOL will also benefit its
13 consumers by providing them a new and convenient source for print and mailing
14 services. The increased flow of information that MOL is expected to generate will
15 ultimately also benefit the public in general.

1 **VI. SUMMARY AND CONCLUSIONS**

2

3 In Section I above, I laid out several arguments presented by various participants in this
4 case that I have addressed in the preceding sections of my testimony. These include
5 the following:

6

7 • *The OCA's assertion that advertising costs for POL are volume variable:* I
8 have shown that advertising costs are not volume variable because they are
9 not caused by changes in volume.

10

11 • *The OCA's and Witness Prescott's proposal that POL advertising costs be*
12 *distributed to products using relative transaction counts:* I show that such an
13 approach is arbitrary because it does not reflect cost causality. Such an
14 approach violates longstanding Postal Service and Commission precedent.

15

16 • *The OCA's argument that even if advertising costs are not volume variable,*
17 *they should still be distributed to products sold through the POL channel:* I
18 have shown that in some cases, advertising costs can be considered product-
19 specific to individual products. In many cases, however, advertising costs are
20 shared by a group of products and cannot be allocated to any particular
21 product within the group. The present POL case is such an example of
22 shared costs across a group of products. Advertising costs for POL should
23 be included in the incremental costs of the group of products sold through the
24 POL channel, and not allocated to any one product individually (such as
25 MOL).

26

27 • *The OCA's use of the testimony of witnesses appearing before the*
28 *Commission in previous Dockets to support its position in this case:* I have
29 shown that the OCA has mischaracterized these testimonies.

30

1

2

- *The OCA's use of past Commission treatment of the costs associated with*

3

Special Delivery Messengers to support its position in this case: I have

4

shown that this example is inappropriate in this case and (if taken to its

5

logical conclusion) could lead the Commission to allocate a vast array of

6

costs that have previously been considered institutional – resulting in a form

7

of fully distributed costing.

8

9

My conclusion concerning POL advertising costs is that the Postal Service should

10

include the advertising costs for POL in the incremental costs of the group of products

11

sold through the POL channel as a *whole*, and not allocate them to any particular

12

products sold through the POL channel. These costs are caused by products sold

13

through the POL channel as a whole, and not by MOL or any other product specifically.

14

The Postal Service should ensure that the revenues for the group of POL-related

15

products cover all costs (including POL advertising costs), but the revenues of any

16

particular product sold through the POL channel should not necessarily have to cover

17

any arbitrarily allocated POL advertising costs.

18

19

Finally, I address several of the concerns raised by Witness Prescott regarding the

20

supposed harmful competitive effects of the MOL service. I argue that witness Prescott

21

has failed to consider a number of factors that would alleviate or eliminate these

22

supposed harms. Witness Prescott also ignores the economic benefits for consumers,

23

printers, and other firms that are likely to ensue from allowing the Postal Service to offer

24

the MOL experiment.

1

2 COMMISSIONER LeBLANC: Is your witness now ready
3 for cross examination?

4 MR. RUBIN: Yes, he is.

5 COMMISSIONER LeBLANC: Three participants have
6 requested oral cross examination of Witness Takis: the Mail
7 Advertising Service Association International; Office of the
8 Consumer Advocate; and Pitney Bowes.

9 It is my understanding that it is part of the
10 counsel's agreement that the Office of Consumer Advocate
11 will go first, Pitney Bowes will go second, and MASA will go
12 third. Is that correct?

13 MR. BUSH: That is correct, Mr. Presiding Officer.

14 COMMISSIONER LeBLANC: Okay. Then I believe Mr.
15 Costich, you were going to lead off for us, please, sir.

16 MR. COSTICH: Thank you, Mr. Presiding Officer.

17 CROSS EXAMINATION

18 BY MR. COSTICH:

19 Q Good morning, Mr. Takis.

20 A Good morning.

21 Q Could you turn to page 4 of your testimony?

22 A Yes. I have it here.

23 Q And if you could look at lines 5 and 6, here you
24 say, "Causality is the key consideration for the development
25 of product cost." Is that correct?

1 A I'm sorry, which lines again?

2 Q Lines 5 and 6.

3 A Yes, I have it there.

4 Q Could you provide the Commission with a definition
5 of cost causality?

6 A Well, actually that is a very good question. That
7 can be answered by looking at the exhibit which is found
8 right above those lines.

9 There are two major types of causality that I am
10 talking about here in my testimony and they answer two
11 different questions.

12 The first question is when you are looking at a
13 particular component like a transportation component or mail
14 processing or something like that the first question to ask
15 is are changes in the costs associated with that component
16 caused by marginal changes in volume within that particular
17 component. If the answer to that question is yes, then
18 under Postal Service and Commission parlance, that is
19 considered a volume variable cost.

20 The second type of question that one would ask in
21 terms of causality is if they are not volume variable costs,
22 then are those costs caused by the provision of the entire
23 product, and if that is the case, then the product -- or
24 those particular costs within that component are what is
25 know as product-specific or in past Commission terminology

1 they are called specific fixed costs, and so those are the
2 two types of causality that I am talking about here.

3 Q Right. If I heard you correctly, you used the
4 word "cause" or "causation" in describing the definition of
5 cost causality. Do you have a definition that is more like
6 a definition that would be used in a formal mathematical or
7 logical proof?

8 A What you want to get away from is a mathematical
9 sense of the word there because, as I argue later in my
10 testimony, you don't want to mistake correlation for
11 causality there, but I am not quite sure where you are
12 going. Perhaps you could restate the question slightly
13 differently.

14 Q Okay. You have got a B.A. and an M.A. in
15 Economics, right?

16 A That's correct.

17 Q And you have done work on a Ph.D.?

18 A That's correct.

19 Q So you have been exposed to formal proofs in
20 economics?

21 A That's correct.

22 Q Now do you understand a definition to be an
23 equivalency relationship?

24 A Could you restate that? Do I understand that a
25 definition is a equivalency?

1 Q Yes.

2 A I am not familiar with what you are trying to get
3 at there.

4 Q Okay. A definition of cost causality might start
5 out something like "cost causation occurs if and only if"
6 and then something else.

7 A I think that's -- okay, now I see where you are
8 going.

9 It is very similar to what I just said before.
10 Again there's two types of causality that I am talking
11 about. One is volume variability, where changes in cost are
12 caused by or are created by small changes or marginal
13 changes in volume in a particular cost component.

14 The other type of causality I am talking about is
15 when we are talking about product specific costs or specific
16 fixed costs and those costs are caused or created by the
17 entire provision of a particular product or service.

18 So in a sense, that is what I mean by causality
19 and what I don't mean by causality is correlation, in which
20 case we have -- we may have some mathematical relationship.
21 There may be some type of mathematical relationship between
22 a cost and a volume change or the provision of a total
23 product but it is not caused by that volume change.

24 Q Are you familiar with the phrase "necessary and
25 sufficient conditions"?

1 A Yes, I am.

2 Q Is that another way to define something?

3 A Using the terms necessary and sufficient to define
4 what? I am --

5 Q In the case of cost causality to say "necessary
6 and sufficient conditions for cost causality are" and then
7 list conditions.

8 A Perhaps you can try out a definition on me. I
9 don't -- I could imagine a scenario where one could use the
10 words necessary and sufficient in a definition of cost
11 causality, but I have not provided one here today.

12 Q Yes. That is my problem. I can't come up with a
13 list like that either, but maybe we can give it a try.

14 A I think perhaps again if I could go back to my
15 answer before, what I am arguing here is that the
16 fundamental problem I had with the OCA submission in this
17 case about the allocation of advertising costs to the
18 Mailing Online service is that as I talk about for many
19 pages within my testimony is that it fails the causality
20 test.

21 It does not -- to me at least, it does not pass
22 the test of causality, which is critical to the Commission's
23 and the Postal Service's development of costs over the last
24 several decades, and what I mean by that is that it tries to
25 turn on its^{head} the causality argument.

1 I think, if I can correctly paraphrase what the
2 OCA and to a certain extent Witness Prescott are saying, is
3 that they are looking at the situation where changes in
4 advertising cost may cause changes in volume if the
5 advertising is successful, but that is not the type of
6 causality that the Postal Service and the Commission uses in
7 developing its volume variable and product specific costs.

8 It looks at exactly the reverse of type of
9 causality, which is where do changes in cost, ~~where are~~
10 caused by changes in volume, so what I am saying there is
11 that the notion that the OCA has put forth in its submission
12 turns Commission precedent and Postal Service precedent in
13 the development of its costs on its head. It is not
14 causality as we talk about them in developing postal product
15 costs.

16 Q Well, let's restrict ourselves to necessary
17 conditions for cost causality to exist. One necessary
18 condition for cause causation would be a correlation between
19 changes in subclass volume and changes in cost, is that
20 right?

21 A Could you be more specific? If you are talking
22 about volume -- are you talking about volume variable costs
23 and not product specific costs or the specific fixed costs?

24 Q Well, in the case of product specific costs we are
25 talking about the entire volume of the subclass, right?

1 A The change in the entire volume, that's correct.

2 Q But isn't it correct that cost and volume are
3 thought of as moving together in the same direction but not
4 necessarily in proportion?

5 A Again I don't -- I don't mean to be difficult. I
6 just don't quite understand your question.

7 If you are trying to say a necessary condition is
8 that there is some correlation between cost and volume, I
9 would agree with that statement for the case of volume
10 variable costs but it is not a sufficient condition. I
11 think that is where you are headed.

12 Q That is where we're headed.

13 A For cost causality, as I have defined it and the
14 Commission -- my reading of how the Commission has defined
15 it in the past.

16 Q If there is a causal connection I can expect to
17 see correlation; is that correct?

18 A I can't think of an example of the top of my head
19 where that's not the case, but it certainly -- there may be
20 that type of situation. For example, the Eagle network
21 example that I give in my testimony, the premium costs
22 associated with the Eagle network, the overnight
23 transportation network that the Postal Service uses to
24 transport Express Mail, my understanding is that there may
25 not be a correlation between changes in volume at the margin

1 and changes in those costs, but certainly if Express Mail
2 were to go away, the entire product known as Express Mail
3 were to be eliminated, then those premium costs would be
4 eliminated as well.

5 So in that situation, I can't point to a
6 mathematical or statistical relationship between changes in
7 volume or changes in the entire incremental volume of
8 Express Mail and changes in those costs, because it's a
9 hypothetical in that situation. So I guess I've talked
10 myself into disagreeing with your supposition.

11 Q Well, in the case of the Express Mail premium
12 costs, or other product-specific costs, it's an all-or-none
13 type of correlation, if you will. If you have the product
14 going, then you're going to have, in the case of Express
15 Mail, these premium --

16 A I would quibble with your use of the word
17 "correlation," and that's what I'm trying to say. It's
18 something much more -- it's much more deep than just simply
19 correlation. There's a causation there.

20 Q Well, that's --

21 A Let me finish my answer. And it's something that
22 we don't see. We're not going to go back and look at the
23 Postal Service's CRA, for example, and changes in mail
24 volume and see those types of relationships because it's a
25 hypothetical situation.

1 Q Okay. I understand your distinction. But what
2 I'm working toward here is some way of understanding or
3 defining causation that isn't self-referential, that doesn't
4 use the word "causation" in the definition.

5 A I think I -- in my discussion a few moments ago, I
6 think I used a different word. I'd have to go back and look
7 at what the specific words were, but "stems from" --

8 Q Created by.

9 A Is created by, there's various synonyms that could
10 be used there.

11 Q Generated -- yes, I've come across all of those in
12 trying to work up a definition as well.

13 If we can stick to volume-variable costs then and
14 continue to talk about correlation, if one were to
15 hypothesize the existence of a causal relationship and then
16 be unable to find correlation, one could conclude that there
17 was no causal relationship; is that correct?

18 A Can you restate the question again, please?

19 Q Sure. If we take as a working hypothesis that
20 there is in fact a causal relationship at work between some
21 volume and some cost, and then we were to go out and attempt
22 to actually find correlation, and we couldn't, could we then
23 conclude that there was no causal relationship at work in
24 that situation?

25 A In the particular case of volume-variable cost?

1 Q Yes.

2 A I'm not so sure I would agree with that. I am
3 trying to think of a counter-example. Certainly I would
4 agree with the statement that -- let's take for example the
5 case of surface transportation within the Postal Service,
6 which is an example of a type of cost component where we do
7 develop volume-variable costs, or the Postal Service does
8 develop volume-variable costs.

9 What we see in Witness Bradley's testimony in the
10 past docket is that he hypothesized that there was a causal
11 relationship between changes in cubic foot miles -- or
12 changes in volume and changes in cubic foot miles and then
13 changes in particular costs. And so he then went back and
14 looked at that based on statistical analysis and econometric
15 analyses and found that yes, there was that type of
16 statistical relationship there. So that's an example of I
17 think what you're talking about.

18 Q Well, not quite. What I'm talking about is the
19 situation where you don't find that statistical
20 relationship. It seems to me that if correlation is in fact
21 a necessary condition for causality, then if you don't find
22 correlation, it's just a matter of logic that --

23 A If I were an analyst looking at, let's say again
24 for example transportation costs within the Postal Service
25 or any other one and I hypothesized that there was a causal

1 relationship there, and I went and did my econometric
2 studies or statistical studies or what have you and I didn't
3 find it there, it would give me pause. I would reexamine my
4 hypothesis certainly.

5 Q Well, isn't that basically the way things work in
6 economics and in other sciences? One submits a hypothesis
7 that can then be falsified some way or another?

8 A Generally. I don't pretend to be a physical
9 scientist, but that's generally the scientific method, yes.

10 Q And if one can in fact falsify a necessary
11 condition for a hypothesis to be true, one has disproved the
12 hypothesis definitively.

13 A Given the particular paradigm and parameters that
14 you're looking at, I would tend to agree with that
15 statement, yes.

16 Q On the other hand, if you can't falsify the
17 condition, if you, in our case, hypothesize causation, go
18 out, run the correlation, find that you have correlation,
19 that doesn't prove anything. Right? It's consistent with
20 your hypothesis, but it doesn't prove it.

21 A Say that again? So if I had a hypothesis -- let's
22 use the example that I used before. If I had a hypothesis
23 that changes in mail volume cause changes in transportation
24 costs in this particular example I'm talking about, and I
25 went back and looked at the evidence, the statistical

1 evidence, and I did find a strong correlation there, or as
2 Professor Bradley did in R-97, he used econometric models to
3 do that, it doesn't prove categorically, but it certainly
4 proves to me that I'm on the right track, that I have a good
5 relationship. And I think that's what the entire Postal
6 Service costing system and the Commission's approach to this
7 type of costing has been built on in the past.

8 Q When you talk about spurious correlation, are you
9 referring to a situation in which you hypothesize causation,
10 you go out, look, you find correlation between cost and
11 volume, but for some reason you're convinced that there's
12 really no causation at work?

13 A Well, could you refer me to where I talk about
14 spurious correlation, please?

15 Q Let's see. Try page 8, note 7.

16 A Exactly. What I am trying to get at on page 8,
17 Footnote 7, is that the Postal Service simply does not go
18 out and -- again, let's take transportation as an example.

19 It simply doesn't go out and start trying to run a
20 lot of different correlation analyses and try to just
21 essentially willy-nilly come up with some statistical
22 relationship and pass that off as causality. It takes a
23 very careful look at the operational considerations that are
24 going on within the transportation network. It understands
25 really what those cost drivers are within the transportation

1 network, and then develops a hypothesis of how that
2 causation will work.

3 It then goes out and tests that empirically and
4 either confirms or rejects hypotheses based on that, but it
5 is not simply trying to go find some type of spurious
6 correlation of some type of relationship that is not based
7 on causality.

8 Q Well, again I think we are using the term that we
9 are attempting to define, but --

10 A "Spurious" here I ^{was using} ~~would use in~~ the term -- and I
11 think this was your original question -- as not based on
12 causality.

13 Q You are describing a situation where you simply go
14 out and run regressions without even thinking about how
15 likely it is that you are going to find a relationship and
16 then when you find one you say "Aha -- there must be
17 causality at work here" -- is that --

18 A I think that is the first ^{thing} ~~that~~ an economist learns
19 in Economics 101, that you don't do that type of approach,
20 that's correct.

21 Q All right, but what about a situation where you do
22 think about it for awhile. You say I hypothesize causation
23 here. I go out. I find a correlation.

24 In that situation how do I distinguish spurious
25 correlation from correlation that really means causality?

1 A Well, you are never going to be 100 percent
2 certain that you have actually got it right, but the
3 critical issue there is that you have to do your job
4 upfront. You have to think long and hard about the
5 operational considerations, which way the causality is going
6 to play out. It is not simply just a case where a cost
7 analyst can just take two columns of numbers and start doing
8 statistical analyses on them. He or she has to think long
9 and hard about which way that causality is going to occur
10 and why the causality is occurring and various other factors
11 as well and that is what the Postal Service tries to do, and
12 frankly that is that is what the Commission does as well
13 when it thinks about and analyzes the validity of the
14 various costing studies that are presented before it.

15 Q Could you look at page 14 of you your testimony?

16 A Certainly.

17 Q Line 4 through 6. Here you say, "It is clear that
18 changes in advertising costs are not caused by subsequent
19 changes in volume and therefore cannot properly be treated
20 as volume variable" -- is that correct?

21 A That is correct, and I think that gets back to my
22 point before is that again the definition of volume variable
23 costs or marginal costs is as the case -- an economist would
24 call them is that changes in costs are caused by marginal
25 changes in volume. That is the definition that the Postal

1 Service and the Commission has used for many decades.

2 What is happening here is the OCA and Witness
3 Prescott again, to a certain extent, would have you believe
4 that costs are creating changes in volume or changes in
5 transactions as the case -- in this particular incident
6 case. That is not the definition of volume variable cost
7 and I just want to be very, very clear about that.

8 There is a causal relationship going on there if
9 the advertising is successful, which I talk about a couple
10 ~~case~~ ^{cases}. It may not be successful and you may not have any
11 correlation whatsoever mathematically, but that causation is
12 reversed from the way that an economist or the Commission
13 has thought about cost causality in the past.

14 It is an example of correlation in that sense.

15 Q When you use the word subsequent -- where you say
16 "costs are not caused by subsequent changes in volume" -- do
17 you mean later in time? Is that what subsequent means?

18 A One could apply that. What I essentially mean
19 there, however, is that ~~affirm~~ ^{a firm} or the Postal Service or
20 whoever, creates an advertising cost, creates an
21 advertisement thereby incurring a cost, and then there may
22 be a change in volume associated with that.

23 It could occur five years down the road. It could
24 occur tomorrow. It could occur that day. I didn't mean any
25 specific timeframe there, but I meant to think about it from

1 that view of causality, which is a change in advertising
2 costs create a change in volume. That is not what volume
3 variable costs are and that is not what the Commission uses.

4 Q But you did have in mind some time in the
5 future -- not necessarily tomorrow but somewhere down the
6 line?

7 A No specific time.

8 Q So you are saying that a volume change that occurs
9 in one time period can't be the cause of a change in cost in
10 a prior period. Is that the point you are trying to make?

11 A Could you say that again, please?

12 Q A volume change that occurs in one time period
13 cannot cause a change in cost in a prior period.

14 A I would have to think long and hard about the
15 logic of how -- well -- again, I am not being difficult.

16 Could you state it just one more time? I want to
17 be absolutely sure what you are saying.

18 Q Sure. A volume change that occurs in one time
19 period cannot cause a change in cost in a prior time period.

20 A I don't think I am saying that necessarily here.

21 What I am saying here is very simple. I don't
22 want to make this rocket science here. What I am saying is
23 that in the case of these advertising costs, they are
24 incurred and presumably, not necessarily, presumably volume
25 is going to change at the end of the day or at some time

1 period in the future.

2 That causality ^{says} ~~ways~~ that a cost is incurred and
3 then a volume change may or may not occur as a result of
4 that.

5 What the Postal Service does in its costing
6 methodology and the Commission does in its costing
7 methodology, it says that a volume change takes place and
8 then a cost change takes place as a result of that. That is
9 the direction of causality that marginal costing is based on
10 within the economics profession. It is the basis for which
11 the Postal Service develops its costs and it is the basis
12 for which the Commission attributes cost. It is fundamental
13 to what the Postal Service and the Commission do.

14 This notion of causality that the OCA and again
15 Witness Prescott to a certain extent are proposing turns
16 that on its ear.

17 Q What I am trying to nail down here is are you
18 saying that the arrow of causality, if we can talk of it
19 that way, is like the arrow of time -- it only points in one
20 direction and that is into the future?

21 A No. I am not saying that at all. You are reading
22 way too much into it.

23 Q Well, then I am trying to understand ^{what} it is you are
24 saying about advertising costs in this particular sentence
25 that makes them not properly treated as volume variable.

1 A I'm sorry, I stand corrected. In this particular
2 sentence, that is what I am saying. In general, I don't
3 necessarily agree with your supposition.

4 Okay. Again this is -- it's -- I am not trying to
5 play games here with my sentence. It is meant to be a very
6 simple statement.

7 Q So you are not espousing a general principle here.
8 You are just saying in the case of advertising it is
9 advertising first, volume later, and that is always the
10 case?

11 A But -- no. You just -- you took my sentence one
12 step further. I didn't say it's always the case.

13 Q I mean with respect to advertising.

14 A Well, no. That is not the case either. As I
15 talked about before -- or -- I'm sorry -- in subsequent
16 paragraphs, lines 8 through 22 on this page in particular,
17 there may be situations where a company will undertake an
18 advertising expense and won't see any change in volume as a
19 result of that, and that might be their plan.

20 I think I talk about an example of my firm, Price
21 Waterhouse Coopers. It is undertaking ^{an} ~~and~~ advertising
22 campaign right now to promote brand awareness. It is not
23 undertaken to subsequently drive changes in volumes or at
24 least directly drive changes in volumes there.

25 There's lots of different uses for advertising. I

1 think you are trying to pin me down into too narrow a view
2 of advertising.

3 Q Well, again, let's get back to the proposition
4 that you are trying to dispute, namely that volume causes
5 advertising costs.

6 Your sentence seems to say that because the change
7 in volume occurs later in time ^{than} ~~then~~ the expenditure on
8 advertising -- there is no causal relationship in the sense
9 of volume causing cost.

10 A Can you give me a moment to think about it.

11 Again, as I said before, I am not trying to create
12 a real temporal problem here in this sentence. I am not
13 trying to make this more complicated than it is. In fact,
14 you could delete the word "subsequent" and my thoughts would
15 be the same.

16 What I am trying to say is that advertising costs
17 are not caused by changes in volume. Changes in advertising
18 costs are ^{not} caused by changes in volume.

19 Q That's just an assertion, isn't it?

20 A Yes, it is an assertion. It's a relatively
21 logical assertion and it's no -- I think it's a better
22 assertion than what the OCA and Witness Prescott have put
23 forth.

24 Q Well, in the sentence that I quoted at lines 4
25 through 6, it seems that the only word that allows you to

1 say "and therefore cannot properly be treated as volume
2 variable" is the word "subsequent."

3 A No, again -- I will let you make that case, but I
4 don't agree with it. I think -- again I am going back to
5 the definition of what marginal costs really are, and that
6 is changes in cost are caused by changes in volumes. That
7 is the definition. That is the economist's definition.

8 You can talk about long-run marginal costs. You
9 can talk about long-run marginal costs. You can talk about
10 short-run marginal costs. You can even in many cases talk
11 about instantaneous changes in marginal costs. There is no
12 time point on that.

13 The temporal issue is not relevant to what I am
14 trying to say here. What I am trying to say is that the OCA
15 and Witness Prescott have turned this relationship on its
16 head.

17 Q And I am still trying to determine what the
18 relationship is without simply using the word "cause" --
19 let's try a different example.

20 Would you agree that a capital expenditure
21 incurred now can be said to be caused by volume in the
22 future?

23 A In some cases it could well be, because, for
24 example, when a company or -- I'll use the generic case.
25 When a company is a startup company for example it may go

1 out and purchase capital equipment in anticipation of volume
2 in the future.

3 Q Well, doesn't the Postal Service do that as well
4 if it anticipates that five years from now volume is going
5 to be a lot greater for a particular category? It may
6 decide to purchase more equipment or start the purchasing
7 process now because it will take five years to get it
8 ready --

9 A One would hope the Postal Service would plan
10 optimally. That is correct.

11 That's the nature of business planning. Any good
12 business would do that, that's correct.

13 Q When a firm makes a capital expenditure in the
14 expectation of volume, sales, revenue, profits in the future,
15 there is an accounting mechanism for matching that capital
16 expenditure with the expected benefits, is there not?

17 A Could you restate that, please?

18 Q Yes. If a firm makes a capital expenditure now in
19 the expectation of future benefits, future sales, ultimately
20 generating future profits, there is an accounting mechanism
21 called depreciation. It is used to match the capital
22 expenditure with the profits that it generates, is that
23 correct?

24 A That's correct, but I could also envision cases
25 where a company -- you know, a business would bring on extra

1 capacity that is not capital and would not get depreciated,
2 for example, labor.

3 A company may staff up, hire additional workers in
4 anticipation of increases in volume, and those expenses
5 wouldn't be depreciated.

6 Q As an economist wouldn't you say that the cause of
7 those expenditures is in fact volumes in the future?

8 A What is happening, and this is a very good
9 example, what is happening in this situation is that I as a
10 businessman, let's say, am anticipating that there is going
11 to be additional volume in my business in the future, and
12 therefore I am going to have a capital expense or an
13 increased labor expense or what have you to meet that change
14 in volume, okay? And it might be a capital expense and I
15 might depreciate it or it might be an expense which I don't
16 depreciate but I am in that situation -- my thinking on this
17 or my addition to that capacity is being driven by a change
18 in volume, an expected change in volume in the future.

19 That is not why the Postal Service is making an
20 advertising expense today. It is not saying that, gee,
21 Mailing Online, I might have some volume in the future,
22 therefore I better advertise for it today. That makes
23 absolutely no sense whatsoever.

24 What it does is it says I want to have volume in
25 the future and therefore I spend the advertising today. I

1 think your example again is turned on its head.

2 Q So the answer to my question is yes?

3 A I don't remember your question, I'm sorry.

4 Q If a firm -- I believe this arose out of your
5 example -- a firm adding labor, staffing up in the
6 expectation of the need for that labor in the future --

7 A Yes. We talked to that example, yes.

8 Q And my question was as an economist wouldn't you
9 consider that a cost caused by an event in the future?

10 A Yes, I would, and I also said why that is
11 different from this advertising example today, just to ~~still~~
12 ~~making~~ ^{make} the record clear.

13 Q But we do agree that expectations about future
14 events can cause behavioral changes in the present?

15 A Absolutely.

16 Again, so the record is clear, that is not what I
17 believe is happening in this case.

18 Q Could you look at page 14 of your testimony?
19 You are there, right?

20 A Yes.

21 Q Lines 14 through 17. Here you list some reasons
22 why a firm might engage in advertising, correct?

23 A Yes, and I think as I said on line 10, I am not an
24 expert in advertising nor do I purport to be. However, just
25 a layman's interpretation -- I could ^{give} many different reasons

1 why a firm might engage in advertising, and it is not
2 necessarily to drive directly changes in the volume.

3 Q Well, let's look at these reasons that you do have
4 here. The first one is ^{induce}~~induced~~ purchases by a new customer,
5 is that correct?

6 A Right, and I can stand corrected if you choose to
7 do so, but I think that is what the OCA said was the cause
8 of advertising expenditures in its brief, but what I am
9 trying to say here is that the OCA's supposition is very
10 narrow. There's a lot of other reasons why a firm might
11 engage in advertising as well.

12 Q So your next reason is induce new purchases by an
13 existing customer?

14 A Certainly.

15 Q Right. In these cases there is a direct
16 relationship between cost and volume, correct?

17 A Yes, and it is the exact opposite of what -- of
18 the volume variability analysis that I have talked about
19 before, yes.

20 Q But the relationship is there, correct?

21 A Uh-huh.

22 THE REPORTER: The relationship is there, yes or
23 no?

24 THE WITNESS: Sorry? Could you -- which
25 relationship are you referring? I'm sorry I --

1 BY MR. COSTICH:

2 Q These first two reasons that you list for a firm
3 engaging in advertising, ^{induce}~~induced~~ purchases by a new customer
4 or ^{induce}~~induced~~ new purchases or more purchases by an existing
5 customer, in those cases there is a direct relationship
6 between cost and volume?

7 A If the first were to incur an advertising expense
8 to induce purchases by a new customer or to induce new
9 purchases by an existing customer, there is a relationship
10 there. That is correct.

11 Q The third reason --

12 A It is not necessarily the causal relationship upon
13 which postal costs are based.

14 Q The third reason you list for advertising is to
15 increase brand awareness among new and existing customers,
16 right?

17 A Certainly.

18 Q And the fourth reason you list is to increase
19 customer loyalty?

20 A Right -- and as I said before, again I am not an
21 expert in advertising. I didn't go back and consult any
22 advertising ^{+ext}~~technician~~ or people that are experts in
23 advertising. There may be 20 more reasons. I am not sure.

24 Q Well, just focusing on the third and the fourth
25 that you have got here, could you explain the difference

1 between increasing customer loyalty and increasing brand
2 awareness among existing customers?

3 A I can give you another good example. Again the
4 advertising that I am most familiar with is the advertising
5 that my company, Price Waterhouse Coopers, is undergoing
6 even as we speak.

7 As you probably know, we just went through a
8 merger. Price Waterhouse merged with Coopers & Lybrand,
9 thereby creating a new brand. Over the last several weeks
10 and months we have been trying heavily to promote that brand
11 awareness among the public, to get them to think of Price
12 Waterhouse Coopers as a brand.

13 That may be different from trying to increase
14 customer loyalty, trying to make sure that our clients are
15 happy clients and will continue to come back to us. That
16 may not necessarily be what we are trying to do in that
17 advertising.

18 I think it is pretty clear that there can be a
19 distinction between those two.

20 Q When you talk about --

21 A For example -- could I give one more example?

22 Q Sure.

23 A For example, imagine a car company that is
24 advertising its products. It may be the case that the car
25 company advertises its entire product line and says, for

1 example, you know, GM products are the best products in the
2 world and we are trying to increase the brand awareness of
3 GM, and however then it has specific targeted advertising to
4 its existing customers, people that own GM cars. I may get
5 a mailer because I own a GM car that says your service
6 record of GM cars is outstanding, various things like that,
7 so I could see a company taking two different approaches to
8 advertising to do those two different things.

9 Q In the case of specific product advertising
10 intended to increase customer loyalty, the purpose there is
11 to increase the probability that the customer will be a
12 repeat customer?

13 A Perhaps. It could be other things as well.

14 Q Can you give me an example?

15 A It could be to create more word of mouth
16 advertising too. If I am an existing customer and I am
17 loyal to that company I may tell my friends about it too.

18 Q So again, the ultimate end of that kind of
19 advertising is to increase sales, correct?

20 A In that particular case the ultimate end may be to
21 increase sales way down the road indirectly but that is not
22 always what advertising is.

23 Again, go back to my example of Price Waterhouse
24 Coopers. Our advertisements, which unfortunately I don't
25 have a copy of here with me today, but our advertisements

1 are not just meant to increase sales. It's also to promote
2 Price Waterhouse Coopers as a fun and interesting place to
3 work. It is trying to promote our people to show potential
4 customers, potential recruits, various other folks that we
5 are a good company so it is not -- advertising is not always
6 targeted to increase sales.

7 Q You don't think being able to say we have got the
8 best employees ultimately doesn't increase sales?

9 A Oh, it certainly helps but it is also, that
10 advertising is also meant for a recruiting tool, to try to
11 attract those best employees as well.

12 That's a very -- very indirect link to sales, as I
13 can attest.

14 Q Well, I guess we can argue about whether it is
15 indirect. It seems to me that the whole reason for having
16 good employees is to produce the product, whatever it might
17 be.

18 A I will let you make that case then.

19 I can attest -- I can tell you here that this
20 advertising I am talking about is meant to not only attract
21 potential customers but also to attract employees and to
22 increase our brand awareness. Lots of different reasons.

23 Q You mentioned that there was a name change that
24 seemed to generate some extra advertising.

25 Did I understand you correctly on that?

1 A That's correct.

2 Q Why would you need to do extra advertising because
3 of a name change?

4 A Well, it appears self-evident to me that if before
5 a merger I was operating in the marketplace as Price
6 Waterhouse and then separately Coopers & Lybrand, I would
7 need to promote the fact that now my new name, my
8 organization's name is Price Waterhouse Coopers so that
9 people wouldn't get confused with old names and
10 nomenclature.

11 Q Well, would one reason to prevent confusion be to
12 retain existing customers of the two former companies?

13 A It could well be, certainly, among other things.

14 Q Can we hypothesize that in the absence of that
15 advertising there would be a reduction in the number of
16 customers at Price Waterhouse Coopers?

17 A No, we cannot hypothesize that.

18 Q And why is that?

19 A Because I could also hypothesize a situation where
20 our customers are so happy with the services that we provide
21 they would never look elsewhere, no matter what we
22 advertise.

23 Q Well, is that the situation with Price Waterhouse
24 Coopers, that all their customers of the former two
25 companies are so happy that you don't need to let them know

1 that now there is a different company running the show?

2 A I would certainly hope so but that may not be the
3 case -- but again, that is not the entire reason why this
4 advertising campaign has been put forth.

5 Q But it is a reason.

6 A It is a very broad-based -- I mean we are sitting
7 here talking about Price Waterhouse Coopers's advertising
8 campaign. It is a very broad-based campaign meant to
9 increase our brand awareness.

10 What I am trying to get at is again a very narrow
11 discussion in my testimony, and that is that the OCA
12 purports that the reason that advertising expenditures are
13 incurred is to, if I remember correctly, it's to induce
14 purchases by a new customer or something very similar to
15 that.

16 I am simply trying to point out that there are
17 many other reasons why advertising can be used by companies
18 such as the Postal Service and they don't always have to
19 relate to changes in volume. That is my fundamental point
20 here. It is very narrow.

21 Q Well, the hypothesis I would like to put to you,
22 Mr. Takis, is that in the case of Price Waterhouse Coopers
23 one possibility that has been considered by the folks who
24 design advertising campaigns is that some customers will be
25 lost in the future because they didn't know of the name

1 change that the advertising is specifically, at least for
2 one reason for that advertising, is to retain those
3 customers that one fears will be lost if there is no
4 advertising done.

5 A That is certainly a possibility, among others.

6 Q You discuss incremental costs at some points in
7 your testimony, is that correct?

8 A That is correct.

9 Q Your view is that advertising costs for POL,
10 PostOffice Online, are incremental costs of the group of
11 products sold through the POL channel, is that correct?

12 A That is correct, and maybe I could just make sure
13 that we are all on the same page of what I mean by that.

14 In the Postal Service's costing methodology that
15 it put forth in Docket Number R97-1, in fact it was in my
16 testimony, it treated several advertising expenditures as
17 product specific to an entire product line. Those costs
18 should be included in incremental costs associated with
19 those particular product lines.

20 They are not volume variable. They are product
21 specific or specific fixed, as the Commission has used in
22 the past.

23 Q Could you look at page 18, lines 13 through 15.

24 A Yes. I have that here.

25 Q Here you are stating that no advertising costs are

1 incremental to Mailing Online alone, is that correct?

2 A That is the conclusion of my testimony, yes.

3 Q Now at these lines what you say is, "The Postal
4 Service has stated that there are no plans for advertising
5 MOL only and if MOL did not exist, the advertising plan for
6 POL would not be affected." Is that --

7 A That is my understanding of the advertising plans
8 for the Postal Service.

9 Q Okay. What is the basis for your understanding?

10 A It is -- I have cited a specific transcript
11 reference here which -- I would have to get back to you. I
12 am not exactly sure where that came from.

13 It might have been from a Postal Service
14 interrogatory response there, but I have also had
15 discussions with Witness Garvey on this issue.

16 Q Okay. Would it help if I showed you a copy of the
17 transcript page you're citing there?

18 A It would be very helpful. Thank you.

19 COMMISSIONER LeBLANC: Mr. Costich, so we can keep
20 the record clear, do you have some copies for the bench?

21 MR. COSTICH: Yes.

22 COMMISSIONER LeBLANC: Thank you.

23 Mr. Rubin, have you had a chance to take a look at
24 it? Are you all right with this?

25 MR. RUBIN: Yes, this is fine.

1 COMMISSIONER LeBLANC: Thank you.

2 BY MR. COSTICH:

3 Q As an economist, as an analyst, do you think it's
4 plausible that the Postal Service is not going to advertise
5 MOL specifically?

6 A Absolutely. I don't -- the first part of your
7 question is "as an economist." I don't know that why being
8 an economist would make me any more or less knowledgeable
9 about how the Postal Service is going about doing its
10 advertising. But my understanding is that this is the case,
11 what the Postal Service has said here is going to be the
12 case with Mailing Online.

13 Q The Postal Service is going to offer a product
14 available through PostOffice Online and never tell anybody
15 about it.

16 A That's not what -- I don't think that's what
17 they're saying here in this information. They're saying
18 that they're not going to advertise Mailing Online
19 separately from advertising the entire channel which is
20 known as PostOffice Online. I think that's -- this is
21 actually touching on a very interesting and important point,
22 is that my understanding of the advertising associated with
23 PostOffice Online is really to advertise a channel. It's
24 another way that a postal customer can get to purchase
25 Postal Service products, much the same way as a retail

1 outlet might be.

2 This PostOffice Online is a separate channel, so
3 it's going to be advertising a number of different products,
4 not just Mailing Online or the services that end up being
5 part of Mailing Online, which my understanding is Standard A
6 and First Class mail, but it's also meant to advertise other
7 products which will be sold through that channel such as
8 Express Mail or Priority Mail.

9 Q Well, do you have an understanding of whether
10 these products are mentioned in the advertising for ^{POL}~~policy~~?

11 A Yes, I do.

12 Q And are they?

13 A I didn't -- while I certainly trust the Postal
14 Service's response here, I also wanted to kind of see for
15 myself what the advertising looked like. I didn't want to
16 just sit in an ivory tower and opine on what the
17 advertisements meant. So I actually kind of took a look at
18 some of the printouts and the direct-mail ads that were
19 associated with PostOffice Online, and in fact it's very
20 interesting, it never mentions the word, or at least the
21 ones that I saw, there may be other ones out there, but the
22 ones that I saw don't mention Mailing Online specifically,
23 they mention Priority Mail and Express Mail.

24 What they're really trying to do, or at least the
25 way I read it as, this advertising is trying to promote the

1 channel, this electronic channel, which will allow customers
2 to access these various products like Express Mail, Priority
3 Mail, Standard A, First Class Mail, the various products
4 that are under Mailing Online and Shipping Online.

5 Q But in your examination of the ads, the only
6 products you saw specifically mentioned were Express Mail
7 and Priority Mail?

8 A With regards to specific references to existing
9 postal products, again, that is the case, but it was also
10 generally discussing the concept of Mailing Online too, the
11 ability of a customer to come in and create a mailing, send
12 it to the Postal Service, have it printed, and then sent
13 out. He was talking about that as well. And presumably the
14 mail pieces that are created as a result of that are First
15 Class and Standard A, although I didn't see those referenced
16 in the advertisement.

17 Q So the advertising really does address Mailing
18 Online without giving it a name; is that correct?

19 A It addresses the concept of Mailing Online, but
20 again, it -- as I look at that advertising, and again, I'm
21 just a layman when I'm analyzing advertising, it hits me as
22 it's trying to advertise the channel. It's trying to say
23 hey, the Postal Service has this new interesting neat way to
24 allow you to interface with us better, and you can come into
25 PostOffice Online via the Internet and send a package, send

1 a Priority Mail package or send an Express Mail package. Or
2 point and click and send out your own mailing, which would
3 involve First Class mail and Standard A mail. I read it as
4 advertising a channel, and it just so happens that Mailing
5 Online is one of the products that it's talking about in
6 here. Again, without matching the words Mailing Online.

7 And that indicates to me that these costs, the
8 Postal Service's trying to advertise a channel which
9 promotes a number of different products, Standard A, First
10 Class Mail, Priority Mail, Express Mail, and those -- and
11 any one particular one of those products should not bear the
12 costs associated with the Mailing Online -- or, sorry, the
13 PostOffice Online advertising.

14 Rather, it should be -- those costs should be
15 included in the incremental cost for the group of products,
16 Priority Mail, Standard A Mail, First Class Mail, and
17 Express Mail, and whatever other types of products that
18 PostOffice Online is trying to advertise.

19 Q Well, let's go back to that transcript page that
20 you cited. Could you read the question that appears under
21 Part B? Read it out loud, please.

22 A The actual interrogatory itself?

23 Q Yes, the question.

24 A Please identify and provide the costs associated
25 with informing potential customers or advertising the

1 availability of Mailing Online service during the expanded
2 or market test period.

3 Q And the first line of the response says there will
4 be no advertising specific only to Mailing Online. Correct?

5 A That's correct.

6 Q Any advertising of the Mailing Online service will
7 be part of more comprehensive advertisements promoting the
8 use of existing Postal Service products, et cetera. Is that
9 correct?

10 A That's what it says; yes.

11 Q And then the last sentence says: Accordingly,
12 there are no advertising costs directly associated with
13 Mailing Online and no such costs are identified by Witnesses
14 Seckar and Stirewalt. Correct?

15 A Again, and if I could again paraphrase what I think
16 the Postal Service is saying here, and what I just said
17 again, maybe slightly differently, is that the advertising
18 costs here to promote PostOffice Online are meant to promote
19 the entire channel of PostOffice Online, and through that
20 channel, Express Mail, Priority Mail, First Class Mail,
21 Standard A Mail, Mailing Online, Shipping Online.

22 There's going to be a number of different products
23 that are going to come through that channel. But it is not
24 correct from an economist's standpoint or from the
25 Commission's precedent standpoint to take those costs and

1 assign them to any particular product within that channel,
2 because they're not caused by that particular product. And
3 again we're going back to the fundamental root of Postal
4 Service and Commission costing is they're not caused by that
5 particular -- the advertising costs are not caused by any
6 particular product within that channel. Those costs are
7 caused by the entire stable or the entire group of products
8 which are being sold through PostOffice Online. Very
9 important issue here.

10 Q Did you notice that the question only asked about
11 the market test?

12 A That's the nature of the question.

13 Q Do you have any knowledge of the Postal Service's
14 plans for advertising MOL during the experiment?

15 A Other than what's presented here? No. My
16 understanding is that there are no plans to advertise
17 Mailing Online specifically.

18 Q During the experiment.

19 A That's my understanding. That's what I've been
20 told.

21 Q The cited transcript page wouldn't support that
22 statement; correct?

23 A Well, actually in this case I'll have a broad
24 definition of -- I'll tell you what I know, and you can
25 infer what you'd like from that. My understanding is that

1 the Postal Service has no plans right now to advertise
2 Mailing Online specifically.

3 Q No plans --

4 A Now I don't know whether that's during the
5 experiment phase, the test phase, the actual national
6 rollout, or whatever, but that's what I've been -- that's my
7 understanding. Perhaps this is a question better suited for
8 Witness Garvey.

9 Q Well, is that the basis for your understanding
10 beyond what is in the transcript?

11 A I'm sorry?

12 Q Is Witness Garvey the basis for your understanding
13 of the advertising plans?

14 A Yes, but I say primarily, my understanding comes
15 from this transcript reference, but I've had brief
16 conversations with Witness Garvey.

17 Q Okay. But you do understand that the transcript
18 page only discusses the market test.

19 A I'll let you make that case. It appears on the
20 surface.

21 Q But you do understand there will be no advertising
22 for MOL as far into the future as you can see?

23 A Again, that's my understanding based on brief
24 conversations; yes.

25 Q Conversations --

1 A I can't tell you what I don't know, and that's
2 what I know.

3 Q But your conversations were with Witness Garvey?

4 A Yes.

5 Q Anyone else?

6 A The conversations I've had on this issue are with
7 Witness Garvey -- I'm just trying to recollect if I've ever
8 had a conversation about this particular issue with any
9 other Postal Service employee other than the attorneys as
10 I've tried to develop this testimony. I can't recall that
11 off the top of my head; no.

12 Q The statement that you seem to rely on from the
13 transcript is that if MOL didn't exist, there would be no
14 change in advertising expenditures for POL; is that correct?

15 A That's correct, and the importance of that
16 statement is as follows, and it's really the way that the
17 Postal Service has generally tried to think about
18 incremental costs, and it's thought about it in the past
19 Docket R97-1, is that one way to think about incremental
20 costs is to think about it that if a particular product or
21 service were to go away, what would be the resulting change
22 in those costs? And that's one way to think about
23 incremental costs.

24 Q Well, if advertising costs for POL would not
25 change with the elimination of MOL, would you agree that the

1 entire advertising cost must be incremental to Shipping
2 Online?

3 A Absolutely not. What I'm saying here is that the
4 provision of any particular product, be it Mailing Online,
5 be it Standard A, First Class Mail, Express Mail, or
6 Priority Mail, if those products individually were to go
7 away, my understanding is that the advertising costs
8 associated with POL would not change. And therefore there's
9 no specific fix or product-specific costs associated with
10 those advertising costs associated with any particular
11 product sold through that channel of POL.

12 However, when you look at the entire group of
13 products that we're talking about here, if the entire group
14 were to go away, then there would be no need for advertising
15 POL, and therefore you would want to treat those costs,
16 these advertising costs, as part of the incremental-cost
17 test for the entire group of products under POL, but not any
18 one particular product under POL. That's my testimony.

19 Q Well, if there's no Mailing Online, all that's
20 left is Shipping Online, right?

21 A My understanding is that if there's no Mailing
22 Online, there is still a channel called POL.

23 Q And all it's selling is Shipping Online; right?

24 A Yes, and within ~~Shipping~~^{Shipping} Online there is all sorts
25 of different services: Express Mail, Priority Mail,

1 Delivery Confirmation, various other things.

2 Again, the reason why I come to this conclusion is
3 that I'm thinking about this and I think the Postal Service
4 is thinking about this as advertising a channel, much the
5 same way as a retail network might look for the Postal
6 Service.

7 Actually, that's a good example. Let me go into
8 that for a moment. I think you can think of the retail
9 network, the window-service network that the Postal Service
10 operates, as a channel. It's one way, one convenient way,
11 for customers to come in to the Postal Service and buy
12 stamps, send a parcel, buy an Express Mail package, what
13 have you. There are -- in much the same way PostOffice
14 Online is another convenient way for a customer to come in
15 to the post office and buy a number of different services,
16 be it Express Mail, Standard A Mail, Priority Mail, what
17 have you.

18 Within window-service costing there are certainly
19 volume-variable costs which are associated with particular
20 products. When a customer comes in and buys a stamp, a
21 portion of that time that the clerk uses is assigned to
22 First Class Mail. However, there are also a bunch of
23 institutional costs which are there to support the entire
24 channel of the window-service unit, but are not meant to
25 support any one particular product within that particular

1 channel, meaning the retail unit.

2 So therefore if I was going to do an
3 incremental-cost test on the window-service function, I
4 would certainly include those volume-variable costs which
5 are associated with the particular products and services
6 that are incurred at the window. But then there's this
7 group of institutional costs that are also incurred at the
8 window to promote all the products that the window-service
9 unit sells, and I would not include those costs in any
10 particular incremental-cost test for First Class Mail or
11 Express Mail or Priority Mail, but I would include it in the
12 incremental-cost test for all the services that are being
13 provided at the window. Again,^{there is a} very similar type of
14 argument here with PostOffice Online.

15 I do not believe again because of the causality
16 arguments that I make in my testimony that the advertising
17 costs associated with POL should be included in the
18 incremental costs of Mailing Online. However, I do believe
19 that the advertising costs associated with POL should be
20 included in the incremental costs of the group of products
21 together that are under PostOffice Online -- or sold through
22 that channel.

23 COMMISSIONER LeBLANC: Mr. Costich, excuse me for
24 interrupting you. It may be about time to take a midmorning
25 break here. Do you have any feel for your time? Are you in

1 a particular set -- or are you at a point you can stop at
2 right now?

3 MR. COSTICH: We can stop right now.

4 COMMISSIONER LeBLANC: All right, if you will,
5 let's take a ten-minute break or 12-minute break by my watch
6 or whatever it is, but we'll come back at 11 o'clock by the
7 clock on the wall.

8 [Recess.]

9 COMMISSIONER LeBLANC: Okay, Mr. Reporter, we'll
10 go back on the record. Mr. Costich, before we get started,
11 try to get my afternoon planned here. Any way of knowing
12 what time you have remaining?

13 MR. COSTICH: About 10 minutes, Mr. Presiding
14 Officer.

15 COMMISSIONER LeBLANC: Oh, it's better than I
16 thought then. Okay.

17 [Laughter.]

18 COMMISSIONER LeBLANC: Mr. Bush, do you have any
19 earthly idea?

20 MR. BUSH: Oh, I would guess I am somewhere in the
21 20 minute range.

22 COMMISSIONER LeBLANC: Mr. Wiggins?

23 MR. WIGGINS: That would be sort of my estimation
24 as well -- twenty minutes, half an hour.

25 COMMISSIONER LeBLANC: Looks like we may just push

1 on through then, with a little luck and leave the afternoon
2 free for all of us, hopefully.

3 Mr. Costich, please.

4 MR. COSTICH: Thank you, Mr. Presiding Officer.

5 BY MR. COSTICH:

6 Q Mr. Takis, before the break we were discussing
7 incremental costs. Do you recall that?

8 A Yes, I do.

9 Q And you had stated that to your knowledge there
10 would be no advertising for, specifically for Mailing
11 Online, is that correct?

12 A That is my testimony, yes.

13 Q Are you aware of the volume that the Postal
14 Service has estimated for MOL during the experiment?

15 A Volume meaning the number of pieces that are being
16 sold or --

17 Q Yes.

18 A Not -- no, I am not. Sorry.

19 Q If the advertising for PostOffice Online that
20 occurs during the experiment is similar to the advertising
21 that you have seen, then there will be some description of
22 what is available through Mailing Online, even though there
23 is no use of the words "Mailing Online" -- is that your
24 understanding?

25 A I think I testified just a few moments ago, before

1 the break, that the advertising that I saw, and I don't know
2 what time period it was for or where it's been placed or
3 anything like that, but I did ^{see} ~~seen~~ printouts and direct
4 mailing ads.

5 It mentioned -- I'm sorry, it did not mention
6 Mailing Online specifically but it generally talked about
7 the service that we collectively here are talking about as
8 Mailing Online among other things as well.

9 It talked about Priority Mail and Express Mail and
10 the ability of a customer to access various different
11 services through the PostOffice Online through the Internet.

12 Q Now what you saw were print ads, is that correct?

13 A I saw two things. I saw print ads and I saw a
14 direct mail insert type of advertisement.

15 Q You didn't see any TV ads or hear any radio
16 announcements?

17 A Let me amend my statement there. I also saw
18 web-based advertising as well and I am not an expert on the
19 internet but when you log into a various site, you might see
20 advertising as well, so I saw those three types of things --
21 the web-based advertising, the print ads and a direct mail
22 insert.

23 Q Would the web-based advertising be those little
24 banner ads that run across the top of the screen?

25 A I believe so. I believe that is what you call

1 them, yes, but again I am not an expert in the Internet, so.

2 Q But you have to click on those to get more
3 information?

4 A I actually only saw the hard copy printout of
5 those advertisements so I don't know the exact mechanism of
6 when a customer goes into the site how he or she is
7 presented that information, so I don't know how that works,
8 but it is off the Internet base.

9 Q Are you aware that there may be or are broadcast
10 advertisements for POL?

11 A I think so I have not seen them, nor have I
12 studied them in any detail.

13 Q Would you agree that the space in the print ads or
14 the time used in a video ad to discuss MOL could be used for
15 some other purpose?

16 A Like for example -- for example another product
17 that the Postal Service might sell?

18 Q Yes.

19 A Absolutely, and again that goes back to what I was
20 saying before the break is that the Postal Service here,
21 according to my understand, which is just based on common
22 sense, not any real analysis expenditures or the way it is
23 trying to target people, but my looking at these
24 advertisements is that it is trying to promote the channel
25 known as POL and any number of products could be sold in

1 that particular channel.

2 Does that answer your question?

3 Q Yes. Would you agree that advertising space or
4 advertising time equates to money?

5 A Unless it is free advertising, I would agree to
6 that statement.

7 Q Would you agree that if Mailing Online were
8 eliminated as a product that the space or time used to
9 discuss MOL could also be eliminated from ads?

10 A It could well be, but that is not my understanding
11 of what the Postal Service would do if Mailing Online were
12 to be eliminated and I think that is stated pretty clearly
13 here in the exhibit that you showed me, transcript reference
14 881.

15 Q Do you have any knowledge --

16 A Let me finish that thought. I'm sorry. The
17 thought there is that the Postal Service would not change
18 its advertising campaign significantly or it wouldn't change
19 the costs that were incurred there if Mailing Online were to
20 be eliminated.

21 Q Well, does it sound plausible to you that the
22 Postal Service would continue to advertise or describe a
23 service like MOL if MOL didn't exist?

24 A Certainly not if MOL did not exist, but that does
25 not mean that the Postal Service would not advertise a

1 channel known as PostOffice Online.

2 Again, what ^{it's} ~~is~~ trying to do is say to customers,
3 very succinctly say, come look at us. We have a new channel
4 for which you can access our products and services. I think
5 that is the point of the ads and again it is just based on
6 my looking at those ads but it certainly comports with what
7 the Postal Service is saying here. If that is really the
8 purpose of the ads is saying, hey, we have this channel and
9 you can access the Mailing Online type of product, again
10 without mentioning Mailing Online in particular, you can
11 access Priority Mail or Express Mail or delivery
12 confirmation or what have you, if any one of those
13 particular products were to go away then I don't think the
14 Postal Service would necessarily change its advertising
15 strategy or change the way it promotes those products if you
16 are adverting a channel.

17 Now if you have an ad that is out there for
18 example for Express Mail -- you know, it says come use our
19 product, Express Mail -- if that product were to go away,
20 then those products -- you might change that. I will leave
21 it at that. Thank you.

22 Q I believe you testified before the break that the
23 ads you have seen do describe the service that we call MOL.
24 Is that correct?

25 A Again, as part of a number of different services

1 that the Postal Service provides, that is correct.

2 Q And I believe you agreed a minute ago that
3 advertising space or advertising time equates to money, is
4 that right?

5 A Yes. I think what I am trying to say also and the
6 Postal Service has said very directly here is that if
7 Mailing Online were to go away, it would not change the
8 expenditures that the Postal Service makes to promote the
9 channel PostOffice Online.

10 Q So they would continue to occupy the same amount
11 of space in print ads and continue to occupy the same amount
12 of time on broadcast ads, is that your understanding?

13 A That would be the logical conclusion of what they
14 have said in this interrogatory response, and it makes
15 perfect sense. Again, if you are there to advertise a
16 channel, you will take the same amount of print ad space
17 whether you have maybe 10 products or 5 products or
18 whatever. That is what they are trying to say in this
19 interrogatory response.

20 Q So if MOL has gone away, then now they have space
21 or time available to do something else with, is that your
22 understanding?

23 A Perhaps, and my testimony here today is that the
24 Postal Service has said, and I have to take them at face
25 value, that they are truthful in this response, that they

1 would not change their advertising expenses as a result of
2 that.

3 Q Are you familiar with the concept of opportunity
4 cost?

5 A Absolutely.

6 Q Can we agree that when MOL occupies space in
7 advertising that becomes freed up when MOL goes away, that
8 the value of that space was an incremental cost of MOL?

9 A I would be extremely wary about any approach that
10 tried to say take an ad -- let's say, for example, a print
11 ad, and it had ten words of it on it that was talking about
12 Mailing Online, and 100 words that was talking about Express
13 Mail, Priority Mail, and what have you -- I would be
14 extremely worried about using some type of arbitrary
15 allocation mechanism like the number of words or the square
16 inches on the page or what have you to allocate those
17 individual costs that are on that ad to individual products
18 within that ad. Because again you're going to -- the only
19 thing you can do is use some arbitrary allocation mechanism.

20 What you need to do is think about the way that
21 expenses occur, and as I've said many times here today, in
22 my testimony, and the Postal Service has said in the record,
23 that if Mailing Online were to go away, they would not
24 change the way that they advertise for PostOffice Online.

25 Q Well, they'd wipe out those nine or ten words that

1 you just mentioned, wouldn't they? They would remove them
2 from the ads, right?

3 A One would think so; yes.

4 Q And then they've got some space that has some
5 value, doesn't it?

6 A Perhaps they'd fill it with other advertisements.
7 Perhaps they would leave it blank. Perhaps they'd
8 reconfigure the rest of the advertising to do something
9 else. I don't know, and I'd have to take what they'd do at
10 face value here.

11 Q A moment ago you indicated that you're familiar
12 with the concept of opportunity cost?

13 A Yes, I am.

14 Q Could you define opportunity cost for the
15 Commission?

16 A Well, I think that economist's textbook version is
17 the value of a forgone alternative. In the case -- I'll
18 leave it at that.

19 Q And isn't that what we're talking about? When
20 advertising for MOL goes away, one now has a resource that
21 one formerly was consuming to promote MOL and one can now do
22 something else with it.

23 A But again I think you need to think about the way
24 that advertisement is developed in general. If you have a
25 print ad, let's say, that consists of a piece of paper,

1 there's going to be blank spaces on that piece of paper.
2 You don't necessarily want to fill all of the blank spaces
3 on that piece of paper, because then you're oversaturizing
4 the viewer of that print ad or something like that. It's
5 not necessarily the case that just simply because you take
6 out a set of words out of an advertisement that you would
7 necessarily want to replace it with another product or what
8 have you.

9 Again, I think we're going a little bit far afield
10 here. The purpose of this advertising is to advertise the
11 channel, and if you take a look at it, that's what it's
12 trying to do. It's saying hey, we have this neat new way of
13 coming to the Postal Service. You can come and purchase a
14 wide array of different products through this channel. And
15 therefore the Postal Service has said that if Mailing Online
16 were to go away, it wouldn't change the way it advertises
17 that channel. That tells me that there are no incremental
18 costs associated with Mailing Online. That's my testimony
19 today.

20 Q Ads that describe Mailing Online consume
21 resources; is that correct?

22 A But they don't necessarily cause those resources.

23 Q If MOL goes away, those resources are freed up;
24 correct?

25 A Only if they are caused by that resource. And

1 what I'm trying to tell you here today is that these
2 advertising costs are not caused by the presence of Mailing
3 Online, they're caused by the channel which is known as
4 PostOffice Online. It's very simple. The Postal Service is
5 trying to advertise a channel, not any particular product
6 within that channel. If that were the case, if they were
7 trying to advertise products, then we may have a different
8 conclusion here. But that's not what they're trying to do
9 here.

10 Q And your basis for your understanding is the
11 transcript page that you've cited?

12 A And also looking at the advertisements which I've
13 seen, the ones at least that I've seen, and discussions with
14 the Postal Service.

15 Q I have no further questions, Mr. Presiding
16 Officer.

17 COMMISSIONER LeBLANC: Thank you, Mr. Costich.

18 I believe according to the agreement, it's now Mr.
19 Wiggins. Yes. Mr. Wiggins.

20 MR. WIGGINS: Thank you, Mr. Presiding Officer.

21 CROSS EXAMINATION

22 BY MR. WIGGINS:

23 Q Mr. Takis, I'm Frank Wiggins. I'm here for
24 Pitney-Bowes.

25 Put out of your mind, or at least put out of my

1 question, the version of causation that you talked about in
2 your testimony as product-specific or specific-fixed-cost
3 causation. Can you do that with me?

4 COMMISSIONER LeBLANC: Mr. Wiggins, you're going
5 to have to move that mike a little closer.

6 MR. WIGGINS: Sure. Absolutely.

7 COMMISSIONER LeBLANC: Thank you.

8 THE WITNESS: I believe so.

9 BY MR. WIGGINS:

10 Q Okay. Is it your testimony that the only other
11 kind of cost causation that this Commission has ever
12 recognized is the variety of volume-variable-cost causation
13 as to which you testified to Mr. Costich and talk about in
14 your paper?

15 A Not necessarily. I don't purport -- I've been
16 doing postal costing for 13 years, but I haven't read every
17 single word of every single decision that the Postal Rate
18 Commission has put forth, and so I'd leave it to others to
19 be able to answer that question.

20 What I'm trying to produce in my exhibit, which we
21 were talking about earlier today, is essentially a
22 simplified view of the two major types of causality that
23 certainly underlies or undergirds the Commission's and the
24 Postal Service's presentation.

25 Q But there might be others.

1 A There could be. I'm not familiar with them right
2 now on the surface.

3 Q I notice that when -- throughout your discussion
4 of causation you cite to the testimony of postal witnesses
5 who have addressed those questions in prior cases.

6 A Um-hum.

7 Q I didn't notice a citation to the Commission's
8 deliberations. Was there anything in particular decisional
9 law that you referred to in coming to the conclusions that
10 you reached?

11 A When you use the word "decisional law," do you
12 mean --

13 Q Recommended decisions by this body. Recommended
14 decisions by this body. Right.

15 A I didn't refer to that in my testimony per se,
16 other than the case about Special Delivery messengers --

17 Q Right.

18 A I believe. But it was more of a matter of
19 convenience. I'm very familiar with the testimonies that I
20 cite in this -- in my testimony.

21 Q Right. If you had known when you were -- well,
22 let me ask you. Have you reviewed Mr. Garvey's rebuttal
23 testimony?

24 A In this particular case?

25 Q Yes.

1 A I have had the chance to review that. That's
2 correct.

3 Q He testifies that there came a time in this
4 market-test period where because Mailing Online was not
5 working as well and as dependably as the Postal Service had
6 expected and demanded, they actually curtailed -- I think he
7 uses the word "deferred" -- some advertising in order to
8 decrease or curb volume. Do you remember that?

9 A Well, you are characterizing Witness Garvey's
10 testimony in a very specific way. I'd probably prefer to
11 take a look at it myself, which I don't have a copy.

12 Q Accept for me then just hypothetically that the
13 events that I've just described to you are accurate. Can we
14 do it that way?

15 A Can you give me a hypothetical?

16 Q Sure. Absolutely. That there came a time in the
17 course of the market test authorized by the Commission --

18 A Um-hum.

19 Q In which Mailing Online was not working as well or
20 as dependably as the Postal Service expected and demanded.
21 In consequence of their learning of these glitches in the
22 system, to use the technical term, they curtailed or
23 deferred advertisements that were planned in order to
24 curtail volume, so they could fix it, or at least not have a
25 bunch of customers who were on a system that wasn't working

1 well --

2 A Right.

3 Q Okay? Accept that hypothetically to be true.

4 A Okay. And those glitches could occur for

5 technical reasons, all sorts of different reasons, I could

6 imagine.

7 Q The testimony doesn't tell us, and I will not

8 hypothesize --

9 A Okay. Nor will I.

10 Q What caused those problems. Just take those

11 events as being accurate. Would knowledge of those facts

12 have changed any of your answers to Mr. Costich when you

13 were talking about causation, causality?

14 A Absolutely not. And let me --

15 Q Sure.

16 A Explain the reason for that. If I accept your

17 hypothetical, and again I'm not as familiar with Witness

18 Garvey's testimony as I would need to be to be able to say

19 this is the exact reason why the Postal Service curtailed

20 that advertising, but certainly it makes sense that if you

21 have technical glitches in your system, you don't want to

22 have new customers come into that system and have a bad

23 experience with that system. Is that what you're trying to

24 get at there?

25 Q No, not really. It's not your place, I think,

1 certainly not mine, to wonder why the Postal Service did
2 what it did in its advertising budget. I'm asking the
3 question whether that knowledge of the Postal Service's
4 perception of a relationship between advertising and Mailing
5 Online volume would have changed your appreciation of that
6 relationship in a way that in turn would have changed any of
7 your discourse with Mr. Costich on the issue of causation.

8 A Well, I'd have to go back and review in detail
9 what I said to Mr. Costich, but in general I would say no.
10 And the reason why I would not change my testimony is
11 because again that relationship is backwards or reversed
12 from the relationship which the Postal Service and the
13 Commission uses to establish postal cost.

14 Again, the Postal Service and the Commission use
15 changes in volume and how they affect or cause or create
16 changes in costs, and yet what you're talking about here and
17 now and what Mr. Costich was talking about before are
18 changes in advertising costs resulting in changes in volume.
19 It's the exact opposite of the relationship that we use in
20 postal costing.

21 Q Is it a fair summary of part of your testimony to
22 say that you're not a big fan of fully distributed costing
23 systems?

24 A That would a fair and accurate statement.

25 Q Let me read you a sentence that appears at page 9

1 on lines 4 and 5 of your testimony. You say: Under a
2 generic FDC system, all of an organization's costs are
3 distributed to individual products.

4 A I'm sorry, Mr. Wiggins, could you tell me where we
5 are?

6 Q Yes, we're on page 9.

7 A Um-hum.

8 Q Lines 4 and 5, the sentence there that begins
9 "Under a generic."

10 COMMISSIONER LeBLANC: Is that rebuttal or
11 original -- just the rebuttal testimony he submitted, right,
12 his testimony?

13 MR. WIGGINS: Yes.

14 THE WITNESS: I have that under line 4. Is that
15 where you are?

16 MR. WIGGINS: Yes, lines 4 and 5.

17 THE WITNESS: Okay.

18 COMMISSIONER LeBLANC: Are you with him now, Mr.
19 Takis?

20 THE WITNESS: I am with him, yes, sir. Thank you.

21 BY MR. WIGGINS:

22 Q Under a generic FDC system, all of an
23 organization's costs are distributed to individual
24 products --

25 A Um-hum.

1 Q Even though they may not be caused by those
2 products. That's what an FDC is in your appreciation.

3 A That's correct, and I go through and explain an
4 example of an FDC approach applied in a postal context.

5 Q The probably most common thing that one sees in
6 FDC costing is something like your method C on Exhibit
7 RT-2-B. I've seen a bunch of those.

8 A I've seen them all different ways.

9 Q Okay.

10 A I've seen probably 50 different methods of
11 allocating those costs.

12 Q But at the end of the day the function of a fully
13 distributed costing system is to distribute the totality of
14 cost to individual products. Is that right?

15 A Let's -- let me take your example and narrow it
16 slightly. If I were an analyst using an FDC approach to do
17 product costing, let's say, to develop costing for prices,
18 then -- and I were to use a generic approach to it where I'm
19 trying to distribute all the costs to individual products,
20 then yes, I would agree to that statement.

21 Q Well, at the close of business over some period,
22 it's pretty important to do that, isn't it? If you don't do
23 that, you're going to be losing money.

24 A For overall revenue analysis, absolutely, but not
25 for product costing and pricing analysis directly.

1 Q Okay.

2 A Again, I mean, I think the Commission is very
3 familiar with the concept of having product costs which are
4 assigned to particular products and then having
5 institutional costs which are not, and those institutional
6 costs are covered by markups over product costs --

7 Q Good.

8 A However they are defined.

9 Q Good. That's really what I wanted to hear from
10 you a little bit more on.

11 A Right.

12 Q Which is to say a comparison between this
13 methodology, your definition of fully distributed costs or
14 FDC costing, and how the Commission, which is under a
15 break-even constraint, right? It has to make its revenues
16 equal its costs -- its revenues over any reasonable run
17 can't exceed its costs. Is that your understanding?

18 A Yes.

19 Q That's a break-even --

20 A My understanding is that in the test year, the
21 Postal Service has to propose and the Commission has to
22 adopt or recommend rates that cover all costs that are
23 incurred in that test year, and they may include -- they
24 include all sorts of different costs. That's correct.

25 Q And the Commission frequently refers to two

1 varieties of such costs, does it not, attributable costs and
2 institutional costs?

3 A That is correct. Among other things, too, the
4 Commission has used in its decisions the word "volume
5 variable" and "specific fixed" and other things as well, but
6 that's a characterization generally of the types of costs it
7 looks at.

8 Q And attributable costs and volume variable costs
9 are sort of the same populations of costs, is that your
10 understanding?

11 A No, that is not my understanding of that.

12 Q Explain to me the difference between those two
13 categories?

14 A Well, I think we are running a little bit far
15 afield of my testimony.

16 Q What do you get? I'm sorry.

17 A I can comment on it through my experience with
18 postal costing.

19 Q Sure.

20 A My understanding, for example, in Docket R97-1, in
21 its Opinion and Recommended Decision, that the Commission
22 included volume variable and a notion ^{Product} ~~private~~ specific, or
23 specific fixed costs in its definition of attributable
24 costs.

25 Q Precisely. And I am sorry, I misspoke. I was

1 still excluding the product specific.

2 A Sorry.

3 Q But with that exception, attributable costs and
4 volume variable costs are kind of coterminous notions?

5 A Can you repeat the question?

6 Q With the exception of specific fixed or product
7 specific costs, which the Commission has indeed treated as
8 attributable, the remainder of attributable costs are
9 basically the same population of costs as volume variable
10 costs, is that right? To the extent that you know, and I am
11 not trying to press you outside the scope of your testimony.

12 A In my general knowledge, yes, I will agree to
13 that, but there may be some costs out there that I am not
14 thinking of.

15 Q Sure.

16 A Again, I am trying to present a very simplified
17 approach in that exhibit.

18 Q Let's -- I am fascinated by the advertising
19 campaign that your firm has mounted here. And it --

20 A It must be working then.

21 Q Somebody has -- well, I didn't know about it
22 outside of this hearing room, so I am not --

23 A Then it must not be working then.

24 Q I am not sure. I don't read many accountancy ads,
25 though. Somebody has got to pay for that advertising

1 campaign, is that right?

2 A That is correct.

3 Q This isn't free advertising that you talked about?

4 A Oh, no, that is correct.

5 Q Yeah. It may not be as expensive as Young &
6 Rubican, whom the Postal Service is using, but you have got
7 to pay somebody something, is that right?

8 A That's correct. Right.

9 Q Okay.

10 A Be it print or television ads, or however those
11 ads are developed, yes.

12 Q Right. It seems to me that there at least three
13 different targets on whom those costs could be imposed.
14 Those costs, in the case of your firm, could come out of
15 profits, diminishing short-term profits somewhat, is that
16 right? I am not asking you now what is actually happening,
17 but what might be happening.

18 A Well, let me take your statement and interpret it
19 the following way. If an expenditure were made in a
20 particular period, then it would -- it may reduce profits in
21 that particular period. Also, if that advertisement is
22 successful, it may increase profits in that period, too.
23 But the exact -- the expense item of the advertisement would
24 certainly hit on the negative side of the bottom line.

25 Q And if you wanted not to reduce profitability in

1 that period, you might increase the rates that you charged
2 to your client, your whole population of clients, might not
3 you?

4 A One might, but one also might treat them in a
5 similar way to the -- Price Waterhouse Coopers has not used
6 the term "institutional costs," but one might also have them
7 be borne by all lines of service and products.

8 Q Say how that would work.

9 A Well, let me go -- let me move back to an example
10 that -- a Postal Service example. The Postal Service may
11 incur advertising, and, again, I am not an expert in the
12 Postal Service advertising campaigns, but the Postal Service
13 may incur advertising to promote the Postal Service in
14 general, all the products associated with the Postal
15 Service.

16 Maybe at Christmas time the Postal Service puts
17 out ads that talk about delivering all mail pieces on time
18 and making sure that it gets done. That advertising is not
19 specific to any one particular product but is meant to
20 promote all products that the Postal Service offers. Those
21 costs would be properly included as overall institutional
22 costs and would not be assigned to any one particular
23 product or attributed to any one particular product that the
24 Postal Service offers. I believe. Again, I am not an
25 expert in the actual way they do cost attribution for that

1 right now.

2 Q But let's think about your firm's advertising
3 campaign. It can't have been contemplated, or at least not
4 in detail, until the merger that you have talked about was
5 in prospect, or maybe even concluded, is that right?

6 A The exact advertising campaign to promote the
7 Price Waterhouse Coopers brand?

8 Q Well, an unexpected advertising campaign that
9 costs money that you didn't previously have in your
10 advertising budget. Let's think about it that way.

11 A But both predecessor firms, I am sure, although I
12 am -- well, both predecessor firms, I would hazard to guess,
13 would have advertising budgets that they would use to
14 promote the brand awareness. I know that Price Waterhouse
15 did, my legacy firm.

16 Q So just suppose with me a new advertising campaign
17 that comes out of the merger, that exceeds the combined
18 advertising budgets of the two firms when they were
19 separate. You increase your advertising budget to reflect
20 the fact of the merger probably relatively short-term.
21 Okay. Suppose that.

22 A I will suppose that. I am not sure if that
23 occurred in our case.

24 Q I am not asking whether it occurred. If you are
25 going to pay for that advertising, you can take it out of

1 profitability, you can increase the prices charged to all of
2 your clients so that you have enough extra revenue to defray
3 those costs, correct?

4 A Those are two that we have discussed previously.

5 Q Okay. And I suppose, finally, you could seek to
6 defray those costs either by higher charges levied on new
7 clients or simply the fact that new clients brought extra
8 profitability so that you could pay these costs without
9 decreasing profitability, or increasing the prices charged
10 to former clients, existing clients?

11 A Well, I would quibble that you are -- that that
12 example, and increasing the rates to all of our clients is
13 just a shade of gradation. I think what you are -- that is
14 the way I perceive it. Perhaps you could restate the
15 question.

16 Q No, that is precisely the way it was intended.
17 You perceive what I meant.

18 A Okay.

19 Q And those are three alternatives, albeit not
20 starkly differentiated alternatives in the last two cases,
21 is that right? There are shades of differentiation, those
22 are your words.

23 A Correct. And what I am trying to also -- well,
24 what I am also trying to say, which I said before, I think
25 you are trying to walk us -- walk me down a path where we

1 are going to talk about how those costs might be allocated.
2 Maybe I am putting words in your mouth. But if an expense,
3 an advertising expense is being incurred to promote all
4 products that a company offers, like the Postal Service or
5 Price Waterhouse Coopers, then, in a good assignment
6 methodology, those costs should not be assigned to any one
7 particular service or product within that particular service
8 offering.

9 Q Look at the revenue side with me for a minute.

10 A Okay.

11 Q You have this new expense that was not
12 contemplated when you made your annual budget. Okay.

13 A No. I think --

14 Q Well, suppose that with me. Is that so far --

15 A Okay. I see you are going -- well, I will let you
16 make a case.

17 Q Is that so far-fetched that you can't imagine it?

18 A No.

19 Q Okay. Suppose that with me. You have now got a
20 new drain on revenue, and I am saying to you know, what do
21 you do? Where do you find the money? And we looked at a
22 decrease of profitability. That is not an alternative
23 available to the Postal Service, is it?

24 A Not necessarily.

25 Q The Postal Service has profits?

1 A No, the Postal Service does not have profit.

2 Q Okay. So a decrease --

3 A I am sorry, I have to step back. The Postal
4 Service over time is, by statute, supposed to break even.

5 Q Okay.

6 A That does not mean that in any one particular time
7 period the Postal Service doesn't have fluctuations either
8 above or below a break even situation. Rates are designed
9 to break even, even in a hypothetical future test year.

10 Q So that, at least as a theoretical matter, the
11 Postal Service cannot turn to retained earnings, generated
12 profits in order to defray a new advertising campaign that
13 it undertakes, though your firm could?

14 A I think you are starting to get into legal issues,
15 or at least what I perceive to be legal issues.

16 Q Fine.

17 A My understanding as not a lawyer and not an expert
18 in the legal issues associated with the Reorganization Act
19 are that -- I would prefer to leave it there.

20 Q That's absolutely good. Assume with me that the
21 Postal Service can't turn to a pocket of profit in order to
22 defray a new advertising campaign that it has undertaken.
23 It has got to get the money from its customers, isn't that
24 right?

25 A Well, not necessarily. Now, and I am not going to

1 accept your hypothetical, because in any given year where
2 rates are currently in effect, there is going to be -- there
3 are going to be cases where the Postal Service has
4 under-forecasted costs and over-forecasted costs in that
5 particular year. And to the extent that there is an
6 unforecasted additional expense, in any particular year, the
7 Postal Service doesn't necessarily raise rates to cover
8 that. In fact, --

9 Q Let us -- you don't know what the case is right
10 now, today, in terms of rates over-recovering or
11 under-recovering, do you?

12 A Not specifically, no.

13 Q Okay. So let's suppose that the Postal Rate
14 Commission has done its usual exemplary job and the recovery
15 is just right.

16 A Okay.

17 Q Okay. And we have a new expense. Something has
18 got to happen to recover that from somewhere. And whether
19 it happens in precisely this rate period or whether it is
20 recovered in a future rate case, because you have got
21 operating losses carried forward, forget about those
22 niceties, okay, it has got to come from somewhere. And the
23 question is, from what population of Postal Service users
24 should that cost be defrayed? And you answer that in your
25 testimony, don't you?

1 A No, I don't.

2 Q Well, could you?

3 A I testify about the cost assignment process, or
4 cost allocation process, not about the rate recovery
5 process.

6 Q I sort of thought that, right, because I didn't
7 see where the money was coming from. But you tell me not --
8 you say don't pay any attention to this fellow Prescott, who
9 tells you what he wants you to do in order to recover this
10 money, but you don't give me an alternative. You don't tell
11 me what you, Mr. Takis, believe is the right mechanism for
12 recovering this money. And I would like to have your view
13 if you have one.

14 A Yes, I do. If you can give me a moment, I will
15 cite you to the specific part of my testimony.

16 Q That would be good.

17 We are on the record. Go ahead.

18 A I talk about this in general terms in the section
19 entitled, "The Proper Treatment of Advertising Costs" from
20 page 21 to 23. However, if you take a look at page 23,
21 lines 4 through 12, that I think summarizes what I have
22 testified to and how I think these costs should be assigned
23 or allocated.

24 Q When you use the word allocate, is it your
25 contemplation that these costs would be treated as

1 attributable costs and marked up for the purpose of
2 recovering institutional costs from this group of services?

3 A That is not a part of my testimony here.

4 Q I understand, but that is how you get the money,
5 isn't it?

6 A Let's take a very narrow view of my testimony
7 here. I am telling you how the proper way to attribute
8 costs or -- I'm sorry to allocate costs --

9 Q Right --

10 A The word "attribute" is a term of art the
11 Commission uses to understand how to mark up those overall
12 costs. What the Commission wants to do with volume variable
13 and product specific and these group incremental costs is up
14 to the Commission. I am not here to testify to that today.

15 Q So you are not talking at all about the revenue
16 side of the equation?

17 A I am not testifying on that today.

18 Q Okay. Is it right that if Mr. Garvey is just
19 right in saying that the services should be marked up by 25
20 percent, to have 125 percent cost coverage, and the
21 Commission accepts your advice to allocate advertising
22 costs, will the rates stay the same or necessarily go up to
23 accomplish Mr. Garvey's 125 percent cost coverage?

24 A You have now stepped way beyond where I am
25 testifying today. I have not considered how these costs

1 would be marked up.

2 Q It's your testimony I think that advertising costs
3 are associated with POL -- there are some POL advertising
4 costs, is that right?

5 A Can you restate that, please?

6 Q Sure -- that there are some advertising costs
7 associated with PostOffice Online?

8 A Absolutely. My testimony assumes that.

9 Q Sure, and have you looked at whether there are any
10 other costs associated with PostOffice Online?

11 A I am sure there are, but it's not the purpose of
12 my testimony here today.

13 Q You don't wish to give us the benefit of your
14 wisdom on how to allocate those other costs?

15 Let me just take you through some costs and see
16 whether you have any reaction. If you don't, I am not
17 trying to pressure you into fresh testimony here.

18 A That's fine. That's fine.

19 Q There is a registration process that goes on in
20 PostOffice Online by which initially 5000 people can
21 register to be participants and that requires the storage of
22 certain data. It requires transmission back and forth of
23 some information. There are some costs associated with
24 that.

25 Should that be allocated in the same way as

1 advertising costs, or do you have no view?

2 A I have not studied that, but I will provide one
3 blanket statement, that if a cost is caused by Mailing
4 Online then it should be allocated to Mailing Online, and if
5 it is not caused by Mailing Online it should not be
6 allocated to Mailing Online.

7 Q No, no. I am talking about --

8 A Could I please finish?

9 Q Sure.

10 A That is as far as I can opine on something that is
11 outside of these advertising costs.

12 Q Okay. I am talking not about Mailing Online now
13 but PostOffice Online, the mother service, as it were.

14 A Then can you repeat the question, because I
15 thought you were talking about Mailing Online?

16 Q No, absolutely not. I am saying to you that part
17 of the PostOffice Online is the process of registering to
18 become a PostOffice Onliner or something like that, and that
19 there are costs associated with that. You have to maintain
20 a database, which includes credit card information. There
21 have to be communications by which that information is
22 transmitted, and there are costs associated with all that,
23 and I am asking you only whether you have any view as to how
24 those costs should be allocated.

25 A It is a tricky question because you are telling me

1 something about the technology of PostOffice Online. I
2 don't know if that technology is shared by other services
3 within the Postal Service. For all I know, it might be
4 shared generally with First Class mail. I don't know. I
5 haven't looked at it --

6 Q If it matters to you --

7 A -- in particular.

8 Q If it matters to you accept what I believe to be
9 true, but accept it hypothetically, that the registration
10 process has nothing to do with anything other than
11 PostOffice Online other than that it is a condition
12 necessary to participate in Mailing Online or Shipping
13 Online, but you have got to do it at the PostOffice Online
14 level and there are costs.

15 MR. RUBIN: I am going to object here as I think
16 we have gotten too far beyond the scope of Witness Takis's
17 testimony and I believe the witness has said that we have
18 reached the scope.

19 MR. WIGGINS: I am good with that and I offered
20 him that alternative if he is willing to answer one more
21 question for me.

22 BY MR. WIGGINS:

23 Q And that is, Mr. Takis, are you testifying as to
24 no cost allocation except that associated with advertising
25 is that correct?

1 A No. Just about a minute and a half ago I said
2 that I have not looked at these server costs and these
3 various costs to which Mr. Wiggins is talking about, so I
4 can't tell you my view on the proper way to allocate those
5 particular costs.

6 I will say, however, that if you use the simple
7 notion of cost causality that I have outlined in my
8 testimony, and I have applied it here to advertising costs,
9 if you apply that same notion to these other types of costs
10 that you are talking about you won't go far wrong. That is
11 very consistent with the way that the Postal Service has
12 developed costs in past rate cases and it is consistent with
13 the way the Commission has opined on those costs in past
14 decisions.

15 COMMISSIONER LeBLANC: Mr. Wiggins, I think he has
16 answered the question.

17 MR. WIGGINS: I do believe that he has, and I will
18 go on.

19 COMMISSIONER LeBLANC: Thank you.

20 BY MR. WIGGINS:

21 Q If there are in your simple model, which I don't
22 find so easy to apply -- but it is simple in concept, I'll
23 give you that -- of cost causation if I could represent to
24 you some costs that are caused in the sense that you use the
25 word by PostOffice Online those costs should be attributed

1 to PostOffice Online, should they not?

2 A Again, attributed is a term of art which I would
3 like to stay away from in my response to this.

4 Q Let me say it a different way then. PostOffice
5 Online should pay for those costs.

6 A Sorry, the products which are sold through the
7 PostOffice Online channel should cover the costs that are
8 associated with PostOffice Online if it is not possible to
9 allocate them to individual products under that channel and
10 they are not shared by other things like periodicals or
11 something like that.

12 Q I am asking a slightly different question,
13 probably inartfully. Why not allocate those costs to
14 PostOffice Online itself?

15 A I am not sure what those costs are.

16 Q Whatever they are. We are talking about the
17 simple concept now. We don't have to clutter our mind with
18 details.

19 A Well, I don't have enough details to answer the
20 question, I'm sorry. The concept is very simple here. It
21 is very much based on a causality argument that I have
22 talked about before.

23 If you have a group of products and we could talk
24 about them as being a group of products being sold through
25 PostOffice Online or any other channel, for that matter, or

any number of different groups of products within the Postal Service, if you have a group of products and you have a cost that is associated with the provision of all those groups, every single one of those products as a group, then those costs should be included in the incremental cost as for that group of products.

However, if those costs are not caused by any one particular type of product within that group of products, then they should not be attributed to any one -- sorry -- allocated to any one particular product within that group of products.

The example I used before, the window service unit, is a good example. One can look at the window service unit and say it sells a number of different products. It sells First Class stamps. You can buy a parcel. You can a zone-rated Parcel Post. You can send Express Mail. You can do any number of different products and services through the window service, and there are volume variable costs which are allocated to those particular service in the window service operation.

However, there are also these institutional costs which are a part of the window service operation which are not associated with any one particular product in particular but should be included -- those overall costs should be included in the group incremental cost test of all the

1 products that are sold through the window service unit, and
2 that may be First Class mail, Priority Mail, Express Mail,
3 money orders, various different products within that overall
4 umbrella.

5 Q Are you through?

6 A Yes.

7 Q You talk in Section 5 of your testimony, beginning
8 on page 24, about vertical integration issues, and that is a
9 topic that a witness sponsored in part by Pitney Bowes
10 addressed -- Roger Prescott.

11 A Witness Prescott, that's right.

12 Q Do you disagree with Mr. Prescott's sort of
13 threshold notion that there are vices, economic vices,
14 associated with vertical integration that combines a
15 monopoly -- a product in which a firm has monopoly power,
16 with other products in which the firm has not formally
17 participated? Is that generally bad?

18 A What I disagree with in Witness Prescott's
19 testimony is the fact that he presents a number, a long
20 laundry list of potential harms associated with this
21 vertical integration problem that he cites in this
22 particular case, and yet he doesn't support his long laundry
23 list of those potential harms.

24 In fact, in many cases when he says that there
25 could be a potential harm, as I talk about in my testimony,

1 I say well, if you just think about it for two more minutes
2 you can come up with a potential benefit as well, so what I
3 disagree with Witness Prescott is his unsubstantiated
4 points -- are his unsubstantiated points.

5 Q Your table of contents under vertical integration
6 issues, as is the first subpart (a), potential harms against
7 actual harms, and you take Mr. Prescott to task there for
8 not having the power to demonstrate that the harms that he
9 says are potential will actually eventuate. Is that a fair
10 summary?

11 A Yes.

12 Q "Potential Harms Against Actual Harms" you call
13 that section.

14 A That's correct.

15 Q And let's skip over (b). We will talk about that
16 in just a moment.

17 You come on down in subpart (5)(c) and talk about
18 potential benefits. Now oughtn't you to be subject to the
19 same criticism that you levy at Mr. Prescott for dwelling in
20 the potential rather than the actual world?

21 A No, because I make no pretense of having analyzed
22 this in a lot of detail.

23 As I stated before, I have not analyzed the
24 effects of the market -- of the Postal Service's contract in
25 this market. I have not done a vast empirical study. What

1 I am saying is that Witness Prescott has not done that
2 either, and he is simply throwing up a lot of potential
3 items out there without thinking about the potential
4 benefits or the other side of the coin.

5 My job -- or I see my testimony here to point out
6 to the Commission that for the potential harms that Witness
7 Prescott throws out there may be potential benefits or
8 essentially there is another side to the story that Witness
9 Prescott is leaving out.

10 I have not taken it upon myself to analyze this
11 market exhaustively.

12 Q So in the terms of John Rawls you are operating
13 behind the veil of ignorance? That is not a question.

14 Do you have Witness Prescott's testimony with you?
15 If you don't have it real handy, I can just show you the
16 small part of it that I am going to ask you about.

17 A That would be better, I think.

18 COMMISSIONER LeBLANC: Mr. Wiggins, do you have a
19 cite to that?

20 MR. WIGGINS: Yes, sir.

21 COMMISSIONER LeBLANC: So counsel can follow.

22 MR. WIGGINS: I certainly do. It is transcript
23 page 2117. It is beginning at page 13 as numbered
24 internally to Prescott's testimony.

25 THE WITNESS: I am sorry, Mr. Wiggins, the example

1 you have provided me starts at 2118. I can --
2 MR. WIGGINS: Okay. That's good.
3 THE WITNESS: Okay.
4 BY MR. WIGGINS:
5 Q But the general section starts at 2117.
6 A Okay.
7 Q I am going to ask you about 2118.
8 A Okay.
9 Q He has got a subheading there, Mr. Prescott does,
10 talking about advantages for the USPS. Do you have that?
11 A Yes, I believe he is talking about competitive
12 advantages for the USPS.
13 Q And it continues under that same subheading over
14 on page 2119, which I have also provided to you.
15 A I do have that, yes.
16 Q Do you have your own testimony handy?
17 A Yes, I do.
18 Q Look at page 25 with me, would you, please?
19 A Yes, sir.
20 Q By my reading, and I would like you to correct me
21 if I have got this wrong, the only argument that you make
22 concerning this advantages for the USPS section of Mr.
23 Prescott's testimony is the paragraph in the middle of the
24 page, lines 12 through 20? Go ahead and study what follows
25 here in your testimony. You tell me whether you make any

1 other observations about Mr. Prescott's advantages for the
2 USPS arguments, of which there are several?

3 A I'm sorry. Is your question, do I make any
4 observations on his --

5 Q On this portion of Mr. Prescott's testimony, that
6 is correct.

7 A No, I make several comments on his supposed
8 advantages for the Postal Service's competition.

9 Q Tell me where they are. Where do they appear in
10 your testimony? I see page 25, lines 12 through 20. You
11 tell me what else I ought to look at.

12 A Well, why don't we go through them one at a time.

13 Q Well, I would like to just talk about the ones
14 that are dealing with this part of Mr. Prescott's testimony.
15 Mr. Prescott was representing two somewhat different
16 interests here. He testified both for Mr. Bush's client,
17 MASA, and for my client, Pitney Bowes. The arguments that I
18 am pointing you to are primarily Pitney Bowes centered and
19 his other arguments are primarily print shop, or MASA
20 centered. So I want to talk about my client's interests.

21 A Well, Mr. Wiggins, I am sorry, I don't -- when I
22 read through his testimony in preparation of my testimony, I
23 did not know which specific arguments were meant to
24 represent either client.

25 Q That's fine. You don't need to. I am just asking

1 you whether any of the other criticisms that you level at
2 Mr. Prescott in talking about specific competitive concerns
3 apply to his testimony at 2118, line 7 through 2119, line 9?
4 I am just trying to make sure I read your testimony right,
5 Mr. Takis.

6 A I am sorry, Mr. Wiggins, you have unfortunately
7 confused me extremely here. My section B, pages 25 through
8 26, respond to Witness Prescott's statements, which I
9 believe are unsubstantiated, about the potential effects of
10 the Postal Service's contracting in this particular market.
11 I don't know which one of those represent your client, or
12 which one represents Mr. Bush's client. I am sorry, I
13 can't --

14 Q Do you know which portions of your testimony deal
15 with which specific portions of Mr. Prescott's testimony?

16 A Yes. Let's look -- for example, on lines 12
17 through 13, I state that on page -- I'm sorry, transcript
18 reference 2119, if I have got the cite correct.

19 Q You do.

20 A I say that Witness Prescott claims that the Postal
21 Service's rate proposal provides MOL with a pricing
22 advantage relative to its competitors. And then I go on and
23 tell you why I think that there is another side to that
24 story that Witness Prescott has ignored.

25 Then in the next paragraph -- let me finish,

1 because you have asked me to provide a list of this, sir.

2 Q Well, I am asking you to provide me references to
3 where you discuss in your testimony the material that shows
4 up in Mr. Prescott's testimony at 2118, line 7 through 2119,
5 line 9. Now, if you are unable to do that quickly, we can
6 all read.

7 A But, Mr. Wiggins, I don't understand. I think I
8 have provided those cites here in my testimony. For
9 example, I just cited you to 2119 and that is one of the
10 pages that you handed me. If we go down to line 25, I have
11 provided you a reference to line 2 -- sorry, reference 2119
12 through 2120, which you haven't provided me, but is included
13 in that.

14 I am looking through the rest. I think my
15 testimony is well documented where I take the -- where I
16 specifically refer to Witness Prescott's arguments. In
17 fact, every time I introduce a paragraph in this section, I
18 say Witness Prescott says X, and I am here to say that X is
19 not the whole story, that there is more to the story.

20 Q Okay. And in each instance, the only portion of
21 the Prescott testimony that you are referring to is the
22 portion to which you have cited, is that fair? That is all
23 I am trying to get figured out, Mr. Takis.

24 A Well, in general, I am referring to Witness
25 Prescott's testimony on vertical integration in general. I

1 don't always provide a specific transcript reference, if
2 that is your question.

3 Q Okay. Turn back to page 25 of your testimony if
4 you no longer have that.

5 A I do have it here.

6 Q Beginning at line 16 -- well, beginning at line
7 15, "In fact, Witness Prescott presents only half the story
8 since he fails to consider the competing services may be
9 able to receive additional discounts based on finer
10 presort."

11 A Right. The issue there is that Mr. Prescott makes
12 an assertion that the Postal Service will have a competitive
13 advantage over other providers of similar types of services
14 because they will have to go to the Postal Service and meet
15 the 500 piece minimum requirement required for -- I believe
16 it is for automation basic is the rate category there.

17 However, Witness Prescott fails to think about
18 cases where the mailer would meet more than that -- the
19 competitor, potential competitor would meet more than that
20 level of presort and that level of volume to meet even
21 deeper discounts. So what I am saying here is that a
22 competitor could enter 5,000 pieces of mail that qualifies
23 for a much finer level presort rate than what Witness
24 Prescott says here, and that is a competitive disadvantage,
25 because the Postal Service is only proposing an automation

1 basic rate.

2 Q So the argument that Mr. Prescott does make is
3 accurate, but there might be offsets, is that your
4 testimony?

5 A That is generally my testimony throughout his
6 testimony, that he puts forth a series -- numerous, and I
7 talk about at least four of them here, of potential harms
8 that the Postal Service, or potential competitive advantages
9 the Postal Service has, or potential harms on the printing
10 industry, or the ultimate mailer. And what I am saying is
11 that he doesn't provide any evidence to support that, and I
12 am simply trying to provide the Commission with some
13 thoughts on the other side of the coin to balance out those
14 unsubstantiated arguments.

15 Q You haven't investigated the likelihood of a
16 competing service being able to receive additional
17 discounts, I take it?

18 A No, nor has Witness Prescott, at least according
19 to my reading of his testimony.

20 Q You can't quantify the actual benefit that might
21 accrue to competitors?

22 A Nor do I purport to.

23 MR. WIGGINS: I have nothing further, Mr.
24 Presiding Officer, and I am sorry I overran myself a little
25 bit there. The witness is trying awfully hard to be

1 forthcoming and that sometimes take a little longer.

2 COMMISSIONER LeBLANC: No problem, Mr. Wiggins.

3 Mr. Bush.

4 MR. BUSH: Thank you, Mr. Presiding Officer.

5 CROSS-EXAMINATION

6 BY MR. BUSH:

7 Q I guess it is good afternoon, Mr. Takis.

8 A Yes. Good afternoon.

9 Q I am Graham Bush and I represent the Mail
10 Advertising Service Association International. I would like
11 to take you back to the beginning here for just a second.
12 If I am understanding your past experience and your
13 learning, you have essentially had experience as a costing
14 witness, is that right, in various kinds of utility and
15 rate-making proceedings?

16 A Yes, and here within the postal context as well.

17 Q Right. And if I could get you to, would you look
18 at page iii, and this is of your testimony.

19 A That is in my autobiographical sketch section?

20 Q Right. Right.

21 A Yes, I have it here.

22 Q And I would like to direct your attention to lines
23 12 through 17 there. You talk about directing Price
24 Waterhouse Coopers' projects in the areas of cost analysis
25 and rate design for regulated utilities, and then you go on

1 and say that your work is focused on cost of service
2 studies, cost of capital studies, rate design analyses and
3 other related financial and economic studies for utilities
4 in the electrical, natural gas, telecommunications and water
5 supply industries. And my question is, what are the other
6 related financial and economic studies, what are you
7 referring to by that language?

8 A In some cases I have done analyses to help
9 utilities plan various capital investments that they have
10 had. I think that the -- I think that I generally have, in
11 my past career, helped utilities, regulated industries in a
12 variety of different financial and economic areas, including
13 these that I talk about here.

14 Q Right. And is autobiographical sketch which
15 appears on page iii and iv, which I have referred to you, is
16 that intended to be a complete and full summary of the
17 expertise that you bring to bear on the various pieces of
18 the testimony that you have provided?

19 A Well, I would certainly hope that it establishes
20 my qualifications to testify here today.

21 Q I don't see anything in here that relates to
22 market definition issues, competition, anti-trust type
23 considerations at all. Did you leave that out? Do you have
24 some experience in that area?

25 A In terms of specific anti-trust experience and

1 activities?

2 Q Well, let's start there.

3 A For example, testifying in front of DOJ or things
4 like that, I have never testified in front of DOJ.

5 Q All right. And have you had any experience in
6 testifying on market definition issues?

7 A I have never testified on that.

8 Q All right.

9 A I think --

10 Q Now I'd like to take you back to the
11 advertising-cost issue for just I hope a brief moment, and
12 everybody seems to have spent a lot of time on the
13 variable-cost issue. I'd like to ask you a question about
14 your example on the Eagle network.

15 A Yes, sir.

16 Q Okay. As I understand that, you used -- first of
17 all, you've used that as an example of specific fixed costs;
18 correct?

19 A The actual term that I used is product-specific
20 costs. To what page are you referring, please?

21 Q Well, I'm not referring you to any page yet, but
22 it happens to be at page 6 --

23 A Okay.

24 Q If you want to refer to it for your own use. And
25 that product-specific cost is also equivalent to what the

1 Rate Commission has used as specific fixed costs, is it not?

2 A Not -- in this particular case, yes, it is, but
3 it's not exactly equivalent to that.

4 Q Okay. For purposes of our discussion here, it's
5 close enough.

6 A It's fine. It's close enough.

7 Q Okay. And as I understand it, you have said that
8 the Eagle network, the cost of the Eagle network is
9 allocable or attributable -- I don't know that you want to
10 use that term "attributable" -- but to Express Mail, because
11 it was created so that Express Mail could have next-day
12 delivery.

13 A Not exactly. What I am saying is that the premium
14 cost associated with the Eagle mail network, the cost over
15 and above what it would cost to fly an Express Mail piece or
16 First Class Mail piece or what have you, on commercial air
17 networks, those premium costs are allocable or however you
18 want to say it to Express Mail because they're caused by
19 Express Mail, and they're not caused by any other product.

20 Q Okay. And the reason is so that Express Mail can
21 achieve next-day delivery. The reason that you allocate 100
22 percent of the premium cost to Express Mail is because you
23 need this network in order to get next-day delivery.

24 A Another way to think about it is that if Express
25 Mail were to go away, the Eagle network would not be needed

1 to transport First Class or Priority Mail, which is also
2 found on the Eagle network.

3 Q And those particular categories, First Class and
4 Priority Mail, may use the Eagle network, but they're, if
5 you will, incidental beneficiaries of that network.

6 A They do use the Eagle network, but they do not
7 cause the fact that the Eagle network exists.

8 Q But they benefit from it.

9 A Well, they may or may not benefit from it. I have
10 not done an analysis of whether First Class Mail benefits
11 from being on the Eagle network. I don't know. But they
12 certainly don't cause the fact that the Eagle network is in
13 existence.

14 Q Okay. Well, let's just stick with what you agreed
15 to, that they do use it.

16 A Yes.

17 Q Okay. And I'd like you to consider the following
18 situation, that on the Eagle network there is excess
19 capacity, and on day 1 the only premium product that's going
20 is Express Mail. So 100 percent of the premium costs under
21 your analysis of this is allocable to Express Mail.

22 Are you with me so far?

23 A I'm with you.

24 Q Okay. And then on day 2 another product is
25 offered which requires the same next-day delivery, but it's

1 not Express Mail, and we don't have to figure out what it
2 is, it's a new product. Maybe it's a parcel. I don't know
3 what it is. And that product is going to start using the
4 Eagle network as well and use up that excess capacity. But
5 it won't cause any further expenditures.

6 How would you allocate, if at all, on day 2, the
7 premium cost of the Eagle network in that scenario?

8 A I think I understand your question. Let me
9 paraphrase it to make sure that I'm right with you.

10 Q Sure.

11 A You're saying that on day 1 we have a product
12 called Express Mail or some extra product that needs the
13 Eagle network. The Postal Service goes out and builds the
14 Eagle network and it's there and it exists.

15 Q The situation we have today essentially.

16 A Okay. Then you're saying hypothetically a new
17 product comes in after that.

18 Q After that.

19 A And could you continue on and --

20 Q And it doesn't cause any increase in expense in
21 the Eagle network. What happens is that that product can
22 achieve all of its delivery standards and other product
23 characteristics by simply using up the excess capacity
24 perhaps as the capacity that's now being used by First Class
25 Mail or priority mail. They get bumped off. This new

1 product is now on board. Same exact expense as --

2 A So therefore the total expenses incurred by the
3 Postal Service have not changed.

4 Q Have not changed. There's no volume variability
5 at all, in other words.

6 A I think I know where you're going here. You've
7 asked a question that unfortunately is just way too complex
8 to answer in this proceeding, and let me tell you why.

9 Initially if you bought that capacity in period 1,
10 let's call it, or day 1, as you've termed it, you should
11 have an optimal level of capacity to plan for your volume
12 growth, let's say for that day 1.

13 Am I characterizing the way that you've set up the
14 question accurately?

15 Q Well, unless you just need to have a certain
16 amount of capacity in order to get the product there, and
17 you're going to have to have more capacity than you really
18 expect to be able to use.

19 A If that capacity is optimally planned, there may
20 be excess capacity in the network to handle unforeseen
21 fluctuations in demand, so when you characterize it as
22 "excess" capacity, there may be an optimal level of excess
23 capacity in the system already planned. So let's say for
24 example that you have an optimal amount of capacity planned
25 in the network, and on day 2 you start introducing this new

1 product which needs that type of service as well, you would
2 actually have to go out and increase capacity in that type
3 of situation.

4 Q Well, now you're trying to change my hypothetical.
5 Can we just stick with my hypothetical, where you don't
6 increase the capacity, you simply use the capacity, the
7 existing capacity, and you now have a new product, so you
8 have this capacity that's one cost that was wholly allocated
9 to Express Mail? Now you've got two products that are using
10 the same service without increasing the cost. How do you
11 allocate it, if at all, between the two products?

12 A I would not want to opine on that today, because I
13 don't know enough about the way that capacity was planned.
14 There's a lot of different decisions that would need to go
15 into my decision making on it. But again I will go back to
16 something I said before. If you use the concept of cost
17 causality, what costs are being caused by a particular
18 product or service, then you're not going to stray too far
19 from the right answer.

20 Q Yes. I guess what I'm having trouble with is I'm
21 trying to understand how your concept of cost causality
22 works in this specific situation, and if you're telling me
23 you can't really tell me right now, that's fine. But --

24 A Because the hypothetical is actually quite complex
25 when you start thinking about planned additions to capacity

1 and things like that to meet -- previously planned volume
2 and the new volume and things like that. It's a little more
3 difficult.

4 Q Let's shift the hypothetical over to PostOffice
5 Online. You have PostOffice Online.

6 A Thank you.

7 Q But I'm going to change this to a hypothetical.
8 And PostOffice Online starts out with Shipping Online and
9 nothing else. And it goes perking along for a couple of
10 years of Shipping Online and 100 percent, I assume under
11 your analysis, 100 percent of the advertising costs of
12 PostOffice Online in that scenario would be allocable to
13 Shipping Online.

14 A I don't believe Shipping Online is a product. I
15 think it would be the products that are sold under
16 PostOffice Online or under the name Shipping Online. I
17 think it includes Express Mail, Priority Mail, and maybe
18 others which I'm not familiar with now.

19 Q All right. Well, let me simplify the example even
20 further. Let's assume that Shipping Online is a product,
21 just to make life simple for us here, and that it has a
22 specific charge, whether you want to call it a rate or a
23 fee. Then the advertising expenses associated with
24 PostOffice Online in that scenario would be allocable under
25 your analysis to Shipping Online, would it not?

1 A If it is not shared by other products and
2 services --

3 Q Right.

4 A Which the Postal Service offers, then it should be
5 allocable to that -- to Shipping Online. It may be
6 allocable to Shipping Online as a whole and not the
7 individual products and services --

8 Q Right.

9 A Underneath Shipping Online.

10 Q Okay.

11 A If you remember what we were talking about before.

12 Q Let's assume that that's the way it works, and
13 then after a couple of years of perking along like that, we
14 add Mailing Online. And as I understand your testimony, at
15 that point -- well, let me not ask -- let me not tell you
16 how I understand your testimony. At that point, what
17 happens to the advertising costs? Assuming that it's the
18 same budget. They're not going to expand it and start doing
19 specific advertising for Mailing Online.

20 A This is an excellent example of what I was trying
21 to talk about before, is that because the Postal Service is
22 trying to advertise the channel of PostOffice Online in this
23 situation, when you add into the mix, into the PostOffice
24 Online, Mailing Online, and it doesn't cause you to change
25 your costs or change the way that you do advertising, the

introduction of Mailing Online into that channel does not cause any new additional costs, and therefore Mailing Online should not bear directly or specifically any costs associated with that advertising.

Q What happens to Shipping Online? Does Shipping Online still eat all of the advertising costs?

A Now -- at this type of situation, now you've got multiple products within that, but you had that before as well when I was talking about the various products sold under Shipping Online.

Q But we simplified the hypothetical so that Shipping Online was itself a product and it was taking all of the burden of the advertising costs. And you're saying that when you add Mailing Online and you don't increase advertising as a result, that Mailing Online doesn't have any of the advertising expense allocated to it. And I take it also that Shipping Online would all of a sudden not have any of the advertising expense.

A Let me be very clear what you'd want to do in a situation where you've got -- where you're adding products to a group such as what you're talking about. What you want to do is you want to make sure that in your incremental-cost test for that particular group of products, which now comprises in your hypothetical Shipping Online and Mailing Online underneath that, you want to make sure that the

1 incremental-cost test includes those costs in its basis,
2 make sure that the revenues associated with those group of
3 products, Shipping Online in your hypothetical and Mailing
4 Online in your hypothetical, cover all of the costs
5 including these group incremental costs associated with
6 that.

7 Q Let me ask you to take a look at page 23 of your
8 testimony.

9 A Let me finish my thought.

10 Q I'm sorry, I didn't mean to --

11 A I'm sorry --

12 Q Didn't know you weren't through.

13 A That you would not want to allocate those costs to
14 any one particular item within that, because they're not
15 caused by that particular product.

16 Q All right. Now, take a look at page 23 of your
17 testimony, if you will, and specifically lines 8 through 12.

18 A I have that section here.

19 Q Okay. And I think this is the section where you
20 refer to this concept of insuring that revenues for the
21 whole group of POL products or sold through the channel
22 anyway cover all costs including the advertising costs. And
23 actually let's just read that specifically into the record.
24 It says: The Postal Service should ensure that the
25 revenues, including postage, for the group of products sold

1 through the policy channel cover all costs including POL
2 advertising costs, but the revenues of any particular
3 product sold through the POL channel should not necessarily
4 have to cover any arbitrarily allocated POL advertising
5 costs.

6 And I guess my first question to you is, what is
7 the source of this requirement that you're referring to here
8 that the Postal Service should ensure that revenues for the
9 group of products cover all costs?

10 A The source of that is multifaceted. It is mostly
11 expounded in Dr. John Panzar's testimony in front of the
12 Postal Rate Commission in R97-1, but he expounded the
13 general principles of an incremental cost test and what the
14 proper pricing base should be for economically efficient
15 pricing.

16 Q Okay. And so the mechanism for ensuring that the
17 costs cover -- I'm sorry, the revenues cover the costs in
18 the way that you're referring to in lines 8 through 12 is
19 what? Through the markup?

20 A It's through the incremental-cost test, and what
21 that means is that in this particular example, you would
22 take the total revenues associated with the group of
23 products that are sold through the POL channel and compare
24 that to the total incremental costs, not volume variable,
25 but incremental costs, associated with that group as a

1 whole.

2 Q Okay. And have you --

3 A It's through the incremental-cost test that you
4 would ensure that. And the important reason why you want to
5 do that incremental-cost test is to ensure that none -- no
6 other postal products are cross-subsidizing these particular
7 products. The incremental-cost test is a cross-subsidy
8 test.

9 Q And if you're doing this particular analysis -- to
10 go back to Mr. Wiggins' question of where does the money
11 come from -- the money that will ensure that this
12 requirement is met comes from a combination of attributable
13 costs and whatever the overhead burden is that's allocated
14 to the specific products in this group of products.

15 Is that right?

16 A Again, you're getting into semantics associated
17 with attributable and what is attributable and what is not
18 attributable. I can tell you what those costs should be.
19 They should be all the volume-variable costs associated with
20 the particular products as well as the product-specific
21 costs associated with the group of products. And that may
22 not necessarily be equal to the sum of product-specific
23 costs associated with each individual product.

24 Q I see. So this particular equation doesn't
25 include institutional or overhead costs at all. You're

1 trying to just get to the cost base, which is then marked up
2 through the Panzar analysis that you're referring to?

3 A No, not at all. The --

4 Q Well, then I misunderstood your last answer.
5 Maybe you could tell it to me again.

6 A I want to set aside for a moment the issue of what
7 is marked up for pricing purposes, what constitutes
8 attributable cost, because there is debate amongst the
9 Postal Service and the Commission on that.

10 What I'm saying is very specific here, for the
11 incremental-cost test, you want to include all the
12 incremental costs associated with a group of products. That
13 may include volume-variable costs and product-specific costs
14 associated with the group of products.

15 Q All right. And I take it that it is accurate to
16 say that you haven't done that incremental-cost analysis in
17 your testimony here.

18 A That is correct.

19 Q All right. Now, you said something in testimony,
20 earlier you have referred to your understanding of the
21 Postal Service's ad campaign as being to advertise the
22 entire channel that is PostOffice Online. You know what I
23 am referring to?

24 A That generally characterizes my testimony.

25 Q Okay. And do I take it from that testimony that

1 at least a critical component of your assessment of whether
2 a cost should be allocated to a particular product is what
3 the Postal Service is intending to accomplish by the
4 advertising campaign?

5 A It is part of it but not the entire story.
6 Intention may be part of causality, but it is not all of
7 causality. What I want to say there is that causality is
8 the criteria for allocation.

9 Q Well, if the Postal Service, to flip its assertion
10 in this case, hypothetically where to say that we are
11 spending the same ad dollars, but our intention here is to
12 achieve a certain volume at Mailing Online and a certain
13 usage of the other products that are on PostOffice Online.
14 Would that affect your analysis of whether to allocate and,
15 if so, in what respect?

16 A Could you repeat that again? I just didn't --

17 Q I will try.

18 A Right.

19 Q If the Postal Service, instead of saying what it
20 has said, which, you characterize it as we are just trying
21 to advertise this channel, but not any particular product
22 and our advertising dollars would change at all if we
23 dropped Mailing Online, instead of that the Postal Service
24 comes in and says our ad dollars might stay the same, but we
25 are intending to increase the volume of Mailing Online, to

1 build the volume of Mailing Online and, also, at the same
2 time, to build a certain volume with the other products that
3 are offered on PostOffice Online, if that was their intent,
4 their stated intent, would that affect your analysis of
5 whether, and, if so, how much of the advertising cost to
6 allocate to one side or the other of this equation?

7 A I think -- I am sorry, I don't mean to be dense,
8 but I think I am starting to get your question. Is it that
9 if the Postal Service were to say we are not here to
10 advertise the channel, we are now here to advertise the
11 group of products under -- that are called Mailing Online --
12 or, sorry, the group of products specifically that may
13 include Express Mail, Priority Mail, Standard A and First
14 Class mail, would that change my conclusion?

15 Q I made it a little more specific than that, but
16 you are headed in the same general direction that I am
17 headed in. If their intention is to build volume of the
18 products that are offered through PostOffice Online, they
19 are not talking about we are just trying to advertise a
20 channel.

21 A Well, I certainly wouldn't call them volume
22 variable.

23 Q So, would it affect your analysis or not?

24 A What I would have to do in that situation, and it
25 is not the situation that we are facing right now, is

1 determine whether or not any particular product under that
2 overall channel were causing any of the particular
3 expenditures that were being made. So I would have to look
4 at that issue. So, I guess, in answer to your question, I
5 am not sure if it would change my analysis. What I am sure
6 is that I would have to go look back at the causality
7 arguments that I have presented before.

8 Q Okay. Now, you also spent a lot of time in your
9 testimony talking about the reasons for advertising
10 campaigns, and, in response to some questions from Mr.
11 Costich, you said that there really could be some reasons,
12 and there are apparently reasons for the Price Waterhouse
13 Coopers' brand name advertising that are independent of
14 generating business, and you referred specifically to
15 attracting employees.

16 A That could be one issue. What I am trying to get
17 at there is that there could be brand awareness and various
18 other things that I talk about in my testimony and before.

19 Q Well, you would agree, though, that brand
20 awareness in and of itself has -- it may not be as specific
21 as other types of targeted advertising, but its ultimate
22 objective is to increase sales, isn't it?

23 A Right. But I would have a very difficult time,
24 and ~~analysts~~ ^{analysts} who could purport to do this, I would view as
25 suspect, of trying to make a causal link between advertising

1 -- sorry, volume growth in any one particular product and
2 that advertising, if it is truly brand awareness
3 advertising, in a multi-product firm.

4 Q So your problem in allocating in that situation is
5 that you don't see any analytical way to tie the advertising
6 expense to any particular volume with all the different
7 products that might or might not increase volume as a result
8 of the campaign?

9 A What I would say is, is there a causal way to do
10 that?

11 Q Right.

12 A And certainly, in no circumstances, would I think
13 of it as the equivalent of volume variable cost or marginal
14 cost.

15 Q Okay. Let me go back to your testimony about one
16 purpose might be to a non-sales based purpose to -- would be
17 to hire or to attract employees. You don't have any reason
18 to believe that the ad campaign for Mailing Online is to
19 attract employees, do you?

20 A I have no reason to believe that. That's correct.

21 MR. BUSH: I have nothing further, Mr. Presiding
22 Officer.

23 COMMISSIONER LeBLANC: Is there any follow-up? I
24 believe we have a few questions from the bench. We started
25 on my right last time, we will move down to my left.

1 Commissioner Omas.

2 COMMISSIONER OMAS: I just have one question. You
3 know, you keep talking, and I know this has probably been
4 asked before, but if the PostOffice Online advertising costs
5 are reduced because Mailing Online has operational problems,
6 are not those cost reductions product-specific to MOL?
7 Like, you know, because of volume problems, they are not
8 doing L.A. and New York.

9 THE WITNESS: They may be associated with Mailing
10 Online, but I don't really have a good feeling for how they
11 should be allocated to Mailing Online.

12 COMMISSIONER OMAS: Well, wouldn't that be causal?
13 I mean that --

14 THE WITNESS: Well, I think, in general, what I am
15 trying to say is that, yes, it may be true that the
16 advertising costs associated with POL are caused by the
17 group of products which compromise -- sorry, which are sold
18 through the POL channel. As I said before, that includes
19 Mailing Online products of Standard A and First Class Mail,
20 and as well as, I think we talked about it before, the
21 Shipping Online products such as Express Mail and Priority
22 Mail and Delivery Confirmation. But it may not -- they are
23 not caused by any one particular product within that overall
24 channel. So, therefore, there is no good basis for
25 allocating those costs to any one particular product or

1 service.

2 COMMISSIONER OMAS: But you are not -- you have
3 pulled back your advertising because of volumes. Wouldn't
4 that necessarily be attributable to MOL? You keep talking
5 about causality. Isn't it the volume has caused your
6 advertising budget to be drawn back? So wouldn't that be --

7 THE WITNESS: It is a good question, which I
8 really haven't thought of, of a case where a product would
9 cause a reduction in the amount of advertising cost. I
10 think this is a particular problem that may or may not be
11 associated with MOL specifically. The hypothetical -- it
12 might be generally a problem with POL, I don't know exactly
13 how that -- what that problem was or what related that to
14 it. But it may not have been a specific MOL problem, it
15 might have been a problem of the entire POL system, I just
16 don't know.

17 COMMISSIONER OMAS: Thank you.

18 COMMISSIONER LeBLANC: Commissioner Covington, do
19 you have any questions?

20 COMMISSIONER COVINGTON: Yes, Mr. Presiding
21 Officer, I do.

22 Mr. Takis, I was noticing on page 24 of your
23 rebuttal testimony, you basically offered some thoughts and
24 views as it related to Witness Prescott's statement about
25 vertical integration and, I guess, overall, the supposed

1 impact that that was going to have on, you know, the Postal
2 Service. Now, when you looked at what it was Mr. Prescott
3 had to offer in his testimony, were you looking strictly as
4 it related to POL, MOL, ^{sol}~~EOL~~, or a combination of all three?

5 THE WITNESS: I was specifically looking at MOL,
6 Mailing Online.

7 COMMISSIONER COVINGTON: Okay. Specifically MOL.
8 Now, I have some information that has been made available to
9 me. Do you agree with the contention that whether or not a
10 firm integrates vertically usually depends upon operating
11 costs and efficiency, or is that something else that you
12 think that will go into the mix as far as this market test
13 is concerned?

14 THE WITNESS: Are you asking whether -- kind of a
15 hypothetical firm, why a firm might vertically integrate?

16 COMMISSIONER COVINGTON: Yes. Would it be more
17 cost related or would it have a lot more to do with what is
18 feasible?

19 THE WITNESS: It could be any number of reasons
20 why a firm, in general, might vertically integrate. It ^{could}~~cost~~
21 be cost, it could be trying to get cost advantages. It
22 might be to expand into new markets that that firm might not
23 be in. It could be any number of reasons. I guess in this
24 particular case, the Postal Service is moving into this
25 printing market through a contractual type of relationship

1 here, and I think that the reason why the Postal Service is
2 moving into that, into this market and trying to do that is
3 to serve a customer demand. There is a demand for this type
4 of service out there.

5 It also provides a very convenient and easy way
6 for the customers to access mailing services, First Class
7 mail and Standard A mail. It helps the small office, home
8 office market, I think, as Witness Garvey talks quite a bit
9 about in his testimony.

10 COMMISSIONER COVINGTON: So, in other words, it is
11 safe to assume that in the long run, depending on what the
12 recommendation is going to be from the Commission's point of
13 view, that if Mailing Online proceeds and goes forward, that
14 it could very well become as simple, like us going into
15 Safeway and buying a book of stamps, or could it be equated
16 to the discounts that the Postal Service gives to those
17 mailers, you know, who presort and make life easier?

18 THE WITNESS: I think that the goal -- again, I am
19 not the witness that is here to testify on what the goals of
20 Mailing Online service is, that is Witness Garvey's domain,
21 but I think that the goal, at least what I have read, is
22 that the Postal Service is trying to provide that ease of
23 use to its customers, and, therefore, it is a benefit to its
24 overall customers.

25 COMMISSIONER COVINGTON: Okay.

1 THE WITNESS: And particularly those within this
2 small office, home office market.

3 COMMISSIONER COVINGTON: Thank you, Mr. Takis.

4 COMMISSIONER LeBLANC: Commissioner Goldway.

5 COMMISSIONER GOLDWAY: Yes. Thank you. I
6 actually think your description of the PostOffice Online as
7 another form of window at the Post Office is interesting and
8 intriguing. I wish the Postal Service had presented that
9 concept earlier on, because it does change to some degree
10 one's thinking about the costs associated with the entire
11 program.

12 But I still think that we struggle with what
13 portions of certain costs are, in fact, caused by different
14 products. And you agree that at least some of these costs
15 should be directly allocated to those products, if you can
16 prove that they are caused by them. Is that your --

17 THE WITNESS: Absolutely. If you can prove
18 causality, then they should be allocated.

19 COMMISSIONER GOLDWAY: Okay. And here we are
20 talking about advertising, and I was shown -- I think the
21 Chairman, Commissioner LeBlanc has this material here which,
22 I don't know if you saw, but it is a public relations
23 packet, and it has a separate sheet for each product, one of
24 which is for Mailing Online.

25 So in my simple mind, it would seem to me that at

1 the very least, the cost for printing this sheet, as opposed
2 to all of the other sheets, since I don't know how many
3 thousands and thousands of copies, would have to be
4 something you would say, in terms of advertising, is
5 specifically related to Mailing Online.

6 I mean you couldn't say that, well, just because
7 they are going to have PostOffice Online advertising all
8 together, that this cost for printing this piece doesn't
9 directly belong to the Mailing Online cost.

10 THE WITNESS: I think I understand where you are
11 going, but I think I was speaking with Mr. Costich before
12 about this, but I am not sure exactly who I was speaking to
13 about it. What I am trying to get at there is that, yes,
14 there may be specific parts of an advertisement, like a
15 print ad or the brochure that you are talking about there,
16 which may refer to Mailing Online, and I think -- I did not
17 see specific advertisement which you are holding, but I have
18 seen other ones like it, or, really, the prints ads and the
19 direct mailing ads.

20 And, certainly, within those advertisements,
21 there's parts of it that talk about the Mailing Online
22 service in particular, as there is also sections that talk
23 about selling more Express Mail and Priority Mail through
24 Shipping Online. But what I am trying to get at is that,
25 really, the only way to allocate those costs is through some

1 arbitrary mechanism like the number of pages or the number
2 of words, or the actual space associated with it.

3 There is no real good mechanism for doing that.
4 And the reason why there is no good mechanism for doing that
5 is because there is no real causality when you are looking
6 at the overall ad campaign as a whole for PostOffice Online.

7 So what I was trying to get at in my previous
8 discussion was, when you are looking at these shared costs
9 which are shared across a group of different services,
10 unless you can develop a real good causal link, you
11 shouldn't allocate those costs directly to any one
12 particular product.

13 COMMISSIONER GOLDWAY: But you don't think that if
14 you had a mailing -- a publication kit that you were
15 presenting, and if you took away Mailing Online, you would,
16 in fact, have a smaller expenditure because you weren't
17 printing as many? Wouldn't the cost of that printing be
18 directly related to Mailing Online?

19 THE WITNESS: I agree with you 100 percent, if
20 that were to be the case. But as I have said before, the
21 Postal Service has said that it wouldn't change the way that
22 it presents its advertising, other than changing around the
23 words or taking out a piece of paper, as you are talking
24 about there. It wouldn't change the overall nature of the
25 advertising expenditure.

1 COMMISSIONER GOLDWAY: Well, I mean I don't know
2 quite how fine to tune the costs here, but it seems to me
3 that that is a clear cost. The other area where I think --
4 I have some questions, I know Commissioner Omas had
5 questions that related to Witness Garvey. But there is this
6 notion that Mailing Online is a part of the PostOffice
7 Online that is being phased in across the country.

8 And a network for printers is being built that's
9 separate from the window service of PostOffice Online, which
10 is a channel --

11 THE WITNESS: Right.

12 COMMISSIONER GOLDWAY: Through the Internet. But
13 there are actual real printers in different parts of the
14 country that are going to have to be hooked up. And the
15 advertising campaign as I understand it is a regional
16 campaign which builds on this notion of real printers in
17 real places being hooked up at different times, so I would
18 think that the costs to the extent you can distinguish them
19 between a regional campaign in these regional markets and
20 the timing of that versus some sort of generalized
21 nationwide campaign, that those costs that are directly
22 attributable to the regional qualifications and
23 characteristics of Mailing Online have to be part of Mailing
24 Online's costs.

25 THE WITNESS: I think I understand where you're

1 coming from, and I don't know the way the Postal Service is
2 rolling this out across regions. But I would be a little
3 bit concerned about that type of approach, in that the
4 advertising that may be going out to those regions is not
5 simply or may not simply be advertising Mailing Online, it
6 may also be advertising the various other products
7 associated with PostOffice Online. And again --

8 COMMISSIONER GOLDWAY: That's true.

9 THE WITNESS: And again acting as an overall
10 channel for it. So the timing of it may coincide with the
11 rolling out of Mailing Online to those particular regions,
12 but the nature of the advertising may not be different. And
13 I don't know the nature of that advertising, how it's going
14 to be rolled out across the country. But I would just
15 caution, if it is that way, I would caution the Commission
16 to think about it in those terms.

17 COMMISSIONER GOLDWAY: Okay. I don't have any
18 more questions at the moment. Thank you.

19 THE WITNESS: Thank you.

20 COMMISSIONER LeBLANC: Mr. Takis, let me just make
21 sure, just clarify for me if you can just a minute, what is
22 your definition of causality then? I mean, life is
23 interpretation.

24 THE WITNESS: I'm sorry?

25 COMMISSIONER LeBLANC: Life seems to be

1 interpretation. What is your definition of causality?

2 THE WITNESS: It's --

3 COMMISSIONER LeBLANC: Bottom line.

4 THE WITNESS: Right. And we had this discussion
5 with Mr. Costich before.

6 COMMISSIONER LeBLANC: Yes, but it's been battered
7 around --

8 THE WITNESS: I know.

9 COMMISSIONER LeBLANC: All morning and now half
10 the afternoon, it seems like.

11 THE WITNESS: And it's hard to define causality
12 without using the word causality. But --

13 COMMISSIONER LeBLANC: Well, try to be definitive
14 for me then and let's look at MOL.

15 THE WITNESS: Okay.

16 COMMISSIONER LeBLANC: And then if you will
17 broaden it, or you can bring it down. I don't care.

18 THE WITNESS: I think a good synonym for causality
19 is "created by." If a cost is created by the provision of a
20 particular service such as Mailing Online, then that cost
21 should be allocated to Mailing Online. Similarly, I could
22 say if a cost was caused by the provision of Mailing Online,
23 it should be allocated to Mailing Online.

24 COMMISSIONER LeBLANC: Excuse me for interrupting,
25 you say you, now is that an economic definition, or is that

1 your definition?

2 THE WITNESS: Of cause or causality?

3 COMMISSIONER LeBLANC: Yes.

4 THE WITNESS: I think --

5 COMMISSIONER LeBLANC: The reason I'm saying it is
6 I've got a friend of mine who heads up the economics
7 department at LSU, and he says Trey, you get five economists
8 in a room, you're going to have five different definitions.
9 So all I'm trying to do is find out what --

10 THE WITNESS: We'll all debate over cause. Right.

11 COMMISSIONER LeBLANC: What causality is here.

12 THE WITNESS: I use that term "created by." I
13 would say it is my definition here today, but I think it's
14 consistent with what an economist would think of as
15 causality.

16 COMMISSIONER LeBLANC: Let me change gears
17 slightly on you and pick up on what Commissioner Goldway was
18 talking about in this brochure that was picked up at one of
19 the trade shows here. There are one, two, three different
20 sheets in here. One deals, headline, Mailing Online, Q&A,
21 PostOffice Online, one click and it sorts all the other
22 clicks. Shipping Online, Post ECS 30-day trial. Basically
23 four, because one on both sides.

24 Now if you take the Mailing Online sheet out, am I
25 to understand you to say then that this is not specifically

1 part of this package? Is that what you're saying?

2 THE WITNESS: I don't quite understand your
3 question. I think it is part of that package, or it is if
4 it's in there.

5 COMMISSIONER LeBLANC: So if this package contains
6 one page then that is devoted strictly to Mailing Online,
7 are not the costs of that page product-specific to Mailing
8 Online?

9 THE WITNESS: Not necessarily, again, because if
10 that page were not there, the question is, would the Postal
11 Service have changed its advertising expenses? Would it
12 have included another page in there to advertise the
13 PostOffice Online in general? I don't know the answer to
14 that particular question.

15 If, Commissioner LeBlanc, if it were the case that
16 if that page were not there, and the Postal Service were to
17 decrease its advertising expenditures as a result, then I
18 would think of that cost as product-specific to that
19 particular product. But in this particular instance when
20 we're looking at the entire campaign of PostOffice Online, I
21 have to -- again I have to rely on what I've been told and
22 my general interpretation of having looked at the print
23 advertising and the analogy to a kind of a window or a
24 conduit to get to people.

25 What the Postal Service is telling me is that they

1 would not change their advertising expenditures in that
2 situation, and therefore they wouldn't be associated with --
3 sorry, they should not be allocated to any one particular
4 product.

5 COMMISSIONER LeBLANC: But now we're talking two
6 different -- well, possibly two different issues here.
7 You've got general advertising costs and you've got a
8 cost-specific or specific costs. Now you seem to be lumping
9 the two together, right? Is that -- that's in essence what
10 you're doing. I mean, as I appreciate what you just said.
11 Now correct me if I'm wrong.

12 THE WITNESS: Well, I think the Postal Service
13 thinks of this advertising as POL advertising, so it
14 includes all the various medium that we're talking about
15 here.

16 COMMISSIONER LeBLANC: So, correct me if I'm
17 wrong, then you are saying that even though this sheet is in
18 the package because of Mailing Online, and you're also
19 saying that this cost could be avoided if Mailing Online was
20 eliminated -- in effect that's what you're saying -- should
21 not the cost to that production of one page be considered
22 product-specific?

23 THE WITNESS: I agree, if that cost could be
24 avoided if Mailing Online were not to be offered, then
25 absolutely I agree with you 100 percent that those costs

1 should be allocated to Mailing Online. However, I don't
2 know. I don't know that's the case. And in general in
3 these print ads that we're talking about here, I don't know
4 that those costs would be avoided.

5 You also indicated -- I haven't had a chance to
6 look at that package --

7 COMMISSIONER LeBLANC: I'd be more than happy to
8 let you look at it. That would --

9 THE WITNESS: If you wouldn't mind, I'd like to
10 for a moment.

11 The other thing about this package is it also --
12 it's talking about Post ECS, which I don't know if that's
13 offered under PostOffice Online. Perhaps Witness Garvey
14 tomorrow would be able to tell you on that. But I guess --
15 it's hard for me to kind of take a look at a package and
16 tell you what's motivating that package or what's causing
17 the costs associated with that package.

18 For example, if, you know, if you were to take out
19 that one sheet that talks about Mailing Online, would it be
20 replaced with general advertising about the PostOffice
21 Online channel? I don't know. I can only go with what the
22 Postal Service has told me and purported in front of the
23 Commission.

24 COMMISSIONER LeBLANC: Thank you very much, Mr.
25 Takis.

1 Did the questions from the bench bring out any
2 other questions?
3 Mr. Costich?
4 BY MR. COSTICH:
5 Q Thank you, Mr. Presiding Officer.
6 Mr. Takis, are you familiar with the expression
7 ceteris paribus?
8 A Yes, I am.
9 Q Could you tell the Commission what that means?
10 A Generally I'm familiar with it the way an
11 economist might use it, which -- I think it means all else
12 being equal. So an economist might try to hold a number of
13 parameters constant and then look at the effects of changing
14 one parameter on a model or process or something like that.
15 Q All right. Let's take that brochure that
16 Commissioner LeBlanc and Commissioner Goldway were
17 discussing, and if we remove the MOL page, then isn't there
18 a cost reduction ceteris paribus?
19 A Not necessarily. That's what I'm saying.
20 Q Would you explain how, if you hold all other
21 things equal, you don't save money by throwing that page
22 out?
23 A Because it might be replaced with another thing.
24 Q That's not holding all other things equal. Please
25 hold all other things equal. Remove the page. You don't

1 print it at all. Right?

2 A And the brochure is sent out that way?

3 Q Yes.

4 A Then if the Postal Service were paying on a
5 per-page basis for developing and printing this
6 advertisement, then the costs would go down if they were to
7 eliminate it all else being equal. But what I'm trying to
8 say is that all else may not be equal.

9 Q But it's all else being equal that counts, isn't
10 it, when you're doing cost analysis?

11 A I think you're kind of going a little bit off on a
12 tangent here. What I'm saying is that in this -- in general
13 if this advertising -- if the advertising costs would not
14 change as a result of removing the entire product of Mailing
15 Online or the entire product of Express Mail or something
16 like that, then if the cost would not change, then none of
17 those costs should be allocable directly to any one
18 particular product.

19 It would be very similar -- we could be debating
20 this same issue if we were talking about the elimination of
21 Express Mail, for example. If Express Mail were to go away,
22 then would the advertising dollars associated with
23 PostOffice Online change? I don't know. According to what
24 I've been told, I don't think they would.

25 Q When you refer to the advertising expenditures not

1 changing, does that make any sense to you in the context of
2 this brochure where one page is removed and never printed?

3 A Again, I think I've -- you've asked that question
4 before, and I answered it just a moment ago. If you hold
5 all else equal and you were to get rid of this page, and
6 this was paid for on the basis of a per-page charge, then
7 the cost would go down as a result.

8 MR. COSTICH: Thank you. I have no further
9 questions.

10 COMMISSIONER LeBLANC: Any other followup?

11 Mr. Rubin, would you care for some redirect here?

12 MR. RUBIN: Yes, we'd like to talk it over.

13 COMMISSIONER LeBLANC: Fifteen minutes? Ten
14 minutes?

15 MR. RUBIN: Ten minutes should be fine.

16 COMMISSIONER LeBLANC: Well, we'll just stretch it
17 out to 15 and we'll come back at ten after the hour then.

18 [Recess.]

19 COMMISSIONER LeBLANC: Mr. Rubin?

20 MR. RUBIN: The Postal Service has no redirect,
21 thank you.

22 COMMISSIONER LeBLANC: Well then, there can be no
23 recross, as they say, re-follow up, et cetera, et cetera..

24 Well, thank you very much, Mr. Rubin.

25 Thank you, Mr. Takis. We appreciate your

1 appearance here today and your contributions to our record
2 and if there is nothing further, you are excused, sir.

3 THE WITNESS: Thank you very much.

4 COMMISSIONER LeBLANC: Before we get to the ending
5 here, Mr. Bush?

6 MR. BUSH: I have one matter in light of today's
7 proceedings I would like to raise and see where we might go
8 with it.

9 The Chair -- Mr. Presiding Officer, you had this
10 advertising brochure which we haven't seen, I haven't seen
11 anyway and hadn't seen before now and I am wondering if
12 there might be some mechanism for getting an update.

13 I do think there was an interrogatory, a document
14 request way back in the mists of time seeking examples of
15 advertising materials and it looks from the material that
16 you have that perhaps things have advanced well along the
17 way since that time. I am wondering if there is some
18 mechanism for getting an update of that so that we have a
19 more current version of the advertising materials that are
20 out there being used.

21 I think that might be of assistance to the parties
22 in trying to make a determination of some of the issues that
23 we have been discussing with Mr. Takis and that are inherent
24 in the case and also I hope would be of assistance to the
25 Commission itself.

1 COMMISSIONER LeBLANC: Are we talking about this
2 specific document here or are we talking about in general
3 here as far as all advertising materials are concerned?

4 MR. BUSH: Well, I would like to see the specific
5 document and it would be nice if we could make that a part
6 of the record in some fashion or at least make it available
7 in some fashion, but I really was talking more broadly.

8 I don't know what the current state of the
9 advertising campaign is, and there's a lot of arguments that
10 are being made here about how the advertising is really not
11 specific to any one product and would -- you know, the
12 expense wouldn't be changed if Mailing Online disappeared,
13 and I appreciate that the Chair has already found one piece
14 of advertising that looks like that may not be true and it
15 would be helpful to find out what some of the other
16 advertising is to see if this is systematic.

17 COMMISSIONER LeBLANC: Mr. Wiggins, do you care to
18 comment --

19 MR. WIGGINS: We --

20 COMMISSIONER LeBLANC: -- to Postal Service --

21 MR. WIGGINS: We did as in a fairly recent round
22 of interrogatories for the state of development of some
23 things that had been called "in development" and got a
24 storyboard for a video advertisement that they called a
25 cable advertisement. I guess I would like to know whether

1 that has proceeded past storyboard to a real video
2 production.

3 I inferred from something that Mr. Costich said
4 that there are also audio electronic advertisements. There
5 has been no reference at all to those in the proceeding and
6 I have not encountered any of them.

7 I think Mr. Bush's suggestion if the Commission is
8 amenable to it is a good one, that we ought just to get a
9 general update to the advertising materials that the Postal
10 Service has and is using.

11 COMMISSIONER LeBLANC: Before we move you to
12 Postal Service, Mr. Costich, got any comments?

13 MR. COSTICH: Yes. Let me just correct the
14 record. I have no personal knowledge of audio ads. I just
15 threw that in on the assumption that there would be some.

16 COMMISSIONER LeBLANC: Mr. Rubin, would you care
17 to comment for the Postal Service at this point or Mr.
18 Hollies?

19 MR. HOLLIES: Yes. I would like to comment. My
20 understanding is that the brochure which was the topic of
21 cross examination here earlier today has already been put in
22 play as an example of ads that we previously filed. As
23 such, assuming that counsel has reviewed the materials we
24 have filed previously, they have had an opportunity at least
25 to take a look at that.

1 Notwithstanding all of that, we do have a witness
2 scheduled for tomorrow whose knowledge about advertising for
3 PostOffice Online I believe exceeds that of all of the rest
4 of us, and I think that questions regarding what has
5 happened since we last reported could appropriately be posed
6 to him.

7 If we are left with questions after that testimony
8 then it might be ripe to take up this topic but at the
9 moment I think it would be premature.

10 We will take a look and try and verify whether the
11 brochure that was discussed earlier is in fact one of the
12 materials that we have previously provided. I recall it was
13 because I remember photocopying it, but we want to make
14 sure.

15 COMMISSIONER LeBLANC: I have not seen it, so if
16 you will double-check that for me, I could have missed it.
17 As we say, there's been a lot of paper but at this point I
18 think your idea might be amenable to Mr. Wiggins and Mr.
19 Bush possibly, unless you have some other idea.

20 MR. WIGGINS: No, I am absolutely amenable to
21 something that tells me this is everything.

22 I know I looked recently, like over the weekend,
23 at what I believed to have been all of the advertising
24 materials submitted and I didn't see that stuff.

25 MR. HOLLIES: You may be right. If we submitted

1 it, it was not in the full color version you see there.

2 MR. WIGGINS: No, I assumed that.

3 MR. HOLLIES: Okay, we will check it out.

4 COMMISSIONER LeBLANC: If you will, let's just
5 leave it that Postal Service will check that out. We have
6 Mr. Garvey coming tomorrow. Let me give some thought as to
7 what I want to do with this brochure if it is not in the
8 evidentiary record at this time, and I will try to rule on
9 that tomorrow, albeit early or late, depending on how it
10 falls, but we will see how Mr. Garvey comes out at the end
11 of the day, if that is amenable to everybody.

12 MR. WIGGINS: That is certainly agreeable to me.

13 COMMISSIONER LeBLANC: Good. Thank you,
14 gentlemen, for all your comments today. That concludes
15 today's hearing. We will resume tomorrow, Tuesday, March
16 30th, 1999, at 9:30 a.m. when we will receive the testimony
17 of Postal Service Witness Lee Garvey.

18 Thank you very much. This hearing is concluded.

19 [Whereupon, at 1:12 p.m., the hearing was
20 recessed, to reconvene at 9:30 a.m., Tuesday, March 30,
21 1999.]

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