BEFORE THE
POSTAL RATE COMMISSION

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 2000 : DOCKET NO. R2000-1

ANSWERS OF UNITED PARCEL SERVICE WITNESS
DAVID E. M. SAPPINGTON TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE
(USPS/UPS-T6-18 through 52)
(June 30, 2000)

Pursuant to the Commission's Rules of Practice, United Parcel Service hereby files and serves the answers of UPS witness David E. M. Sappington to the following interrogatories of the United States Postal Service: USPS/UPS-T6-18 through 52.

Respectfully submitted,

John E. McKeever
William J. Pinamont
Phillip E. Wilson, Jr.
Attorneys for United Parcel Service

Piper Marbury Rudnick & Wolfe LLP
3400 Two Logan Square
18th & Arch Streets
Philadelphia, PA 19103-2762
(215) 656-3310
(215) 656-3301 (FAX)
and
1200 Nineteenth Street, NW
Washington, DC 20036-2430
(202) 861-3900
Of Counsel.

USPS/UPS-T6-18. Please refer to your testimony at page 11, lines 11-12, where you state that "such harm to competition and to captive customers should be avoided, and it can be avoided if rates are not systematically lowered as own-price elasticities rise." [footnote deleted]

Is it your testimony that rates have been "systematically lowered as own-price elasticities rise?" If so, please provide supporting evidence. If not, please confirm that this statement is simply a warning and is not meant to reflect on proposals put forth in this docket. If you do not confirm, please explain.

Response to USPS/UPS-T6-18.

No. My observation regarding the dangers of lowering rates systematically as own-price elasticities rise is best characterized as a general warning. However, the observation is motivated by my concern about the prominent role that the Postal Service appears to have afforded the own-price elasticity as a measure of value of service in this proceeding. Postal Service witness Mayes states that "Another way to look at value of service is by considering the degree to which usage of the service declines in response to price increases, indicative of what has been referred to as the economic value of service. . . . The lower (in absolute value) the own-price elasticity, the higher the value of service" (USPS-T-32, p. 5). Ms. Mayes identifies other indicators of service value. Therefore, she does not extend her systematic association of the own-price elasticity with the "economic value of service" to value of service more broadly defined. However, identification of the own-price elasticity as the "economic value of service" seems to suggest that the own-price elasticity is a reliable and common measure of value of service. As I explain in my testimony on page 9, there is no necessary relationship between own-price elasticity and value of service. Furthermore, to my knowledge, the term "economic value of service" as it is defined by Ms. Mayes is not employed in the economic literature.

USPS/UPS-T6-19. Please refer to your testimony at page 11, lines 17-18, where you state:

> "When high own-price elasticities are presumed to indicate low-value services and when lower rates are established for such services, the lowest rates will be set for those services that exhibit the highest own-price elasticities."

a. Is it your opinion that the rates proposed in this docket represent Ramsey prices? If so, please provide the basis for this opinion. If not, please confirm that this statement in your testimony is meant only as a warning and is not meant to reflect on proposals put forth in this docket.

b. Is it your understanding that the rates proposed in this docket relied solely on a mapping of low rates to high-elasticity products? If so, please provide the basis for this belief. If not, please confirm that this statement reflects only a hypothetical situation and represents a warning, and is not meant to reflect on proposals put forth in this docket.

c. Is it your understanding that the rate levels proposed in this docket were dependent solely on value of service considerations as measured by own-price elasticities, and that no other pricing criterion influenced the proposed rate levels? If so, please provide supporting evidence for this belief. If not, please confirm that this statement does not apply to the rates proposed in this docket.

Response to USPS/UPS-T6-19.

(a)-(c) No. Please see my response to USPS/UPS-T6-18.

USPS/UPS-T6-20. Please refer to your testimony at page 12, lines 3-4 where you state that "the mechanistic use of own-price elasticities as proxies for service value should be similarly rejected."

a. What alternate measure of service value should be used?

b. Please confirm that the "mechanistic use of own-price elasticities for service value" was not proposed in this docket.

Response to USPS/UPS-T6-20.

(a) Alternative indicators of service value include those described in my testimony on pages 31-33 and in my response to interrogatory USPS/UPS-T6-9(b).

(b) Confirmed. Please see my response to USPS/UPS-T6-18.

USPS/UPS-T6-21. Please refer to your testimony at pages 17-18 where you state that "the Commission has not yet adopted any such estimates [of incremental cost]" and "[o]nce the Commission is presented with incremental cost estimates..." Have you read the testimonies of Postal Service witnesses Bradley and Kay in this docket? If not, please state why you did not. If so, please confirm that they provide the Commission with incremental cost estimates.

Response to USPS/UPS-T6-21.

I have read the testimonies of Postal Service witnesses Bradley and Kay. Confirmed that they provide the Commission with incremental cost estimates.

USPS/UPS-T6-22. Please refer to your testimony at page 19, lines 2-3 and explain how your recommendation of a higher cost coverage is consistent with "the Commission's long-standing emphasis on protecting users of monopoly mail services." [footnote omitted]

Response to USPS/UPS-T6-22.

As I explain in my response to USPS/UPS-T6-4(b), my testimony at page 19, lines 2-3, refers to the Commission's emphasis on protecting users of First Class Mail, the class of mail with the greatest number and proportion of letter monopoly mail users and the "only class of mail which the general public uses." S. Rep. No. 912, 91st Cong., 2d Sess. (1970) at 13. By setting a higher cost coverage for Priority Mail than for First Class Mail, the Commission can employ the extra contribution generated by Priority Mail to limit the rate increases it might otherwise be compelled to impose on First Class Mail users.

USPS/UPS-T6-23. Please refer to your testimony at pages 18-19, section IV.B. Please provide the percentage rate increases for Priority Mail for the rate cases "prior to R97-1" to which you refer.

Response to USPS/UPS-T6-23.

The average rate increases for Priority Mail that were implemented as a result of rate cases R84-1, R87-1, R90-1, R94-1, and R97-1 were 0%, 0%, 19%, 4.8%, and 5.6%, respectively. See Table 2 in USPS-T-34, p. 7.

USPS/UPS-T6-24. Please refer to your testimony at page 18 where you state that the rate increase you have proposed "represents a cost coverage of 176% and a markup...of 76%, which is the same markup that the Postal Service proposes for First Class Mail in this case." Please provide the basis for your representation that the Postal Service is proposing a markup of 76% for First-Class Mail in this case.

Response to USPS/UPS-T6-24.

Using its costing procedures, the Postal Service's proposed markup for First Class Mail is 95.3%, and the corresponding markup index for First Class Mail is 1.395. My recommendation is to implement for Priority Mail the same markup index (and thus the same markup) that is implemented for First Class Mail. Taking 1.395 as the relevant markup index and using the Commission's costing procedures, a 76% markup for Priority Mail and First Class Mail ensures that they each have a markup index of 1.395. That is because the systemwide markup is 54.5% under the Postal Service's proposed rates, using the Commission's costing procedures (and because 76/54.5 = 1.395). See UPS-Luciani-WP-3-1.6.

Perhaps my testimony would have been more clear on this point had I stated in the sentence you cite that my recommended rate increase represents "a markup . . . of 76%, which provides the same markup index that the Postal Service proposes for First Class Mail in this case" (changes underlined). Thus, an errata to my testimony will be issued to clarify my recommendation that Priority Mail have the same markup index that the Postal Service is proposing for First Class Mail, and that a 76% markup for both

Priority Mail and First Class Mail will ensure that they achieve a markup index of 1.395. As indicated, the errata will change the phrase "is the same markup" on page 18 at line 15 with the phrase "provides the same markup index." The explanation provided above is also intended to clarify similar statements in my testimony on page 20, lines 14-17, and on page 37, line 14, through page 38, line 2.

USPS/UPS-T6-25. Please refer to your testimony at page 34, lines 3-11, where you describe the application of § 3622(b)(4) to First-Class Mail. Please provide the quantitative impact of the application of criterion 4 on the markup for First-Class Mail.

Response to USPS/UPS-T6-25.

I have not assigned a precise numerical representation to each of the criteria in 39 U.S.C. § 3622(b) for all mail subclasses. Thus, I cannot provide the quantitative impact you request. Qualitatively, though, 39 U.S.C. § 3622(b)(4)'s concern with the effect of rate increases on the general public and on competitors suggests that a higher markup is appropriate for Priority Mail than for First Class Mail, ceteris paribus, because of the Postal Service's letter monopoly. Please see my response to USPS/UPS-T6-4.

USPS/UPS-T6-26. Please refer to your testimony at page 37, lines 5-8, where you state: "That migration [of Priority to First-Class Mail] has reduced Priority mail volume. The reduced volume implies that a larger rate increase is required to generate enough extra revenue to offset any given increase in attributable costs, ceteris paribus." Please confirm that this is only true for non-volume variable costs. If you do not confirm, please explain.

Response to USPS/UPS-T6-26.

Not confirmed. Reduced volume will certainly imply that a larger rate increase is required to generate enough extra revenue to offset any given increase in costs that are not volume variable, as you indicate. Reduced volume may also require a larger rate increase to generate enough extra revenue to offset an increase in volume variable costs.

To see why, consider the simple case where all costs are volume variable. Also suppose that there are initially no economies or diseconomies of scale, so that unit volume variable costs remain consistent with volume. In this case, the same rate -- a rate equal to the unit volume variable cost -- will generate the revenues required to cover costs, regardless of the level of volume. Now suppose that unit volume variable costs increase at all volumes, and that they increase more for low volumes than for high volumes. The result is that unit volume variable costs will now decrease as volume increases. In other words, scale economies will now be present. In the presence of scale economies, unit (i.e., average) costs of production increase as volume declines.

Consequently, a reduction in volume will necessitate a higher rate in order to offset the higher unit costs that result from the lower volume.

USPS/UPS-T6-27. Please confirm that you are recommending that the rate increase for Priority Mail exceed the increase in costs since Docket No. R97-1.

Response to USPS/UPS-T6-27.

Confirmed. As explained on page 38 of my testimony, though, the rate increase that I recommend constitutes a 48% cumulative rate increase since R94-1, which is far less than the 134% increase in Priority Mail's attributable costs since R94-1.

USPS/UPS-T6-28. Please refer to your testimony at page 38, lines 11-14, where you state: "if convincing evidence to the contrary arises which demonstrates that the recommended 40.3% rate increase would unduly affect Priority Mail users, then some further mitigation of the rate increase might be appropriate."

a. Please provide your estimated TYAR volume for Priority Mail, given your recommended rate increase.

b. Please define "unduly affect" as used in this section of your testimony.

c. Please confirm that the long-run own-price elasticity for Priority Mail as presented by Dr. Musgrave in this docket is –0.819. If you do not confirm, please provide the correct figure.

d. What percent decline in Priority Mail volume would you consider to represent a result indicating the rate increase "unduly affected" Priority Mail?

e. What would represent to you "convincing evidence" that the rate increase you propose would "unduly affect" Priority Mail?

f. What should be the goals of such "further mitigation"?

Response to USPS/UPS-T6-28.

(a) 1,070,173,000 pieces, as reported in Table 6 on page 36 of my testimony as revised on June 22, 2000.

(b) As I use the term on page 38 of my testimony, "unduly affect" means to impose severe economic hardship on Priority Mail users.

(c) Confirmed.

(d)-(e) There is a difference between an effect on Priority Mail users, and an effect on Priority Mail. In any event, I do not have a threshold percent volume decline in mind. A volume decline is not the only relevant measure of whether Priority Mail users would be unduly affected by the recommended rate increase. Credible evidence that Priority Mail users do not have ready access to alternative suppliers and so would suffer severe economic hardship if the recommended rate increase were implemented would also be relevant to consider. Careful econometric work which demonstrated that the recommended rate increase would cause Priority Mail's contribution to institutional costs to decline rather than to increase would also provide convincing evidence that Priority Mail, its users, and other mail users would be unduly affected by the recommended rate increase.

(f) The primary goal of further mitigation should be to prevent erosion of the contribution to institutional costs that Priority Mail provides.

USPS/UPS-T6-29. Please confirm that the rate levels you have proposed for Parcel Post and Priority Mail have been proposed outside of the context of a set of rate levels designed to achieve financial breakeven in the test year. If you cannot confirm, please provide a complete set of cost coverage proposals designed to achieve financial breakeven.

Response to USPS/UPS-T6-29.

Confirmed.

USPS/UPS-T6-30. Please refer to your testimony at page 42, line 6, where you refer to "the extremely low cost coverage that Parcel Post has had in recent years." To which years are you referring? Please provide the cost coverages for each of those years to which you refer, and indicate whether such measurement of the cost coverage was before or after the revision of the RPW data for additional Parcel Post volume and revenue.

Response to USPS/UPS-T6-30.

The "extremely low cost coverage" that I mention on page 42 of my testimony refers to the cost coverages that the Commission recommended for Parcel Post in R94-1 and R97-1, rather than to the actual cost coverages realized in the ensuing years. The Commission recommended a 107.4% cost coverage for Parcel Post in R94-1, and a 108.0% cost coverage for Parcel Post in R97-1. See Opinion and Recommended Decision, Docket No. R97-1, Appendix G, Schedule 3.

USPS/UPS-T6-31. Please refer to your testimony at page 43, lines 6-7, where you state: "in practice, revenue and cost forecasts can diverge substantially from actual levels of revenue and cost." Please confirm that such divergences may be in either direction. If you cannot confirm, please explain fully.

Response to USPS/UPS-T6-31.

Confirmed. Actual levels of revenue and cost can either exceed or fall short of forecast levels. However, even if over-estimates and under-estimates occur symmetrically, their ramifications can be asymmetric. In particular, when actual revenues from a service fall short of forecast revenues and when the actual costs of the service exceed forecast costs, the service may fail to bear its attributable costs, contrary to the requirement specified in 39 U.S.C. § 3622(b)(3). Cost coverages that are substantially above 100% based upon forecast revenues and costs can help to avoid such outcomes.

USPS/UPS-T6-32. Please refer to your testimony at page 43, lines 9-10, where you state: "revenue below attributable cost is inconsistent with § 3622(b)(3) of the Act." Is it your interpretation of the Act that criterion 3 refers to each and every year, or to the estimates upon which the Postal Rate Commission recommends test year rates and fees?

Response to USPS/UPS-T6-32.

I believe that the intent of the Postal Reorganization Act is to preclude situations in which the revenues derived from a mail subclass fall below the sum of its attributable costs and a reasonable share of institutional costs on an annual basis. In my opinion, the intent of the Act would not necessarily be violated if the realized cost coverage for a mail subclass fell minimally below 100%, but did so very infrequently (e.g., once in a ten year period).

USPS/UPS-T6-33. Please refer to your testimony at page 43, lines 14-15, where you state: "with only two exceptions, Parcel Post revenues have fallen short of attributable costs in every year between FY1989 and FY1997." If the additional volume of Parcel Post indicated by the revised RPW data is incorporated for each of those years, for how many of those years to which you refer is Parcel Post revenue below attributable cost?

Response to USPS/UPS-T6-33.

I am not aware of any revised Parcel Post RPW data for years prior to FY 1998, so I am not in a position to answer this question.

USPS/UPS-T6-34. Should the Commission fail to adopt the cost revisions suggested by witness Luciani, is it still your position that the appropriate cost coverage for Parcel Post be 111%, lower than the cost coverage proposed by the Postal Service in this docket?

Response to USPS/UPS-T6-34.

No. If the Commission fails to adopt the cost revisions recommended by UPS witness Luciani, the 111% cost coverage that I recommend in my testimony should be increased. As I indicate on page 46 of my testimony, "A more substantial markup [for Parcel Post] would be appropriate, if not for the large increase in Parcel Post's attributable costs since R97-1." The exact magnitude of the appropriate increase in the cost coverage for Parcel Post would depend upon the Commission's assessment of the increase in Parcel Post's attributable costs since R97-1.

USPS/UPS-T6-35. Please confirm that the Postal Service's proposed cost coverage of 114% for Parcel Post would also "reduce the likelihood of violating § 3622(b)(3) of the Act and of disadvantaging competitors and other mail users unfairly, without burdening Parcel Post mailers unduly (§ 3622(b)(4))." [UPS-T-6 at page 44]

Response to USPS/UPS-T6-35.

Confirmed.

USPS/UPS-T6-36. Please confirm that the average delivery time of "less than four days" for Parcel Post is due in part, or in large part, to mailer participation in dropship workshare programs in which mailers provide some portion of transportation prior to entering the packages as Parcel Post. If you cannot confirm, please explain fully.

Response to USPS/UPS-T6-36.

I do not have the information that is required to confirm or not confirm this statement, although it seems reasonable.

USPS/UPS-T6-37. In your opinion, does criterion 4 encompass cumulative rate increases, i.e., rate increases from previous and recent cases in addition to the proposed rate increase from the current docket? Please explain.

Response to USPS/UPS-T6-37.

Criterion 4 (39 U.S.C. § 3622(b)(4)) directs the consideration of the effects of proposed rate increases on mailers and private suppliers of delivery services. To the extent that previous rate increases influence the likely effects of proposed rate increases, the previous rate increases merit consideration.

USPS/UPS-T6-38. Please confirm that the long-run own-price elasticity for Parcel Post as presented by Dr. Tolley in this docket is –1.23, the second highest own-price elasticity presented in this case. If you cannot confirm, please provide the correct figure.

Response to USPS/UPS-T6-38.

Confirmed.

USPS/UPS-T6-39. Refer to Table 6 of your testimony at page 36. Please provide appropriate citations and all calculations and data inputs used to calculate "Average Annual % Change in Real Attributed Cost per Piece."

Response to USPS/UPS-T6-39.

The calculations and data inputs required to derive the "Average Annual % Change in Real Attributed Cost Per Piece" are presented below. All relevant citations and explanations of the calculations are provided in footnotes 45, 46, and 47 of my testimony, on pages 35-37.

Calculation of the Average Annual % Change in

Priority Mail's Real Attributed Cost per Piece

Rate Case	Test Year Estimated Volume (000 Pieces)	Test Year Attributed Cost ($ 000)	GDP Implicit Price Deflator Conversion Factor*	Real Test Year Attributed Cost (1981 $ 000)**	Real Test Year Attributed Cost per Piece	Average Annual % Change in Real Attributed Cost per Piece
R80-1	237,720	465,774	1.000	465,774	1.96	
R84-1	296,017	462,436	0.831	384,284	1.30	- 8.4
R87-1	394,781	712,925	0.768	547,526	1.39	2.3
R90-1	518,458	1,002,899	0.683	684,980	1.32	- 1.7
R94-1	762,115	1,401,597	0.622	871,793	1.14	- 3.4
R97-1	1,058,687	2,419,687	0.591	1,430,035	1.35	6.1
R2000-1	1,070,173	3,288,724	0.563	1,851,552	1.73	9.4

* The conversion factor is the ratio of the GDP Implicit Price Deflator in the first quarter of calendar year 1981 to the Deflator in the first quarter of the calendar year following the year of the rate case (e.g., 1998 for R97-1). The Deflators for 1981, 1985, 1988, 1991, 1995, 1998, and 2001 are 60.66, 73.00, 78.98, 88.76, 97.45, 102.62, and 107.76, respectively.

** Real test year attributed cost is the product of test year attributed cost and the relevant conversion factor.

USPS/UPS-T6-40. Refer to Docket No. R97-1, PRC Lib Ref - 12 at page 22.

a. Confirm that the Postal Rate Commission's estimated Priority Mail volume in the Test Year After Rates are reduced by 107,352 (000) pieces as a result of the recommended classification change increasing the maximum weight for First-Class Mail from 11 ounces to 13 ounces. If not confirmed, please explain fully.

b. Confirm that the Postal Rate Commission's estimated Priority Mail costs in the Test Year After Rates are reduced by $190,238.7 (000) as a result of the recommended classification change increasing the maximum weight for First-Class Mail from 11 ounces to 13 ounces. If not confirmed, please explain fully.

c. Confirm that the Postal Rate Commission's estimated Priority Mail revenues in the Test Year After Rates are reduced by $353,526.4 (000) as a result of the recommended classification change increasing the maximum weight for First-Class Mail from 11 ounces to 13 ounces. If not confirmed, please explain fully.

d. Do you agree that the change in Priority Mail cost per piece in your Table 6 from the Docket No. R94-1 test year to the Docket No. R97-1 test year, in part, reflects the PRC Docket No. R97-1 recommended change in the maximum weight for First-Class Mail from 11 ounces to 13 ounces? If not please explain fully.

Response to USPS/UPS-T6-40.

(a) - (c) Confirmed.

(d) Yes.

USPS/UPS-T6-41. Please refer to page 9 of your testimony, where you assert that own-price elasticity of demand is "an imperfect measure of value in part because demand is influenced by many factors other than price." Please confirm that the estimates of own-price elasticity of demand utilized in postal ratemaking are derived from statistical procedures which are explicitly designed to take account of and control for the factors other than price which influence changes in demand. If you cannot confirm, please explain fully.

Response to USPS/UPS-T6-41.

Although I have not thoroughly studied the procedures the Postal Service uses to measure own-price elasticity, they appear to be designed with the intent to control for factors other than price which influence changes in demand. However, the fact that determinants of demand other than own price are held constant when estimating an own-price elasticity does not imply that own-price elasticities measure value perfectly. As I explain on page 9 of my testimony, even if volume declines substantially when the price of a service is increased, customers may value the service highly. The reduction in volume may arise because the price increase forces customers with limited economic resources to reduce their use of the service, even though they cherish the service dearly.

USPS/UPS-T6-42. Please refer to the following passage from page 9 of your testimony:

> Therefore, even if the demand for a service declines substantially as its price increases, customers may value the service highly. To illustrate this fact, notice that a price increase may force customers with limited wealth to reduce their usage of a service substantially even though they cherish the service dearly.

a. Please confirm that if customers are faced with comparable price increases in all of the postal services they use, the services of which they reduce their usage most substantially are the ones that they cherish least dearly. If you do not confirm, please explain fully.

b. Please confirm that to whatever extent demand for a service declines as its price increases, customers who are no longer purchasing the service value the services or products they consume instead more than they value the service that they have chosen to forgo. If you do not confirm, please explain fully.

c. When you used the term "may" in the first of the above quoted sentences, did you more nearly mean to imply that customers "are likely to" value the service highly, or that customers "conceivably might" value the service highly? Please explain.

d. If "the demand for a service declines substantially as its price increases," the reported own-price elasticity for that service will be relatively high. Of the postal services with relatively high own-price elasticities (see USPS-T-41 at page 11 for the own-price elasticity for each subclass), which do you believe have such relatively high price elasticities because "customers with limited wealth" have been forced to reduce their usage substantially "even though they cherish the service dearly." Please explain the basis for your answer fully.

Response to USPS/UPS-T6-42.

(a) Not confirmed. Mailers do not necessarily reduce their usage of the services that they value least highly as the prices charged for postal services rise. To illustrate this fact, consider the following example.

Suppose that a mailer has one indivisible item to send, and that she has $10 to spend on postal services. The mailer places a monetary value of $100 on service A and a monetary value of $50 on service B. (The higher monetary value that she places on service A may arise because service A provides faster delivery, for example.) Initially, the price of service A is $10 and the price of service B is $5. At these prices, the mailer sends her item via service A, and derives a net monetary value of $90 from doing so (as opposed to the net monetary value of $45 she would have derived from sending the item via service B).

Now suppose that the price of each service rises by 20%, so that service A now costs $12 and service B now costs $6. The mailer can no longer afford the service she values most highly, service A. Consequently, she decreases (to zero) her use of the most preferred service (A) and increases her use of the less-preferred service (B).

This simple example helps to illustrate and explain the more general fact that mailers do not necessarily reduce their usage of the services that they value least highly as the prices charged for postal services rise.

(b) Not confirmed. The example presented in part (a), above, illustrates the more general fact that when rate increases induce customers to switch services, they do not necessarily value the service they consume more than the service they chose to forego. In the example, the mailer places a higher monetary valuation ($100) and a higher net monetary valuation ($88 = $100 - $12) on service A than on service B. However, the combination of rate increases and financial constraints compel the mailer to purchase service B.

(c) The word "might" could reasonably be substituted for the word "may" in the sentence you cite. The word is not intended to suggest any empirical estimate (in contrast to the phrase "are likely to" that you suggest).

(d) I do not have the data that would allow one to identify the determinants of measured own-price elasticities. However, the testimonies of witnesses Smith (AISOP-T-1) and Horton (CRPA-T-2) suggest that financial considerations can force mailers to curtail their use of mail services that they value highly.

USPS/UPS-T6-43. Is it your testimony as an economist that an adequate evaluation of the value of a service can exclude all consideration of the presence or absence of effective competition for that service? If not, please explain the exact relationship that exists between value of service and the presence or absence of effective competition.

Response to USPS/UPS-T6-43.

I assume that you are asking whether it is possible to fully assess "the value of the mail service actually provided each class or type of mail service" as directed by 39 U.S.C. § 3622(b)(2) without considering the presence or absence of competitive alternatives.

There are at least two plausible interpretations of the term "value of service": gross value of service and net or incremental value of service. The gross value derived from a service is the value the service provides in isolation, independent of the value provided by other services. The net or incremental value of service is the additional value that a service provides above and beyond the value provided by the next-best alternative.

To illustrate the distinction between gross value of service and incremental value of service, suppose there are only two mail services, labeled A and B. Suppose further that the value of a service can be measured accurately by willingness to pay for the service. In addition, suppose an individual would be willing to pay $10 for mail service A if that service were the only means of sending mail. Also suppose the individual would be willing to pay $8 for mail service B if it were the only mail service available. In this simple setting, the individual assigns a gross value of $10 to service A and a gross value of $8 to service B. Each of these (gross) valuations is derived without considering the value of alternatives. In contrast, the individual in this setting assigns an incremental value of $2 (= $10 - $8) to service A, and an incremental value of $-2 (= $8 - $10) to service B. Each of these (incremental) valuations is derived by considering the value of a service relative to the value of the alternative service.

Problems can arise if one relies exclusively on either the gross or the incremental measures of service value to set prices for postal services in order to reflect value of service. Exclusive use of the gross value of service can promote a pricing structure that allows competitors with higher costs than the Postal Service to serve customers by setting prices below the relatively high prices that are established for services with a high gross value of service. When customers are served by competitors rather than the Postal Service, the Postal Service loses some potential contribution to institutional costs, and so rates for users of monopoly postal services may have to be increased.

Exclusive use of the incremental value of service, in contrast, can protect the Postal Service unduly from competition and thereby discourage innovation and entry in the postal industry. When competitors improve their products, the incremental value of products offered by the Postal Service declines, *ceteris paribus*. Therefore, if Postal Service prices are allowed to decline toward incremental cost as competitors improve their services, three undesirable effects can arise. First, competitors may be discouraged from improving their services. Second, the Postal Service may be encouraged to choose an inefficient production technology that secures low incremental costs on competitive services at the expense of incurring higher institutional costs (as explained on page 11 of my testimony). Third, more efficient competitors may be driven from the market or may produce less than they otherwise would, thereby increasing industry costs and reducing customer welfare.

More efficient competitors may be driven from the industry or otherwise harmed even when Postal Service rates exceed measured attributable costs and even when the Postal Service has not adopted a production technology with inefficiently low incremental costs of providing competitive services and inefficiently high institutional costs. There are at least two reasons for this conclusion. First, as explained on pages 15-17 of my testimony, attributable costs, as measured in these proceedings, systematically understate incremental costs whenever unit volume variable cost (i.e., marginal cost) declines as output expands. Therefore, even if the price of a Postal Service product exceeds its per unit attributable cost, the price may still be below the relevant per unit incremental cost. Such a price can make it unprofitable for a more efficient competitor to operate, because even though the competitor's incremental cost may be less than the Postal Service's incremental cost, the competitor's incremental cost may exceed the Postal Service's attributable cost, and thus the price set for the Postal Service's product.

Second, as explained in footnote 14 of my testimony on page 14, the Postal Service enjoys many artificial advantages over its competitors because of its status as a public enterprise. The Postal Service is exempt from many of the taxes, fees, and regulations that its competitors face. The Postal Service also enjoys privileged access to the United States Treasury and is not compelled to deliver dividends and capital gains to shareholders. Consequently, the Postal Service may face lower incremental costs than its competitors not because it is a more efficient producer, but because it is not required to incur and record the costs that its competitors must.

In summary, there are potential drawbacks to focusing exclusively on either the gross or the incremental value of service when attempting to assess "the value of the mail service actually provided each class or type of mail service" as directed by 39 U.S.C. § 3622(b)(2). Consequently, it is advisable to consider both the gross and the incremental value of service.

USPS/UPS-T6-44. Is it your testimony as an economist that an adequate evaluation of the value of a service can exclude all consideration of the responsiveness of the demand for the service to changes in the price of the service, whether measured by own-price elasticity of demand or in some other fashion? If not, please explain the exact relationship that exists between value of service and the responsiveness of the demand for the service to changes in its price.

Response to USPS/UPS-T6-44.

Use of the term "exact relationship" suggests that there is a systematic, general relationship between value of service and own-price elasticity of demand. That is not the case. A higher own-price elasticity can be associated with either a higher or a lower value of service. The example presented in my response to USPS/UPS-T6-42 can help to explain why this is the case. In that example, use of the most highly-valued service declines sharply as its price increases. Therefore, a high (gross) value of service is associated with a high own-price elasticity in that example. More generally, consumers may judge a service to provide little (gross or incremental) value, and so may reduce their use of the service substantially as its price increases. In such cases, low value of service is associated with a high own-price elasticity.

Using the own-price elasticity as a measure of value of service in order to fulfill the directive of 39 U.S.C. § 3622(b)(2) introduces a further complication (in addition to the complications identified in my response to USPS/UPS-T6-43). The further complication is a circularity in the rate-setting process. 39 U.S.C. § 3622(b)(2) directs that value of service be considered when formulating a rate recommendation. In general, the own-price elasticity of demand for a service varies as the price of the service varies. Therefore, if the own-price elasticity is used to measure the value of a service, the price that is ultimately set for the service will influence its measured "value" (i.e., the own-price elasticity of demand). Consequently, when own-price elasticity is employed as a proxy for value of service, the price that is established for a service can (at least in part) determine its value, rather than (or in addition to) having the value of service determine the appropriate price, as 39 U.S.C. § 3622(b)(2) directs. At a minimum, this circularity complicates the rate design exercise.

Despite the many difficulties that it introduces, the own-price elasticity may provide some information about service value, and so should not be ignored when attempting to assess value of service in accordance with the directives of 39 U.S.C. § 3622(b)(2) . However, if the own-price elasticity is used for this purpose, it should be considered as only one of many potential indicators of service value. Furthermore, the drawbacks and complications inherent in the use of the own-price elasticity as an imperfect indicator of service value should be explicitly recognized, and always kept in mind.

USPS/UPS-T6-45. Please refer to page 10 of your testimony, where you caution against protecting the Postal Service from "effective competition."

(a) Do you believe that the Commission should be concerned about protecting the Postal Service from ineffective competition, where ineffective competition is defined as a situation in which the Postal Service is the low-cost provider of service, but imposition of a share of institutional costs above a certain level may allow higher-cost providers to undersell the Postal Service and deprive the Postal Service's remaining customers of the contribution to institutional costs that could otherwise be obtained and used to lower their rates? Please explain fully.

(b) Do you believe that the Commission, in determining what share of institutional costs is reasonable for any particular service, should attempt to take into consideration the possibility that imposition of a share of institutional costs above a certain level may facilitate ineffective competition, as defined in subpart (a)? Please explain fully.

(c) Do you believe that concerns about ineffective competition as defined above could appropriately cause the Commission to decide that a lower share of institutional costs for a particular subclass is reasonable under the criteria of the Act than might otherwise be the case in the absence of such concerns? Please explain fully.

Response to USPS/UPS-T6-45.

(a) This question is difficult to answer because the term "low-cost provider" is not defined. In the present context, it matters whether the Postal Service has lower costs than competitors because of the artificial advantages it enjoys due to its status as a public enterprise. (Please see footnote 14 on page 14 of my testimony.) If, after eliminating the Postal Service's artificial advantages, it has lower costs than its competitors, then, as indicated in my answer to USPS/UPS-T6-43, the Commission should (and, I am sure, does) consider the possible loss of contribution that may occur when Postal Service rates are increased.

Note, however, that higher rates do not necessarily translate into lower contribution. Higher rates can increase revenues and reduce costs, and thereby increase contribution.

(b) As explained in my answer to part (a), I believe that the Commission should be (and, I am sure, is) concerned about securing contribution from competitive services in order to keep First Class Mail rates low. If the best available evidence suggests that a proposed rate increase for a competitive product offered by the Postal Service would reduce the contribution secured from that product, then I would advise the Commission to weigh this drawback of the rate increase against the potential countervailing benefits it identifies as it considers all of the criteria specified in 39 U.S.C. § 3622(b).

(c) Please see my answer to part (b), above.

ANSWER OF UNITED PARCEL SERVICE WITNESS SAPPINGTON
TO INTERROGATORY OF THE UNITED STATES POSTAL SERVICE

USPS/UPS-T6-46. Please refer to the following passage from pages 9-10 of your testimony:

> The volume of a particular service supplied by the Postal Service may decline substantially as the rate charged for the service increases if mailers can secure comparable services from competing suppliers at reasonable cost. When mailers have ready access to reasonable alternatives, they can protect themselves from the adverse consequences of rate increases on services supplied by the Postal Service. Therefore, they have less need of protection from the Commission than do mailers who use a monopoly service.

a. Please confirm that when alternatives exist, mailers who choose the Postal Service value its service at its current rate more than they value the service offered by the alternative at the rate charged by the alternative. If you do not confirm, please explain fully.

b. Please confirm that when postal rates increase and some mailers in response switch to an alternative service provider, they would be harmed in the sense that they would now be purchasing a service that they value less than the mail service they were purchasing previously. If you do not confirm, please explain fully.

c. Please confirm that if the Postal Service's volume of a competitive product were to decline substantially in response to a price increase, this suggests that there may be many mailers suffering the harm described in subpart b. If you do not confirm, please explain fully.

d. Please confirm that minimizing to the extent possible the potential harm (as identified in subparts b. and c.) of rate increases on mailers with alternatives is worthy of the Commission's efforts in the exact same sense that minimizing to the extent possible the potential harm of rate increases on "monopoly service" mailers is worthy of the Commission's efforts. If you do not confirm, please explain fully.

e. Please confirm that harm to "monopoly service" mailers of a rate increase may be relatively modest if many of such mailers value the service by a substantial amount more than they are currently paying for it (perhaps as a result of the rate restraint resulting from prior ratemaking proceedings). If you do not confirm, please explain fully.

Response to USPS/UPS-T6-46.

(a) Confirmed that when a mailer who can afford both products chooses a Postal Service product rather than a product offered by a competitor, the mailer has revealed a preference for the Postal Service product.

(b) Confirmed that when postal rates increase, even mailers that switch to alternative service providers will generally be worse off than they were before the rate increase. It is possible, though, that as a result of the switch to a new provider, a mailer may purchase a product that provides a higher gross value of service. (Please see my response to USPS/UPS-T6-43). The mailer may do so because the postal rate increase causes the alternative service with the higher gross value to become relatively less expensive. Also notice that mailers who switch to an alternative service, unlike mailers who do not switch, do not necessarily bear the full impact of the rate increase. To illustrate the point, consider the following example.

Suppose there are two mailers, labeled 1 and 2, two Postal Service products, labeled A and B, and one service offered by a competitor, labeled C. Product A is a monopoly service. Products B and C are competing services. The mailers require only the use of one service, one time. Each mailer places a monetary value of $2.00 on use of the monopoly service, A. Mailer 1 places a monetary value of $3.00 on the use of each of services B and C. Mailer 2 places a monetary value of $4.25 on use of Postal Service product B and $4.20 on the use of the competitor's product, C. Initially, the price of service A is $1.00 and the prices of services B and C are each $3.00.

Given these prices and monetary valuations, mailer 1 will use the monopoly service A, since her net return from doing so is $1.00 (= $2.00 - $1.00), which exceeds her net return (= $3.00 - $3.00 = $0.00) from using either service B or service C. Mailer 2 will use Postal Service product B, since his net return from doing so is $1.25, which exceeds his net return from purchasing service C ($4.20 - $3.00 = $1.20) or from purchasing service A ($2.00 - $1.00 = $1.00).

Now suppose that the price of services A and B each increase by 10% and the price of service C does not change. Thus, service A now costs $1.10, service B costs $3.30, and service C costs $3.00. Mailer 1 will continue to purchase the monopoly service, although her net return from doing so falls from $1.00 to $.90. Thus, the net return of the user of the monopoly service falls by the full amount of the rate increase. Mailer 2 will now purchase the competing product, C, and derive a net return of $1.20 (=

$4.20 - $3.00) from doing so. Mailer 2's return is reduced because of the rate increase, but the reduction is smaller than the amount of the rate increase. Indeed, the reduction in Mailer 2's net return is only $0.05, which is less than the reduction in Mailer 1's net return, despite a larger nominal rate increase on Postal Service product B than on Postal Service product A.

This example illustrates the more general common sense point that customers of competitive Postal Service products may be better able than captive monopoly customers to protect themselves against the adverse impact of rate increases on Postal Service products.

(c) Confirmed that a substantial decline in volume of a competitive Postal Service product could suggest that many mailers are suffering some harm. However, as illustrated in my answer to part (b), above, the harm suffered by each mailer with competitive alternatives can be small relative to the magnitude of the rate increase.

(d) I do not know how to interpret your phrase "in the exact same sense." However, confirmed that the Commission should be (and, I am sure, is) concerned with the welfare of all mailers. Also, note that the Postal Reorganization Act exhibits special concern for mailers who use monopoly services as opposed to mailers with alternatives, indicating that those mailers should receive special consideration.

(e) This question suggests a ratemaking philosophy of charging "whatever the traffic will bear," which is not consistent with 39 U.S.C. § 3622(b). In any event, I cannot confirm your assertion, in part because the terms "harm" and "relatively modest" are not defined. Furthermore, the nature of the rate increase you consider is not specified. It is certainly the case that the harm from a rate increase can be "relatively modest" if the rate increase is "relatively modest." But I assume this conclusion was not the intent of your question.

The extent of the harm that a rate increase imposes on mailers who use a monopoly service is not necessarily low merely because the mailers value the monopoly service highly. These mailers, like all mailers that do not alter their usage of the mail service in response to the rate increase, bear the full impact of the rate increase.

USPS/UPS-T6-47. Please refer to the following passage from pages 9-10 of your testimony:

> The volume of a particular service supplied by the Postal Service may decline substantially as the rate charged for the service increases if mailers can secure comparable services from competing suppliers at reasonable cost. When mailers have ready access to reasonable alternatives, they can protect themselves from the adverse consequences of rate increases on services supplied by the Postal Service. Therefore, they have less need of protection from the Commission than do mailers who use a monopoly service.

a. Please confirm that if postal rate increases for a competitive product drive customers to competitors to such an extent that the contribution from the product (total revenue minus total cost) declines, mailers of that product may be able to "protect themselves" by leaving the postal system, but mailers who use services for which no alternative is available do not have that option and are left paying increased rates to cover the lost contribution. If you do not confirm, please explain fully.

b. Please confirm that under the hypothetical scenario described in subpart a., previous mailers of the competitive product who leave the postal system are worse off because they are paying more and/or no longer getting their first choice in service, mailers of the competitive product who stay with the product are worse off because they are paying higher rates and/or mailing fewer units, mailers of all other mail products are worse off because they must pay higher rates to recover the lost contribution, and the only ones better off are the competitors. If you do not confirm, please explain fully.

c. Please confirm that the approach you are advocating to pricing offers the Commission no ability to protect against the risk of raising prices for competitive products to an extent that causes the situation described in subparts a. and b. If you do not confirm, please explain fully.

Response to USPS/UPS-T6-47.

(a) Confirmed that the situation you describe is a possibility, although certainly not an inevitable outcome. The rate increases needed to restore the contribution that is lost from one competitive service could, in principle, be implemented on other competitive services. The rate increases need not be imposed entirely on captive customers.

(b) Not confirmed. There are many parties that can benefit when increased rates induce Postal Service customers to switch to alternative suppliers. Society as a whole can benefit if competing suppliers operate more efficiently than does the Postal Service. When service is provided by the most efficient (i.e., least-cost) supplier, fewer resources are consumed in producing the nation's outputs. Consequently, more resources are available for other productive uses.

The country's citizens also benefit when increased demand for competitors' services causes their earnings to rise. In contrast to the Postal Service, private enterprises pay corporate profit taxes. Consequently, higher earnings for private competitors lead to increased tax revenues, which enable the government to deliver a variety of benefits to many citizens. The prospect of enhanced earnings can also stimulate greater innovation in the delivery industry, which can further benefit consumers.

The threat of losing valued customers to competitors can also motivate the Postal Service to reduce its operating costs. Lower operating costs, in turn, can lead to lower rates for all Postal Service customers, including those with limited access to competitive alternatives.

(c) Not confirmed. As I explain in detail in my answer to USPS/UPS-T-6-43, the Commission should be (and, I am sure, is) concerned with securing contribution from competitive Postal Service products in order to limit the rate increases imposed on First Class Mail users.

USPS/UPS-T6-48.

a. In your view, should the Commission try to protect competitors, or protect competition? Please explain fully.

b. Please confirm that, in general, competition is protected when prices are set so that the low-cost service provider is able to charge the lowest prices. If you do not confirm, please explain fully.

c. In recommending rates, do you think that the Commission should take into account the fact that the Postal Service has a universal service obligation and charges uniform prices established in protracted ratemaking proceedings, while its competitors can pick which portions of a market they wish to serve, may change their published prices virtually unilaterally and immediately, and may negotiate different rates for different customers? If so, how should these factors be taken into account? If not, why not?

Response to USPS/UPS-T6-48.

(a) In my view, the Commission should follow the directives of the Postal Reorganization Act in formulating its rate recommendations. These directives include specific requirements that help to protect competition (as opposed to particular competitors). In particular, § 3622(b)(3) of the Act requires that "each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type." As I explain in my testimony on pages 12-18, this requirement helps to ensure that the Postal Service does not hinder competition by disadvantaging actual or potential competitors unfairly.

(b) I cannot confirm this assertion without precise definitions of the terms "in general," "protected," and "low-cost service provider." As I explain in my answer to USPS/UPS-T6-45, any attempt to manage or protect competition between the Postal Service and alternative providers of delivery services is complicated by the Postal Service's monopoly on letter mail, its status as a public enterprise, and the associated advantages it enjoys over its competitors. Even when the Postal Service enjoys lower accounting costs than its competitors, the full costs caused by Postal Service operations may exceed the corresponding costs of competitors.

For example, I am advised that the Postal Service does not pay property taxes on the buildings and equipment it owns, nor does it pay license and registration fees for its motor vehicles. The Postal Service is also able to borrow funds from the United States Treasury at favorable rates. Because of these advantages, the Postal Service may have lower accounting costs than its competitors, even though its operating costs would exceed the costs of its competitors if it faced the same constraints that they face. Under such circumstances, the enterprise with the lowest accounting costs is not the most efficient producer. Consequently, a policy designed to ensure that the firm with the lowest accounting costs is able to charge the lowest prices is not always in the best interests of society.

(c) Like the advantages the Postal Service enjoys, any disadvantages it faces merit consideration when setting rates. Some of the potential disadvantages you cite are likely reflected in the own-price elasticities of demand for Postal Service products. Therefore, to the extent that smaller rate increases are established for services with higher own-price elasticities, *ceteris paribus*, the potential disadvantages you cite would seem to be taken into account.

Notice also that although the Postal Service's universal service obligation increases its total operating costs, it may lower its incremental cost of providing competitive services. Because it has a ubiquitous network for delivering letters, the Postal Service can deliver non-letter mail at relatively low incremental cost. The Postal Service's ability to share the institutional costs of a ubiquitous delivery network between competitive services and monopoly services provides the Postal Service with another advantage over its competitors.

USPS/UPS-T6-49.

a. Please confirm that a postal service with a relatively high own price elasticity could experience sustained volume and revenue growth over a period of years. If you do not confirm, please explain fully.

b. Please confirm that a postal service with a relatively low own price elasticity could experience sustained volume and revenue growth over a period of years. If you do not confirm, please explain fully.

c. Please confirm that a postal service with a relatively high own price elasticity could maintain a large market share. If you do not confirm, please explain fully.

d. Please confirm that a postal service with a relatively low own price elasticity could maintain a large market share. If you do not confirm, please explain fully.

e. Please confirm that a postal service with a relatively high own price elasticity could offer enhanced service features. If you do not confirm, please explain fully.

f. Please confirm that a postal service with a relatively low own price elasticity could offer enhanced service features. If you do not confirm, please explain fully.

g. Please confirm that the only indicator designed to suggest whether a postal service can sustain a significant rate increase is the price elasticity of demand. If you do not confirm, please explain fully.

Response to USPS/UPS-T6-49.

(a)-(f) Confirmed.

(g) Not confirmed. The own-price elasticity of demand measures the rate at which the volume of a service declines as its price increases, holding all other relevant factors constant. In order to determine whether a Postal Service product can "sustain a significant rate increase," one should consider all of these other factors. For instance, one should consider how rapidly market demand for relevant delivery services is increasing, and whether the Postal Service product will include new features (e.g., Delivery Confirmation) in the future. Only by considering all relevant factors, and not simply the own-price elasticity in isolation, can one assess whether a Postal Service product is likely to be able to sustain a significant rate increase.

USPS/UPS-T6-50. Please refer to the section of your testimony, "Ramsey Pricing in Disguise," at pages 11-12.

a. Please confirm that full-blown application of Ramsey pricing would result in markups and cost coverages based exclusively on the results of the Ramsey model, and no other factors would be considered. If you do not confirm, please explain fully.

b. Is it your testimony that the full-blown Ramsey pricing process described in subpart a. would be essentially the same as a pricing process in which own price elasticities are considered indicative of value of service as part of the application of criterion 2, and criterion 2 is judgmentally balanced in conjunction with all of the other criteria of the Act in order to determine appropriate markups and cost coverages? Please explain fully.

c. With respect to the Ramsey pricing testimony of Postal Service witness Bernstein, please confirm the following, or explain fully:

(i) Because of various additional constraints that he imposes, the markups presented by witness Bernstein are "Ramsey-based" rather than "pure Ramsey" (see USPS-T-41 at page 7, line 22, through page 8, line 2).

(ii) The Postal Service has not proposed that the Commission recommend rates to meet the markups and cost coverages underlying Mr. Bernstein's "Ramsey-based" prices.

(iii) The markups and cost coverages actually proposed by Postal Service witness Mayes (USPS-T-32) vary significantly even from the "Ramsey-based" cost coverages and markups presented by Mr. Bernstein.

Response to USPS/UPS-T6-50.

(a) I do not understand this question, since the term "full-blown application of Ramsey pricing" is not defined. If, by this term, you mean setting "markups and cost coverages based exclusively on the results of the Ramsey model, and no other factors would be considered," then the assertion is tautological.

(b) No, assuming that "full-blown Ramsey pricing" is as defined in my answer to part (a) of this interrogatory. Explicit consideration of factors such as fairness, equity, simplicity, and the educational, cultural, scientific, and informational value of mail should lead to prices that differ from Ramsey prices.

(c)(i) Confirmed.

(ii) Confirmed.

(iii) Confirmed that the markups and cost coverages proposed by witness Mayes differ from the markups and cost coverages presented by witness Bernstein.

USPS/UPS-T6-51. Please refer to page 10 of your testimony, where you refer to mailers that "can secure comparable services from competing suppliers at reasonable costs."

a. Would you agree that the importance of services being "comparable" is that they are capable of meeting the same needs of the mailer, rather than that they closely mimic the same physical processes? Please explain your answer fully.

b. Setting aside for this specific question issues of "reasonable costs," would you agree that almost all, if not all, mailers can obtain "comparable" services of some sort? Please explain any answer other than an unqualified affirmative, and provide specific examples.

c. What standards would you apply to distinguish between mailers for whom comparable services are available at reasonable costs, versus mailers for whom comparable services are available, but only at unreasonable costs? Please explain fully.

d. Would you agree that within any subclass of mail, different mailers are likely to vary substantially in their access to comparable services at reasonable costs? Please explain any answer other than an unqualified affirmative, and provide specific examples.

e. In your mind, is there an unambiguous line between a set of subclasses of mail for which reasonable alternatives are readily available, and a set of subclasses for which they are not? Please explain your answer fully.

f. Please identify exactly which subclasses of mail are those for which you believe substantial increases in postal rates are appropriate because mailers have ready alternatives.

g. Are all subclasses other than those you have identified in response to subpart f. equally entitled to protection from the Commission as "monopoly services"? Please explain any answer other than an unqualified affirmative, and provide specific examples.

Response to USPS/UPS-T6-51.

(a) Yes.

(b) No. For example, other delivery providers of advertising do not have access to the mailbox.

(c) To distinguish mailers for whom comparable services are available at reasonable costs from other mailers, one would need to consider the needs and resources of the mailers as well as the features, performance, and rates of the available delivery services as well as any restraints on the alternative delivery providers. If the essential features and performance of available services are similar, and if the prices of available services are also similar, then mailers will have access to comparable services at reasonable costs. In contrast, if: (1) essential service features and performance are comparable or if mailers do not value highly the differences in service features, and (2) the prices of the available services are very different, then mailers who use the low-priced service will not have access to comparable services at reasonable cost.

Consider, for example, individuals who send letters and for whom expedited delivery is not important. Because of the Postal Service's letter monopoly, these individuals can only secure alternative delivery of their letters by paying rates well above First Class Mail rates in order to secure expedited delivery, which they do not value highly. Such First Class Mail users are mailers who are unable to secure comparable services at reasonable costs.

(d) I have not studied mailer access to alternative delivery services in all mail subclasses, and so I do not have the data required to confirm or dispute your assertion. I suspect, however, that there is typically some variation in the ability of mailers within a subclass of mail to access comparable alternatives at reasonable cost.

(e) As my answer to part (c) of this interrogatory suggests, many senders of First Class letters and cards do not have access at reasonable cost to delivery services other than that provided by the Postal Service.

(f) I believe that the substantial rate increases I recommend for Priority Mail and Parcel Post are appropriate in part because mailers have available alternatives (39 U.S.C. § 3622(b)(5)). However, the rate increases I recommend reflect a balanced consideration of all of the criteria specified in 39 U.S.C. § 3622(b), and are driven largely by substantial increases in attributable costs.

(g) No. I have only studied the Priority Mail and Parcel Post subclasses in detail, but I know that there are other subclasses (such as Periodicals or library rate mail) that are not subject to the Postal Service's letter mail monopoly. The "monopoly services" that I refer to in my testimony are the letter services over which the Postal

Service has a statutory monopoly. I cannot offer useful guidance regarding any de facto monopoly power that the Postal Service may have in other mail subclasses. In general, the "protection" that the Commission affords any mail subclass should be based on a balanced consideration of all the factors cited in 39 U.S.C. § 3622(b).

USPS/UPS-T6-52. Please refer to the following passage from page 10 of your testimony:

> When mailers have ready access to reasonable alternatives, they can protect themselves from the adverse consequences of rate increases on services supplied by the Postal Service.

a. Please confirm that the ability of mailers with ready access to reasonable alternatives to "protect themselves" from postal rate increases may be substantially limited if competitors offering the "reasonable alternatives" use postal rates as an umbrella to their own rate offerings and can respond to postal rate increases with a comparable rate increase of their own. If you do not confirm, please explain fully.

b. Of the subclasses for which you believe mailers have ready access to reasonable alternatives, for which should the Commission not be concerned about the inability of mailers to protect themselves from postal rate increases because of the ability of competitors to respond with their own rate increases. Please explain exactly what it is about the structure of the market which supports your conclusion for each subclass.

Response to USPS/UPS-T6-52.

(a) Not confirmed. It is true that the rates and service features of competitors affect the ability of Postal Service customers to protect themselves from rate increases. However, what is important from the perspective of these customers is not how competitors "can respond to postal rate increases" (emphasis added), as you suggest, but how competitors do respond to postal rate increases. Vigorous competition among firms other than the Postal Service can limit the ability and incentive of these firms to raise rates whether Postal Service rates increase or remain unchanged.

(b) It is always appropriate for the Commission to consider evidence that rate increases by competitors limit the ability of Postal Service customers to protect themselves from postal rate increases. The Postal Service provides some useful testimony in this regard. Witness Bernstein states that "both Federal Express and UPS operate in competitive markets with free entry," and that "private firms operating in competitive markets with free entry can be expected to be pricing at marginal cost" (USPS-T-41, pp. 45-46). Witness Musgrave points out in his analysis of Priority Mail that "the expedited delivery market continues to be highly competitive" (USPS-T-8, p. 23). And witness Tolley notes that United Parcel Service's share of the ground parcel market declined from 86.2 to 75.5 percent between 1992 and 1998, while RPS and the Postal Service more than doubled their combined share of this market (USPS-T-6, p. 158).

DECLARATION

I, David E. M. Sappington, hereby declare under penalty of perjury that the foregoing answers are true and correct to the best of my knowledge, information, and belief.

David E. M. Sappington

Dated: 6/30/10