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

POSTAL RATE AND FEE CHANGES, 2000 | Docket No. R2000–1

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS BERNSTEIN TO INTERROGATORIES OF UNITED PARCEL SERVICE (UPS/USPS–T41-2 - 6)

The United States Postal Service hereby provides the response of witness Bernstein to the following interrogatories of the United Parcel Service: UPS/USPS–T41-2 - 6, filed on March 15, 2000.

The interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorney:

Eric P. Koetting

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March 29, 2000

RESPONSES OF POSTAL SERVICE WITNESS BERNSTEIN
TO INTERROGATORIES OF UPS

UPS/USPS-T41-2. Refer to your testimony on page 43, where you indicated that "the response of the nonpostal firm to changes in" postal prices will be equal to zero when the nonpostal firm is operating in a market with marginal cost pricing. Confirm that the accuracy of this statement depends upon the assumption that marginal costs of production do not vary with the level of output. If you do not confirm, explain.

RESPONSE:

Confirmed. If the nonpostal firm's marginal costs vary with the level of output, then changes in postal prices can lead to a change in the nonpostal firm's price. For example, suppose the price of the postal product is increased, which leads to an increase in the volume of the nonpostal firm due to a cross-price effect. If the marginal costs of the nonpostal firm increase with volume, then the nonpostal firm may respond to the increase in the postal price by increasing its own price in response to an increase in its marginal costs.

UPS/USPS-T41-3. Refer to your testimony on page 46, where you state that "Private firms operating in competitive markets with free entry can be expected to be pricing at marginal cost." You there employ this statement to justify your focus on "the Ramsey model without cross-elasticities of nonpostal firms."

(a) Confirm that you are characterizing the markets in which the Postal Service, Federal Express, UPS, and other such delivery companies operate as "competitive markets with free entry." Provide a precise definition of "competitive markets with free entry," as you are using the term here.

(b) Provide all information that you have relied upon to conclude that nonpostal firms that provide products which are substitutes for products supplied by the Postal Service set prices equal to their marginal costs of production.

RESPONSE:

a. In my view, a competitive market with free entry is one in which above normal profits of existing firms would lead to entry of new firms. It appears to me that the package delivery market is such a market, as it consists not only of the Postal Service, Federal Express, and UPS, but also a number of smaller firms, many of them recent entrants to this growing industry. Among these other firms are Airborne, RPS, Emery, DHL, TNT, and Burlington Air Express, each of which have some share of the domestic package market. There are also a few regional delivery firms such as Eastern Connection and Night Owl Express which serve only certain local markets.

b. I have no information on the marginal costs of nonpostal firms that provide products which are substitutes for Postal Service products. However, the assumption that in a largely competitive industry, firms set prices equal to marginal costs seems quite reasonable, understanding that the marginal cost of private firm includes a normal return on investment. Prices above marginal cost would create an opportunity for a competing firm to "steal" business by offering a price closer to marginal costs. Moreover, it is well known that many private carriers offer discounted prices to select customers. Firms might charge above marginal cost prices for some customers, while charging prices equal to marginal cost to their most price sensitive customers, i.e., customers most likely to use a competing carrier if price is set above marginal cost.

RESPONSES OF POSTAL SERVICE WITNESS BERNSTEIN
TO INTERROGATORIES OF UPS

UPS/USPS-T41-4. Refer to your testimony on page 15, where you state that "postal rates must be set above marginal cost to generate revenues equal to total costs . . . "

(a) Provide all information you have relied upon to conclude that the same is not also true for competitors of the Postal Service. Include all documents and analyses which support this conclusion.

(b) If you do not have any such information, then explain why these suppliers "can be expected to be pricing at marginal cost" (USPS-T-41 at 46).

RESPONSE:

a. As I answered in UPS/USPS-T41-3, I have no detailed information about the cost structure of private firms competing with the Postal Service. Therefore, it is certainly possible that these firms have cost characteristics similar to the Postal Service, namely, the existence of common non-volume variable costs that cannot be assigned to individual products. However, it not clear that the degree to which this occurs for private competing firms will be the same as for the Postal Service. These firms have neither the scale (200 billion pieces of mail delivered each year, with delivery six days of week to every house and business in the nation) nor the scope (16 different subclasses of mail) of the Postal Service.

b. As I explained in my response to UPS/USPS-T41-3, it seems logical that in a largely competitive industry, firms would be pricing at marginal cost. This can occur either because marginal cost pricing in general yields a normal profit for the firm and competition prevents the firm from charging above marginal cost or because the firm selectively discounts its prices to some customers, thereby lowering price to marginal cost in cases where it faces the most competition.

RESPONSES OF POSTAL SERVICE WITNESS BERNSTEIN
TO INTERROGATORIES OF UPS

UPS/USPS-T41-5. Refer to your testimony on page 45, where you state that "Ramsey prices of postal products including rivalry could be less than the Ramsey prices when rivalry is not considered."

(a) Confirm whether this statement and the discussion in the first paragraph on page 45 is meant to indicate that Ramsey prices of postal products including the effects of rivalry from UPS, Federal Express, and other competitors are likely to be less than Ramsey prices when rivalry is not considered under the conditions that prevail in today's postal delivery industry.

(b) If so, define the precise sense in which you are using the term "likely," and provide a complete justification for your conclusion.

RESPONSE:

a and b. I do not say that the Ramsey pricing of postal products including the effects of rivalry is "likely" to be less than when rivalry is not considered. I merely state that under certain circumstances, the Ramsey price would be lower. Specifically, the discussion at page 45 considers the case in which 1) private firms are not pricing at marginal cost and 2) private firms respond to a change in the price of a competing postal product by changing their own price. In this case, a decline in the price of the postal product leads to a decline in the price of the non-postal alternatives. Since the price of these non-postal alternatives is assumed to be above marginal cost, a decline in their price moves the price closer to marginal cost. Since marginal cost pricing is most efficient for the economy, a decline in the price of the postal product leads to an increase in economic efficiency because it causes the competing firms to move their price closer to marginal cost. Thus, the Ramsey price of the postal product, taking account of the conditions in (1) and (2) discussed above, would be lower than if rivalry with competing firms were ignored.

RESPONSES OF POSTAL SERVICE WITNESS BERNSTEIN
TO INTERROGATORIES OF UPS

UPS/USPS-T41-6. Refer to your testimony on page 45, where you state, "Ultimately, the Ramsey prices of postal products are affected by cross-elasticities with nonpostal products only if the nonpostal firms are pricing above marginal cost."

(a) Confirm that equation 8(a) on page 42 of your testimony refutes this statement in cases where the price set by nonpostal firms increases with the price of the postal product (i.e., where $dP_2/dP_1>0$).

(b) Confirm that the price set by nonpostal firms can increase as the price of the postal product increases (so $dP_2/dP_1>0$) even when nonpostal firms set prices equal to their marginal costs of production.

(c) If you do not confirm (a) and (b), provide a detailed explanation.

RESPONSE:

a. Not confirmed. Looking at equation (8a), if the private firm is pricing at marginal cost, then all the other terms of the second part of the equation drop out due to multiplication by zero ($P_2 - M_2 = 0$). Therefore, the pricing rule is the same as it is without consideration of rivalry.

b. Confirmed. A nonpostal firm could respond to an increase in the postal price by raising its own price while still at pricing at marginal cost. This could occur if the increase in the postal price leads to an increase in the nonpostal firm's volume (through a cross-price effect) and the increase in volume leads to an increase in marginal cost. In that case, the firm would increase its price to match the increase in marginal cost. However, as I stated in (a), as long as the nonpostal price is equal to marginal cost, the Ramsey price of postal products will not be affected.

DECLARATION

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

Peter Bernstein

(Signed)

3/24/00

(Date)

CERTIFICATE OF SERVICE

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

E. P. Koetting

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