

1 from 1989 to 1996 to make a determination of whether or not  
2 subtracting Alaska Air costs would show that Parcel Post did  
3 or didn't cover their costs. So I am not paraphrasing  
4 anything.

5 MR. McKEEVER: If Mr. May wants the witness to  
6 confirm that testimony, I have no objection.

7 CHAIRMAN GLEIMAN: Would you like the witness to  
8 confirm that testimony?

9 MR. MAY: Yes, that is what I asked the witness to  
10 do, Mr. Chairman.

11 CHAIRMAN GLEIMAN: Mr. Witness, could you confirm  
12 or not confirm, please?

13 THE WITNESS: Could you just repeat what it is I  
14 am asked to confirm.

15 BY MR. MAY:

16 Q Yes, your testimony on page 43, where you say that  
17 all of those years from '89 to '96, that Parcel Post did not  
18 cover its rates, that that statement is either wrong or you  
19 do not have the data to determine whether it is right or  
20 wrong?

21 A No, I certainly wouldn't characterize it as wrong.  
22 And I am very careful in footnote 56 to give the references  
23 that I used to draw that conclusion, and those conclusions  
24 are to the CRAs as published by the Postal Service, so it is  
25 clear I am using their cost numbers there.

1 Q Well, let me rephrase it. If you used the Postal  
2 Rate Commission's consistent methodology for the treatment  
3 of Alaska Air costs, which subtracts those costs from  
4 attributable costs to Parcel Post, do you know whether  
5 Parcel Post covered its costs or not from 1989 through 1996?

6 A I cannot be absolutely sure of that fact when I  
7 make the correction both for Alaska Air and all the other  
8 differences between the Commission's methodology and the  
9 Postal's methodology, whether revenues exceed costs.  
10 Although the two years for which we do have comparable data  
11 suggest that perhaps the same trend would continue.

12 Q Well, what trend are we talking about?

13 A The trend that I reported here that revenues were  
14 systematically below costs during that 10 year period.

15 Q But I thought you just admitted you do not know  
16 whether that trend exists when you subtract Alaska Air  
17 costs. And if you don't know, then there is no trend, is  
18 there?

19 A The trend I was talking about -- well, I have to  
20 -- perhaps I should play back which trend I was referring  
21 to, whether it was the 10 year period that we are talking  
22 about, or the trend in terms of comparing the data for the  
23 two years in which I do have comparable data.

24 Q I am asking you about the years you do not have  
25 data, that is 1989 through 1996, where you, in your

1 testimony, did testify that in those years, Parcel Post  
2 failed to cover its costs. I am asking about those years.  
3 Do you -- have you made any calculations independent of the  
4 CRA to make a determination whether Parcel Post covered its  
5 costs for any of those years

6 A I have done a related calculation, but it will not  
7 answer definitively whether revenues were below costs in  
8 those eight years.

9 Q So you don't know?

10 A The data that I have available to me will not  
11 allow me to determine with 100 percent confidence which way  
12 it went.

13 Q Thank you. Now, if you would refer to your answer  
14 to PSA-6-2(d), where you were asked to provide United Parcel  
15 Service estimates of volume and revenue for Fiscal Year  
16 1999, and you originally said I am not aware of any such  
17 estimate and then your revised answer gave a citation to  
18 witness Luciani's workpapers, correct?

19 A That's correct, yes.

20 Q What is his number?

21 A The number is 279 million.

22 Q Did you know what that number was when you  
23 prepared your testimony?

24 A No, I don't believe I did.

25 Q When how are you able to testify that Parcel Post

1 volumes have grown substantially in recent years in your  
2 testimony?

3 And I believe you also confirmed in your answer to  
4 2(a) that "recent years" does include 1999?

5 A My statement regarding recent Parcel Post volume  
6 is based upon Table 7 in page 41 of my testimony and that is  
7 actual data as reported by the Postal Service as opposed to  
8 estimated numbers by Mr. Luciani.

9 Q But you were unaware of any UPS estimates at the  
10 time you filed your testimony?

11 A That's correct.

12 Q And so your statement is a correct statement, at  
13 least as it applies to 1999 only if the Postal Service is  
14 correct in their use of the BRMP business, the Bulk RPW  
15 methodology as opposed to the DRPW, isn't that the case?

16 A That was the only data I had available on 1999  
17 Parcel Post volume, yes. I am not aware of any DRPW  
18 calculation that was offered by the Postal Service.

19 Q But I am talking about your own estimates. You  
20 also said you were not originally aware at the time you  
21 prepared your testimony of any contrary UPS estimate of 1999  
22 volume, isn't that what you said?

23 A That is correct.

24 Q And therefore I am just wondering -- so your  
25 statement, the testimony you made depends, does it not, upon

1 the validity of the Postal Service's RPW methodology for  
2 your statement to establish that there has been growth in  
3 recent years?

4 MR. McKEEVER: Mr. Chairman, I apologize but we  
5 just established a few moments ago that the other estimate  
6 was \$279 million for 1999, which exceeds the 1998 volume,  
7 actual volume, shown on the chart, so Mr. May's question  
8 assumes a fact that not only is not in evidence but is  
9 contrary to the evidence.

10 MR. MAY: It doesn't assume anything. I am asking  
11 the witness what he had in mind at the time he testified.

12 What he said he had in mind at the time he  
13 testified was the Postal Service's estimate of volume.

14 CHAIRMAN GLEIMAN: Is that what he said? I  
15 mean --

16 MR. McKEEVER: No, that was asked and answered,  
17 Mr. Chairman.

18 CHAIRMAN GLEIMAN: Well, then, if that is what you  
19 were after, do you agree that, do we all agree that it was  
20 answered? Then we can move on to the next question.

21 BY MR. MAY:

22 Q Now referring again back to pages 40 and 41 of  
23 your testimony you there say that Parcel Post can sustain  
24 higher coverage, your 111 percent, because of substantial  
25 volume growth in recent years, recent years to include 1999.

1           The question I have is do you know whether Parcel  
2 Post volume has increased or decreased for Fiscal Year 2000?

3           A     No, I do not know.

4           Q     Well, if you are going to make the claim that you  
5 make on pages 40 and 41 that increased volume will sustain  
6 higher coverage, shouldn't you have found out what is  
7 happening to Parcel Post volume in the current year, the  
8 year in which we are in right now?

9           A     I think it is quite clear in my testimony the  
10 years I was referring to.

11          Q     You believe it is irrelevant what is happening to  
12 current Parcel Post volume as to whether or not it can  
13 sustain a higher cost coverage?

14          A     I wouldn't characterize it as irrelevant, no.

15          Q     Assume for the moment, and the records speak for  
16 themselves, but assume for the moment that in fact Parcel  
17 Post has shown a decline in Fiscal Year 2000.

18                Would that cause you to temper your optimism about  
19 the ability of Parcel Post to sustain higher cost coverages?

20          A     Not necessarily, no.

21          Q     It is irrelevant then? I thought you were  
22 premising your higher cost coverage on increased Parcel Post  
23 volumes, isn't that what you said?

24          A     What I say is that in contrast to the years  
25 immediately prior to the R97-1 rate case, in particular

1 years 1995 and 1996 where volume declined by 2.7 and 2.3  
2 percent, respectively, Parcel Post volume and revenue have  
3 grown substantially in recent years as Tables 7 and 8 show,  
4 and Tables 7 and 8 show volume and revenue for Parcel Post  
5 between 1990 and 1999.

6 Q But isn't that one of the reasons for your belief  
7 that Parcel Post can sustain higher cost coverage?

8 A Yes, the strong volume growth.

9 Q Well, and I ask you then if it were, if you were  
10 to know, assume for the time being, assume that Parcel Post  
11 volume has declined in the current fiscal year, a year which  
12 is rapidly coming to a close, are you saying that that would  
13 not necessarily cause you to temper your optimism about the  
14 ability to sustain higher cost coverages?

15 A Yes. That is correct.

16 Q And why would that be, since it is the higher  
17 volumes that in part led you to recommend a higher coverage?

18 A Because a 12 percent rate increase went into  
19 effect in January and so I would assume that revenue  
20 would -- I'm sorry, that volume might well decline.

21 Q In January when?

22 A Of '99, I believe.

23 Q But we are in year 2000 now and so you mean that  
24 that it is effect for part of Fiscal Year 1999?

25 A Excuse me?

1 Q This 12 percent increase was in effect for a  
2 substantial part of the Fiscal Year 1999, wasn't it?

3 A Yes.

4 Q And what happened to the volume as a result of  
5 that rate increase?

6 A It is hard to pinpoint exactly what was the  
7 response of the volume to the rate increase, since a variety  
8 of other factors might have affected volume, but in 1999,  
9 using the Postal Service's estimate relative to 1998, using  
10 the BRPW methodology, the volume increased by just about 1  
11 percent.

12 Q Now I am asking you to assume for purposes of the  
13 question that in the year 2000 Parcel Post volume declined.

14 You may want to attribute that, as you suggested,  
15 to the fact that the 12 percent increase had something to do  
16 with that, but nevertheless the question is because under  
17 the hypothesis there is a volume decline, why doesn't that  
18 cause you to have second thoughts about the ability of the  
19 class to sustain higher coverage?

20 A Because I would expect a volume decline following  
21 a rate increase, just as, for example, if you look at the  
22 table 1995 and 1996, there were two years in which volume  
23 actually declined and then in the following two years we  
24 resumed double-digit growth in volume.

25 Q So the fact that under the hypothesis we are in a

1 volume decline in Parcel Post that that does not trouble you  
2 at all in terms of recommending the fact that the Commission  
3 should believe that Parcel Post, even though it is in volume  
4 decline, should get a higher cost coverage than it has  
5 recommended in the last several cases?

6 A Yes. I don't see any inconsistency there.

7 Q Now if you will refer to your response to Parcel  
8 Shippers' Question 6 --

9 A Yes.

10 Q On page 44 of your testimony, you state that  
11 Parcel Post has a higher value of service because the  
12 average time of delivery since 1995 has been less than four  
13 days. And in your response to PSA's Question 6, you say  
14 that you are unable to compare this delivery performance  
15 with that achieved by United Parcel Service because you  
16 don't know what their performance was. Do you see that?

17 A I do see my response to PSA/UPS-T6-6, yes.

18 Q Now, is it your testimony that it is immaterial  
19 what Parcel Post competitors' performance is when  
20 considering whether an improvement in Parcel Post  
21 performance has increased the value of service of Parcel  
22 Post?

23 MR. McKEEVER: Mr. Chairman, may I just ask that  
24 the question be repeated. There were about three elements  
25 in it.

1 MR. MAY: No, it is not. I am asking the witness  
2 whether he thinks it is immaterial to know whether the  
3 principal competitor of Parcel Post, that is United Parcel  
4 Service, to know what their delivery performance has been in  
5 determining Parcel Post performance improvements have  
6 increased their value of service.

7 MR. McKEEVER: Thank you.

8 THE WITNESS: The answer to that question depends  
9 upon how you are defining value of service. And in my  
10 response to a UPS interrogatory, I believe it was Number 43,  
11 I explained the difference between gross value of service  
12 and incremental value of service. The first concept tries  
13 to measure value of service of a particular mail service in  
14 and of itself, as opposed to the incremental value of  
15 service which tries to measure the value of the Postal  
16 Service product relative to competitors'. So the answer to  
17 your question would depend upon which of those two value of  
18 service concepts you have in mind.

19 BY MR. MAY:

20 Q Well, let's take a concrete example, because I  
21 mean you have testified that Parcel Post value of service  
22 has increased. That is your testimony, isn't it? And one  
23 of the reasons is because their performance, their average  
24 delivery time has been kept under four days. Do you see  
25 that testimony?

1           A     I see the place in my testimony that you are  
2 referring to, but I don't draw the same conclusion that you  
3 do from those words.

4           Q     That is not one of the reasons you say value of  
5 service has increased?

6           A     The statement on page 44 that I believe you are  
7 referring to says that historically, or traditionally,  
8 Parcel Post has been viewed as a lower value service. And I  
9 just pointing out in the successive sentence that the  
10 average time for delivery of Parcel Post packages has been  
11 less than four days on a fairly consistent basis since 1995.  
12 At that point I do not say, therefore, value of service is  
13 higher.

14          Q     Now, Doctor, let's look at the caption for that  
15 section, it says, paragraph 4, higher value services, right?  
16 Isn't that what it says there?

17          A     Yes, it does.

18          Q     And right under that, it says, in part because of  
19 the relatively low priority it is afforded in the  
20 mailstream, Parcel Post has traditionally been viewed as a  
21 lower value of service. However, the average time for  
22 delivery of Parcel Post packages has been less than four  
23 days on a fairly consistent basis since 1995. Are you  
24 trying to tell us that you are not trying to convey there  
25 the thought that the value of service of Parcel Post has

1 increased as to what it used to be because of this  
2 performance standard?

3 A The relevant question is when you say "before."  
4 Before what?

5 Q Before, what you said, it says has been  
6 traditionally viewed and you say in the last -- has been  
7 less than four days since 1995. That is the period you are  
8 talking about.

9 A Right. Since 1995, but there has been a rate case  
10 in between then, and I just want to be clear that I am not  
11 saying that the average time to delivery has increased since  
12 the Commission last looked at this issue.

13 Q No, no. You stated what you said, which is it is  
14 since 1995. My question is, are you not trying to, if not  
15 overtly claim, at least imply the claim that because of  
16 that, the value of Parcel Post -- the value of service of  
17 Parcel Post has increased?

18 A Okay. I just want to be clear that we are talking  
19 about the correct time period. Are we talking about --

20 Q Yes. That four year time period.

21 A Pre-1995 average time to delivery has increased  
22 and, therefore, I would associate that with a higher value  
23 of service.

24 Q Thank you.

25 A And, again, I also do want to make clear that the

1 years for which I have measured the average time to delivery  
2 prior to '95 are '92, '93, '94, those three years.

3 Q Now, let us suppose that before 1995, it took six  
4 days, or let's say five days. It took five days average  
5 time of delivery. And before 1995, it took four days for X  
6 company, X company being the principal competitor of Parcel  
7 Post.

8 A Okay. Five days for Parcel Post, four days for  
9 the competitor.

10 Q Yes. And now Parcel Post has consistently been  
11 just under four days since 1995 and X company, their  
12 principal competitor, is now 2-1/2 days. Has the value of  
13 Parcel Post, value of service of Parcel Post increased?

14 A Again, I will go back to the answer I tried to  
15 convey earlier, that the answer to that question depends  
16 upon your definition of value of service.

17 Q Well, you are the one who is testifying about  
18 value of service, Doctor, so I would ask you to supply that  
19 definition.

20 A Okay. Using the gross value of service, which I  
21 think is a reasonable measure of value of service, Parcel  
22 Post value of service has increased in the example you give  
23 here because its average days to deliver have declined from  
24 four or above to below four.

25 Q And, therefore, as you use it, it is utterly

1 immaterial, which is what I began asking you, it is utterly  
2 immaterial what Parcel Post competitors have done with their  
3 performance standards, is that right?

4 A No, that is not right, and I don't -- I think I  
5 said before it is not utterly immaterial.

6 Q Well, how is it material if any improvement in  
7 delivery performance for Parcel Post is an enhancement of  
8 the value of service, then how is it material what its  
9 competitors have done?

10 A Because when the Commission has to undertake the  
11 difficult task of determining appropriate markups, the  
12 performance of the Postal Service relative to its  
13 competitors may come into play in determining how much  
14 contribution a particular service can reasonably make.

15 Q But it will have nothing to do with value of  
16 service?

17 A Well, that is, I think, a matter of opinion, and  
18 it is another part of my testimony, that there are different  
19 interpretations of value of service. The Postal Service,  
20 for example, talks about the concept of economic value of  
21 service in which they are talking about the price elasticity  
22 of demand, and that price elasticity of demand will, in  
23 fact, be influenced by relative performance characteristic.

24 Q I am talking about the value of service that you  
25 claim has been increased for Parcel Post, not what the

1 Postal Service, what you say has happened to Parcel Post.  
2 That kind of value of service is what I am asking you about.

3 A Okay. In that case, if we are talking about the  
4 gross value of service, my claim is that, in fact, Parcel  
5 Post's value of service has increased.

6 Q And, therefore, I repeat, so far as that limited  
7 definition that you have given of value of service, in  
8 making a determination about that, it is irrelevant what the  
9 competition's performance standards have -- what has  
10 happened to them, whether they are better or worse, it is  
11 immaterial, isn't that what you are saying?

12 A For that definition, yes. But not in the  
13 context --

14 Q That is all I wanted to establish. Thank you.

15 A But not in the context of determining rates and  
16 cost coverages.

17 Q No, no. I mean your definition.

18 A Yes.

19 Q The one you use in your testimony.

20 A Yes.

21 Q Now, if you would, turn to your response to Parcel  
22 Shippers Question 8(c). Now, you were there asked to  
23 explain why the Rate Commission should not be concerned that  
24 your proposed coverage would cause such a high loss of  
25 volume. And you responded that the loss -- you corrected

1 the question by saying, well, the loss won't be the 81  
2 million parcels, but because of Mr. Luciani's correction, it  
3 will only be 45.8 million. Now, is it your position that an  
4 11 percent markup in what is "reasonably assignable," even  
5 though it is reasonably, you know, a reasonable assignment,  
6 even though it drives almost 46 million parcels out of the  
7 system, do you think that a reasonable, a reasonably  
8 assignable amount when it has that effect?

9 A Yes, I do.

10 Q Now, that, I think you have previously  
11 established, you know, that is significant, you finally  
12 conceded to Mr. Olson that that was a substantial loss of  
13 volume, I believe?

14 A I am not sure if we were talking about Parcel Post  
15 or Priority Mail at the time.

16 Q Well, let me ask you again then, is that a  
17 substantial loss of volume?

18 A Yes, I think that is a substantial loss of volume  
19 relative to the benchmark we are talking about, which is the  
20 one in which there is no rate increase for Parcel Post,  
21 which, as I indicated in my answer to Mr. Olson, I don't  
22 think is the most relevant benchmark.

23 Q Right. Now, it didn't bother you either, however,  
24 when you thought it was going to be 81 million parcels?  
25 When you originally filed your testimony, you thought it was

1 going to -- your rate recommendation, your coverage  
2 recommendation was to going to cause the loss of 81 million  
3 parcels, didn't you?

4 A That was the original estimate, but I certainly  
5 would not say that it didn't bother me. In fact, I believe  
6 I have constrained my cost coverage recommendations  
7 substantially. Given the best available data I have, I have  
8 seen revenues fall below costs repeatedly over the past 10  
9 years, so I would feel much more comfortable with a much  
10 higher cost coverage. However, because costs have increased  
11 substantially, even what I consider a very modest 111  
12 percent cost coverage does require a 29.4 percent rate  
13 increase, which is also substantial in my view, which is why  
14 I did not feel comfortable recommending more than a 111  
15 percent cost coverage.

16 Q Well, just so the record stays corrected, I  
17 thought we had just agreed that you do not know whether  
18 Parcel Post fell below cost coverage, attributable costs,  
19 from 1989 through 1996. So isn't it not the case that you  
20 cannot say that you know Parcel Post volume -- Parcel Post  
21 fell below attributable cost coverage in the preceding 10  
22 years? You can't say that, can you?

23 A I believe I did say that given the data, the best  
24 available data that I had, that statement is true.

25 Q Okay. All right.

1 MR. McKEEVER: Mr. Chairman, I might note, too,  
2 that at the end of the question, counsel said the last 10  
3 years when he used less than that period. But the question  
4 has been asked and answered, so I guess we will await the  
5 next question.

6 MR. MAY: Well, the record, of course, says what  
7 it is.

8 BY MR. MAY:

9 Q And the witness, I believe, did -- did you or did  
10 not say that because of the -- one of your concerns about  
11 the coverage factor, even though it would cause an 81  
12 million loss of parcels, that despite that, you felt you had  
13 to have this high cost coverage because parcels had failed  
14 to cover their costs in the previous 10 years?

15 MR. McKEEVER: My point, Mr. Chairman, was that  
16 the witness specifically testified that in 1997 and 1998, he  
17 did have numbers that allowed him to confidently state that  
18 it was below cost. That was the reason.

19 MR. MAY: I have a pending question, and he hasn't  
20 objected to it, Mr. Chairman.

21 CHAIRMAN GLEIMAN: Counsel is correct. Perhaps  
22 you need to restate the question now, Mr. May. It may have  
23 gotten lost in the shuffle.

24 BY MR. MAY:

25 Q Do you need the question restated, Doctor?

1 A Yes, please.

2 Q Did you not say that when you filed your testimony  
3 originally, despite the fact that your coverage proposal of  
4 111 percent was going to cause a loss of 81 million pieces  
5 of Parcel Post, or so you thought at the time, that  
6 notwithstanding that, you felt you had to propose a higher  
7 cost coverage because for the preceding 10 years, Parcel  
8 Post had failed to cover its costs, isn't that what you had  
9 said?

10 A I believe I qualified that by saying that, given  
11 the data available to me, that was what the data showed.

12 Q For those 10 years, right?

13 A That's right. And in two years, I do have data  
14 which does take account of the Alaska Air correction, plus  
15 all the other differences between the Postal Service and the  
16 Commission methodology.

17 Q Well, should it develop that for all those other  
18 years, from 1989 to 1996, when you or the Commission,  
19 whoever has the capacity to do it, runs the numbers and find  
20 out that without Alaska Air costs, Parcel Post did cover its  
21 costs, suppose that happened, what is your recommendation  
22 then about the need for an extra amount of cost coverage to  
23 protect against falling below attributable costs?

24 A I haven't thought carefully about that calculation  
25 and I would need to do so before offering any particular

1 recommendation.

2 Q Okay.

3 A I would point out though that, well, I will just  
4 leave it at that at this point.

5 Q If you would refer to your response to Parcel  
6 Shippers' Question 16(a). This was a follow-up question  
7 which pointed out that your response to Question 7(b) about  
8 whether delivery confirmation services increases the value  
9 of service to Parcel Shippers and you stated that, quote,  
10 "An increased array of options associated with the service  
11 increases the value of services to its customers" and you  
12 were asked, well, does an option which costs too much  
13 increase the value of service, and your answer was there  
14 that you didn't know what I meant by too much but you said  
15 that an option provides value as long as there is some  
16 chance that the option will be exercised at the prevailing  
17 rates.

18 It says, "Only if the price of the service" -- in  
19 this case let's say delivery confirmation service -- "Only  
20 if the price of the service is so high that it exceeds the  
21 value of the service to the shipper in every conceivable  
22 situation will the option to purchase the service have no  
23 value to the shipper."

24 Do you literally mean one shipper?

25 A In answering that interrogatory I was talking

1 about the value of having the option to purchase delivery  
2 confirmation for a particular shipper.

3 Q So that you are saying that for that one shipper  
4 the value of service has been increased for Parcel Post  
5 because they can get that option?

6 A I was talking about one shipper in this response,  
7 but the same answer holds for all shippers.

8 Q Well, I know, but let's -- as I understand your  
9 answer it says that in every conceivable situation. I take  
10 that to mean that if in the whole world of parcel shippers  
11 there is only one who finds the price of delivery  
12 confirmation not to be too high that nevertheless because  
13 there is that one the value of service of Parcel Post has  
14 been increased?

15 A No, that was not the intent of the answer.

16 Let me try to explain what I meant by that phrase  
17 "every conceivable situation."

18 The way you calculate the value of an option is  
19 you think from the viewpoint of a particular shipper. The  
20 shipper says let's think about all the possibilities that  
21 may occur in the future. For example, let's think about I  
22 may only ship one package or I may ship 100, I may ship  
23 1000, and I may -- delivery confirmation may be extremely  
24 valuable to me or not valuable at all, so you lay out all  
25 these possibilities.

1           You assign to each of those possibilities a  
2           likelihood that each will occur and then you figure out how  
3           much value do you get if in fact you do choose to purchase  
4           delivery confirmation in each of those contingencies, and  
5           then taking that expected value is what gives you the value  
6           of an option.

7           So what I was talking about here is that is how  
8           you would calculate and determine whether the option has a  
9           value to an individual shipper and then to get the value to  
10          parcel shippers as a whole you would sum up the values to  
11          the individual shippers.

12          Q     Yes, I understand that, but the question was  
13          suppose the option, suppose the service costs too much, and  
14          I understood you to be saying here that while you don't know  
15          what "too much" is that so long as the price of this option  
16          is not so high as to exclude every conceivable shipper from  
17          using it, then it has value.

18          A     That's right, because the nice thing about options  
19          is that they can never have negative value.

20          Either you use them or you don't. If you don't  
21          use them you get zero value out of it. If you do use it,  
22          you get positive value, so options can never hurt you. They  
23          can only help you.

24          Now in the case where there is only one shipper  
25          who values it and the other, for everyone else the price is

1 so high that there is no conceivable situation in which they  
2 would ever use it, then the value is zero to every shipper  
3 except that one who does foresee using it.

4 Therefore, in that -- in my view extremely  
5 unlikely -- scenario the value to Parcel Post shippers as a  
6 whole of delivery confirmation would be very small, but in  
7 the more likely scenarios where many shippers place a  
8 strictly positive value on the option, then you would sum  
9 those up to get a measure of the total value to parcel  
0 shippers of this delivery confirmation option.

1 Q Why do you say that is more likely? Do you have  
2 any knowledge of what the usage of delivery confirmation by  
3 Parcel Post is?

4 A I haven't seen the usage but I have seen the  
5 prices.

6 Q Yes.

7 A And I can certainly conceive of situations where  
8 it would be worth 65 cents to me to employ --

9 Q And you are the one. Do you think the Commission  
0 should increase the cost coverage for Parcel Post because it  
1 finds the value of service of Parcel Post has been enhanced  
2 because you don't think 65 is too much to pay to get a  
3 delivery confirmation?

4 A I think that if I am a Parcel Post and I get  
5 positive value from it and even if nobody else does, the

1 presence of delivery confirmation has increased the  
2 aggregate value of Parcel Post.

3 Q And it's simply -- but no matter -- and again if  
4 you are the only one, it still has increased the value of  
5 service? That is what you are saying?

6 A That is correct.

7 Q Would you refer to your responses to Questions 7  
8 and 8 of Parcel Shippers -- excuse me, to Questions 10(b)  
9 and 19(b) -- forgive me.

10 A 10(b) and 19(b)?

11 Q Yes. They are kind of the same thing -- 10(b)  
12 asks you to for Parcel Post compare the collection, mode of  
13 transportation, speed and reliability, et cetera, with the  
14 same performance criteria of its competitor or competitors  
15 and 19 was somewhat the same kind of question, following up  
16 on that. It asked that you compare Parcel Post performance  
17 and asked whether or not you had asked United Parcel Service  
18 to supply you with any of the data, because you had  
19 originally said you don't have data on the performance and  
20 internal operations of private competitors, so you weren't  
21 able to make the comparison and this simply asks you, well,  
22 did you ask anybody for it, and I believe you said no,  
23 because -- and I think you covered that with Mr. Olson.

24 You said if these private competitors wanted the  
25 world to know this information, it would be out there and

1 you would be able to go to the library and get it. You  
2 wouldn't have to ask him. Is that correct?

3 A I believe that is a rough characterization of what  
4 I said, yes.

5 Q And so then you don't know whether Parcel Post  
6 value of service increased compared to the value of service  
7 of UPS or any of the other competitors, if there are any?

8 A Compared to competitors, I have not done that  
9 calculation, no.

10 Q Well, I am just saying that you have originally,  
11 formerly said that in value of service you are kind of  
12 looking at the particular service itself and if it's  
13 improved by itself, that is an increase, and I am asking  
14 you, say, well, there are other competitors, has their value  
15 of service comparably increased or decreased?

16 You don't know?

17 A That is correct.

18 Q And you don't think it is at all relevant to the  
19 Commission's deliberations whether that would or would not  
20 be the case?

21 A No, I don't believe I have said that.

22 Q Oh, you think it is relevant?

23 A Yes. I believe I have said that before. It could  
24 be relevant.

25 Q But you simply have nothing to enlighten the

1 record on that score?

2 A That is correct.

3 Q Now would you refer to your response to PSA  
4 Question 20.

5 If you look to the very bottom of the page, and we  
6 are talking here about the Section 3622(b) and the many  
7 factors the Commission has to determine in assigning  
8 reasonable shares of attributable costs, and you say at the  
9 bottom of the page, "The Commission can still take into  
10 account the fact that the Postal Service has many artificial  
11 advantages over its private sector competitors and that low  
12 cost coverages will almost inevitably lead to volume,  
13 revenue and earnings losses for those competitors."

14 My question is what evidence do you have to prove  
15 that low cost coverages, and I am quoting, "will almost  
16 inevitably lead to volume, revenue, and earnings losses for  
17 the those competitors" since you have said you do not know  
18 anything about, for example, United Parcel Service's volume,  
19 revenue, and earnings and you didn't ask them?

20 A That statement only requires knowledge that there  
21 is some competition in the industry, because what it says is  
22 that if one competitor lowers its rates the performance of  
23 competitors are going to be harmed in the sense that their  
24 volumes and revenues and earnings will go down.

25 Q This is a theoretical truism?

1 A I am not sure I would choose those exact words,  
2 but I would probably say a principle of economic analysis.

3 Q Well, but you don't have any actual evidence, do  
4 you?

5 A I do not have data which would allow me to  
6 calculate the impact.

7 MR. MAY: Thank you. That's all, Mr. Chairman.

8 CHAIRMAN GLEIMAN: Thank you.

9 The witness has been up there for about an hour  
10 and a half now, so I think it would be a good time to take a  
11 10-minute break, maybe a couple minutes longer. We will  
12 come back at ten after the hour.

13 [Recess.]

14 CHAIRMAN GLEIMAN: United States Postal Service,  
15 Mr. Koetting?

16 MR. KOETTING: Thank you, Mr. Chairman.

17 CROSS EXAMINATION

18 BY MR. KOETTING:

19 Q Good afternoon, Dr. Sappington.

20 A Good afternoon.

21 Q I think I will try to start with some followup. I  
22 don't know that I will be able to clarify anything or just  
23 further confuse matters.

24 It's my recollection, in an exchange with Mr.  
25 Olson going back to this morning, this was in reference to

1 page 40 of your testimony, the lines 13 and 14, in which  
2 there was a revision in your testimony, where what had  
3 previously been a commensurate increase in rates was revised  
4 to substantial, I believe.

5 That was the context of the discussion, and as I  
6 recall, you stated several times, the process that you  
7 utilized.

8 And as I recall, what you stated was that you  
9 evaluated the factors to select an appropriate cost  
10 coverage, which, for example, in the instance of Parcel  
11 Post, I believe, was 111 percent.

12 And then you examined the cost and calculated the  
13 percentage rate increase that was required to achieve that  
14 cost coverage.

15 Is that consistent with your recollection of the  
16 process that you stated this morning?

17 A I believe that's roughly what I said, yes.

18 Q If you didn't examine the percentage rate increase  
19 until after you set the cost coverage of 111 percent, for  
20 example, for Parcel Post, how did you consider that portion  
21 of the criterion for the effect of the rate increases on  
22 customers when establishing that the cost coverage you had  
23 ended up with was appropriate?

24 A The 111 seemed to me to be the minimum conceivable  
25 appropriate coverage, so I started there. And when I saw

1 the rate increase was that significant, even at that level,  
2 I didn't feel comfortable going higher.

3 But I certainly had higher cost coverages in mind  
4 as potential candidates for being recommended.

5 Q In an exchange with Mr. May much more recently,  
6 you were discussing various -- I don't know whether the term  
7 is definitions or aspects of value of service, and, again, I  
8 think this followed up on your response to Postal Service  
9 Interrogatory 43.

10 And I don't know that you need to refer to it or  
11 not, but the concepts are in there, which is the gross value  
12 of service and the incremental value of service; do you  
13 recall that discussion, in general?

14 A Roughly, yes. I think it went on for quite  
15 awhile, so I wasn't sure what part you were talking about.

16 Q That's fine. I just wanted to make sure you knew  
17 what terms I was referring to with gross and incremental in  
18 this context.

19 Which definition, which version of value of  
20 service should the Commission apply when it's considering  
21 Criterion (b)(2)? Should it rely on the gross value of  
22 service or the incremental value of service?

23 A As I explain in my answer to USPS/UPS-T6-43, I  
24 think it's appropriate for the Commission to think about and  
25 consider both of those concepts.

1           As I point out, if you focus exclusively on either  
2 one, some dangers arise, and so what I recommend in my  
3 response here is that it's appropriate to think about both  
4 concepts, but realize that there are distinctions between  
5 them.

6           Q     Okay, and if you're going to rely on incremental  
7 value of service, then you would need to know the comparable  
8 -- have comparable information about the value of service of  
9 the competitor product; is that correct?

10          A     Ideally, yes.

11          Q     And have you provided any such information or  
12 pointed to any place where that type of information is  
13 available for the Commission's consideration?

14          A     Well, this gets back to, I think, the Postal  
15 Service's point that some information about what competitors  
16 are doing and how customers value what competitors are  
17 doing, is contained in the price elasticity of demand.

18                So there is evidence in the record of that  
19 particular measure of what the Postal Service refers to as  
20 the economic value of service, which does rely upon the  
21 concept of incremental value of service.

22          Q     Okay, let's leave that for a moment, and I think  
23 we'll be back to it shortly. But in terms of another issue  
24 that was discussed a great deal, earlier -- and I'm hoping  
25 we can move through this pretty quickly -- I certainly don't

1 want to belabor it.

2 I would refer you to your testimony on page 38,  
3 lines 4 through 6.

4 [Pause.]

5 There you are discussing a cumulative average rate  
6 increase for Priority Mail since R94-1 of approximately 48  
7 percent, and then you contrast that, say the increase is  
8 much less than half of the corresponding increase in  
9 Priority Mail's attributable costs.

0 And you cite the figure there of 135 percent,  
1 correct?

2 A I do see that there, yes.

3 Q How would you -- would you characterize the  
4 cumulative average rate increase with an alternative way to  
5 express that would be the cumulative average increase in  
6 revenue per piece?

7 Is that how you would calculate the average rate  
8 increase, was to compare average revenue per piece in the  
9 R94 time period, and then with you recommended average  
10 revenue per piece?

11 A Roughly, yes.

12 Q Okay.

13 So that's the 48 percent number. The 135 percent  
14 number, that is a change in total attributable cost, rather  
15 than unit attributable cost; is that correct?

1 A That is correct, yes.

2 Q So, would you agree that to some extent here,  
3 you're comparing apples to oranges?

4 A Yes. If you wanted to put the comparison in terms  
5 of unit costs, that's easy to do also.

6 And between R94 and R2000, the corresponding  
7 change in increase in unit cost for Priority Mail is 66.8  
8 percent, so the 48 percent, which represents the cumulative  
9 rate increase using the Commission's 5.6 percent which was  
10 implemented in the last rate case, plus my current  
11 recommendation, which totals to 48 percent, is a little bit  
12 less than three-quarters of the corresponding increase in  
13 unit costs.

14 Q We moved through that much more rapidly, thank  
15 you.

16 I'd like to go to page 8 of your testimony.

17 [Pause.]

18 I'm looking at that middle paragraph above the  
19 section heading where you state that the intrinsic and the  
20 economic component of value of service are, quote,  
21 "inextricably linked," and you state the rationale for  
22 distinguishing between them is not apparent; do you see that  
23 testimony?

24 A Yes, I do.

25 Q I have some questions about -- well, first of all,

1 when we're talking about economic value of service, we're  
2 talking about own price elasticity, essentially, correct?

3 A That's correct.

4 Q I don't know how familiar you are with the Postal  
5 Service's own price elasticity or how much you committed to  
6 memory.

7 MR. KOETTING: I would, just so everybody has the  
8 same sheet, I'll pass out a page of Witness Bernstein's  
9 testimony, T-41, in which he does have a column that lists  
10 all of the own price elasticities, so that we can all have  
11 them available for comparison.

12 MR. McKEEVER: No objection.

13 [Pause.]

14 BY MR. KOETTING:

15 Q Dr. Sappington -- maybe I should change the order  
16 here, but let me ask the questions in my order -- not  
17 looking at the own price elasticity here, I would like to  
18 ask you first about intrinsic value of service.

19 Would you agree that Express Mail has the highest  
20 intrinsic value of service of any subclass of mail?

21 A I wouldn't object to that characterization, but I  
22 haven't studied Express Mail, so I would be reluctant to  
23 endorse that.

24 If you're talking solely about speed, my  
25 understanding is that that is the fastest class, and if you

1 want to think of value of service on that dimension, then I  
2 could certainly go along with your supposition.

3 Q What other dimensions do you think are relevant?

4 A Things like delivery confirmation, how often  
5 Express Mail meets its commitments and so on. I have not  
6 studied those factors.

7 Q But you don't -- so you don't have an opinion  
8 whether or not Express Mail is the highest intrinsic value  
9 of service or you have an opinion but it's not a studied  
10 one?

11 A It's certainly not a studied one.

12 Q Would you confirm -- now, I will cite you, if  
13 necessary, to the sheet that I handed out in terms of the  
14 economic value of services measured by the estimated own  
15 price elasticity. Express Mail has the absolutely lowest  
16 economic value service?

17 A Yes, it does appear to have the highest price  
18 elasticity of demand.

19 Q So in the instance of Express Mail, would you  
20 think that intrinsic service -- intrinsic value of service  
21 and economic value service are inextricably linked?

22 A Yes, I would because again, the sensitivity of  
23 customer demand to prices is going to be influenced by the  
24 characteristics of the product, so I don't see any way of  
25 separating those two.

1 Q Well, you say the rationale for distinguishing  
2 between them is not apparent. Wouldn't you want to  
3 distinguish between something that has a high if not the  
4 highest intrinsic value of service and something that has  
5 the lowest economic value of service?

6 A For what purpose?

7 Q For the purposes of determining what the (b) (2)  
8 value of service is.

9 A That comes back again to our discussion earlier  
10 about what definition of value of service you're using. If  
11 you're using incremental value of service, then you would  
12 want to consider the price elasticity of demand as an  
13 imperfect signal about what is the value of a Postal Service  
14 product relative to competitors' products.

15 Q Let's compare some other subclasses, and I would  
16 like to compare first class mail with periodicals.

17 Would you agree that first class mail has a higher  
18 intrinsic value of service than regular periodicals?

19 MR. McKEEVER: Mr. Chairman, I apologize.

20 Was it intrinsic or economic value of service that  
21 counsel was inquiring about?

22 MR. KOETTING: Intrinsic at this moment.

23 MR. McKEEVER: Thank you.

24 THE WITNESS: I believe you mentioned first class  
25 mail.

1 BY MR. KOETTING:

2 Q That's correct.

3 A Were you talking about first class letters or  
4 first class cards?

5 Q Let's go with first class letters.

6 A First class letters? The elasticity is  
7 approximately -.2. And for which periodicals are we talking  
8 about now?

9 Q Regular.

10 A That's -1. -- -.1. So the first class is higher  
11 in absolute value.

12 Q Indicating a lower economic value of service,  
13 correct?

14 A I believe that's the definition, yes.

15 Q Okay. Let's talk about the intrinsic value of  
16 service now. Would you agree that first class has a higher  
17 intrinsic value of service?

18 A Again, I hesitate to comment on that because I  
19 have not studied periodicals, either. In fact, I have not  
20 even studied first class carefully. My testimony is really  
21 focused on priority mail and parcel post.

22 Q Okay. But let's look at the criterion -- the  
23 factors mentioned in 3622(b)(2). Does it talk about  
24 collection, correct?

25 A That's right.

1 Q First class mail has collection boxes distributed  
2 around the country, correct? Are you aware that periodicals  
3 has to be entered at the post office?

4 A That's my understanding.

5 Q Okay. What about mode of transportation? First  
6 class mail, I assume you're aware, gets air transportation  
7 where necessary; is that correct?

8 A Uh-huh.

9 Q Periodicals is essentially surface transportation?

10 A Excuse me, could you repeat the question?

11 Q Sure.

12 Would you agree that periodicals generally do not  
13 get air transportation?

14 MR. McKEEVER: Objection, Mr. Chairman. It's  
15 definitely beyond the scope of his testimony, and he has  
16 said that he hasn't looked at it and he's not comfortable  
17 talking about these measures of intrinsic value with respect  
18 to periodicals.

19 CHAIRMAN GLEIMAN: I understand that; however, the  
20 witness' testimony is he doesn't understand a rationale for  
21 distinguishing between these two different measures of value  
22 of service, and I would believe, if he's going to be  
23 competent to testify about which measure of value of service  
24 the Commission should be using for all subclasses, then he  
25 should be prepared to engage in a reasonable discussion of

1 differences between subclasses.

2 I don't think we're going into Postal esoteric  
3 here to compare the intrinsic service features of  
4 periodicals in terms of the modes of transportation and  
5 collection versus first class letters.

6 MR. MCKEEVER: Mr. Chairman, Mr. Koetting's  
7 question asked the witness to testify as to a fact about  
8 what happens to periodicals, and I believe that is beyond  
9 the scope of the witness' testimony. The witness has been  
10 more than happy to talk about the different measures of  
11 value of service and indicate that some are good for some  
12 purposes and some for other purposes, and I have no  
13 objections to those questions; but a question that asks him  
14 how periodicals are handled I believe is beyond the scope of  
15 his testimony.

16 CHAIRMAN GLEIMAN: Mr. Koetting, I think you  
17 either need to move on or reframe your questions to  
18 something more general in terms of the specific subclasses  
19 that the witness said he has not studied in-depth.

20 MR. KOETTING: Well, let me back off from the  
21 individual questions that Mr. McKeever is objecting to and  
22 just go back to my original question.

23 BY MR. KOETTING:

24 Q Dr. Sappington, would you be comfortable agreeing  
25 that first class mail has a higher intrinsic value of

1 service than regular periodicals, or would it still be your  
2 view that you don't have an opinion on that?

3 A I'm sorry, I don't have an opinion on that.

4 Q What about standard A regular and standard A ECR?  
5 If you'll look at the list, I hope we can agree relatively  
6 quickly that they have different economic values of service,  
7 correct?

8 A The price elasticity numbers given for those two  
9 categories are different, yes.

10 Q All right. Do you have any reason to believe that  
11 the intrinsic value of service for those two subclasses are  
12 different?

13 A I haven't studied either standard regular or  
14 standard ECR, so I would hesitate to try to answer that  
15 question.

16 Q So whether or not you would want to -- whether or  
17 not -- relying on economic value of service as a rationale  
18 for distinguishing between the value of service of those two  
19 subclasses is something you're not aware of?

20 A Could you restate that question, please?

21 Q Sure. You've stated that you don't see a  
22 rationale for distinguishing between economic value of  
23 service and intrinsic value of service, and I'm trying to  
24 ask you the question, in evaluating criterion (b)(2) for  
25 those two categories of mail, which do have different

1 economic values of service, you're saying that you don't  
2 --you don't know enough about the intrinsic values to know  
3 whether or not you should give credence to what the  
4 elasticities are telling you or not?

5 A I think that's a fair characterization.

6 Q And would the same be true for the various  
7 subclasses of standard B -- again, those would be parcel  
8 post, bound printed matter, and special rate in particular.  
9 First of all, would you agree that there are differences in  
10 the economic value of service at least between parcel post  
11 on one hand and bound printed matter and special rate on the  
12 other hand?

13 A I would agree that those two services have  
14 different own price elasticities of demand, yes.

15 Q But you're simply not aware whether or not the  
16 intrinsic value of service can be differentiated between  
17 those products or not?

18 A I would be happy to talk about parcel post, but I  
19 can't offer any advice on bound printed matter, no.

20 Q Let's go back to something that you did talk about  
21 earlier, however. When you state on page 8 that the  
22 rationale for distinguishing between intrinsic value and  
23 economic value is not apparent, one rationale might be that  
24 the economic value reflects what we talked about in the  
25 context of our earlier discussion as the incremental value

1 of service and the intrinsic does not? Might not that be a  
2 rationale for distinguishing between the two?

3 A Yes, I do think that if you're using incremental  
4 value of service, then the own price elasticity of demand  
5 can be an imperfect estimator of that concept.

6 Q Okay. Well, let's look at page 12 of your  
7 testimony, lines 5 through 9, and your testimony there, if I  
8 can restate it, is:

9 In summary, the factors that influence the  
10 intrinsic value of a mail service -- e.g., its priority in  
11 processing, transportation and delivery, and its success in  
12 avoiding content damage -- merit careful consideration in  
13 assessing the value of a mail service. In contrast, the own  
14 price elasticity of demand for a service does not merit  
15 corresponding consideration in this regard.

16 I take it that those statements present your views  
17 on the appropriate application of criterion (b) (2) in the  
18 pricing process?

19 A That's correct, and I think probably a word or two  
20 of explanation might be helpful.

21 I recognize that there are different ways of  
22 measuring value of service, which is what my response to  
23 your question interrogatory number 43 is all about, and the  
24 particular interpretation that I was focusing on in my  
25 recommendation is the gross value of service. In that

1 context, then the price elasticity of demand doesn't tell  
2 you a lot about the gross value of service; it's more of a  
3 valuable but still imperfect indicator of incremental value  
4 of service.

5 Now, I think, at the end of the day, we would  
6 probably arrive at the same point, which is to say that I  
7 don't recommend to the Commission that they ignore the own  
8 price elasticity of demand. It can give some useful  
9 information about the magnitude of a cost coverage that a  
10 service can reasonably bear. But I don't think you need to  
11 necessarily consider that possibility in the context of  
12 value of service. It might alternatively be considered in  
13 Section 3622(b)(3) where you try to determine what is a  
14 reasonable share of institutional costs for a subclass to  
15 bear.

16 Q Well, Dr. Sappington, you have just given us your  
17 views about (b)(2). What I would like to do now is read you  
18 some statements containing the views of others regarding the  
19 appropriate application of (b)(2) and ask whether or not you  
20 agree with them and view them as consistent with your view.

21 MR. KOETTING: Just so there is no mystery here,  
22 these are statements made by the Commission in some of its  
23 earlier proceedings, and if you and your counsel would like,  
24 I'll be happy to give you the pages so you can follow along  
25 as I read them.

1 MR. McKEEVER: I think a reference to the page  
2 number would be helpful, Mr. Chairman.

3 BY MR. KOETTING:

4 Q I'll start with Docket Number R87-1, and I'll  
5 start with the statements appearing at the bottom of page  
6 385, the top of page 386.

7 Dr. Sappington, I have given you these copies  
8 simply because it's easier for you to follow along, but I'm  
9 not asking you to agree that this is what the Commission  
10 said; I just ask you to view these as statements that I'm  
11 reading to you and I'm going to ask you whether you agree  
12 with them or disagree with them when I'm finished.

13 A I understand.

14 Q The statement I'm starting with appears at the  
15 bottom of page 385 from Docket R87-1, and is as follows:

16 So far as pricing is concerned, Section 3622(b)(2)  
17 requires us to consider the relative service quality and the  
18 distinctive service features of the various classes as well  
19 as the relative demand for them on the part of those who pay  
20 the postage. Neither aspect of value of service takes  
21 precedence over the other, though in the nature of the case,  
22 demand considerations are likely to affect the mark-up for  
23 every subclass, while for some, there may be no clear  
24 indication that a service feature or deficiency should do  
25 so.

1           Would you endorse the views expressed in the  
2 statement that I just read as the appropriate way to apply  
3 criterion (b) (2)?

4           A     I think that I would best characterize this as one  
5 evaluation of the value of service criterion which could be  
6 appropriate. And again, I think the second part of the  
7 statement is particularly important in that regard because  
8 as the Commission says, when you're determining the  
9 mark-ups, you certainly want to consider the price  
10 elasticities of demand, and I certainly endorse that  
11 procedure.

12           My -- the way I may depart slightly in my  
13 recommendation is just it's a question of where do you take  
14 that into account? It's definitely when you're setting  
15 mark-ups, it's relevant, but I think you can take that into  
16 account in considering Section 3622(b) (3) instead of Section  
17 3622(b) (2). However, as I try to make clear in my response  
18 to interrogatory USPS-UPS-T6-43, I think reasonable people  
19 can disagree on the best way to measure value of service,  
20 but at the end of the day, I think we all end up with the  
21 same basic relationship between service and reasonable  
22 mark-ups.

23           Q     Just so we're clear, there isn't any doubt from  
24 this statement, is there, that the Commission is  
25 specifically speaking in the context of 3622(b) (2) with

1 regard to these statements?

2 A Excuse me. Not any doubt in what respect?

3 Q Well, you were saying that perhaps demand  
4 information might be considered in other context, but is  
5 there any doubt in your mind when you look at these  
6 statements that the Commission was talking about --  
7 referring to them specifically in the context of 3622(b)(2)?  
8 And again, I would refer you to the bottom of the first  
9 page, 385.

10 A Yes, it does appear to be in the context of  
11 3622(b)(2).

12 Q Moving on to the next page of the pages that I  
13 handed you, which again is the Commission's opinion on  
14 Docket R87-1, page 387, there is a beginning of paragraph  
15 4090 there in which the Commission states:

16 We have used demand elasticities as a rough  
17 estimate of relative value to senders in past cases.

18 Would you view that as an appropriate way to apply  
19 criterion (b)(2)?

20 A Again, if you're looking at incremental value of  
21 service, then the own price elasticity of demand can often  
22 give you a rough estimate of value that a customer or  
23 customers place on a Postal product relative to competitive  
24 products.

25 Q But again, the statute simply refers to value of

1 service and the Commission has to decide what it means in  
2 (b) (2), not whether or not -- the statute doesn't refer to  
3 gross value or incremental value of service. Would you  
4 agree that it refers merely to value of service?

5 A Yes.

6 Q And that's what the Commission needs to decide,  
7 what it's going to consider to be value of service?

8 A That's correct.

9 Q Let's do one more. Let's go back even further to  
10 Docket R74-1.

11 MR. MAY: What page?

12 MR. KOETTING: I am on page 198 of the  
13 Commission's opinion in R74-1.

14 BY MR. KOETTING:

15 Q The first statement I would read would be the  
16 statement: In its ranking of the five major categories of  
17 mail services, the Postal Service places First Class Mail as  
18 the most price-inelastic in terms of either historical or  
19 prospective elasticity.

20 I'm going to skip a couple of sentences where the  
21 Commission has some references about the elasticity measures  
22 that were specific to that case.

23 But it then concludes: Accordingly, value of  
24 service considerations under Section 3622(b) (2) of the Act,  
25 support the assignment of relatively more institutional

1 costs to First Class letters.

2 Dr. Sappington, would you agree that that's an  
3 instance in which the Commission applied the own price  
4 elasticity to directly support a conclusion about the value  
5 of service considerations that it deemed appropriate under  
6 3622(b)(2) of the Act?

7 A Yes, I would. Again, I want to just emphasize  
8 that I'm not saying that there's really only one way to look  
9 at value of service, and, in fact, what I'm trying to say is  
10 that there are multiple ways of looking at it, and the  
11 Commission's way is certainly not wrong.

12 But I also don't think my way is wrong, and also,  
13 as I put it out, I do think it's worthwhile to look at both  
14 measures.

15 Q Dr. Sappington, are you familiar enough with these  
16 and other prior Commission opinions over the last 30 years  
17 to agree that we could sit here for a long time while I read  
18 to you, instances in which the Commission cited the  
19 estimated price elasticity of a particular subclass,  
20 specifically in the context of its application of the value  
21 of service criterion (b)(2) as one factor upon which it was  
22 relying to justify the cost coverage it was recommending for  
23 that subclass?

24 A Yes. My reading of the Commission decisions does  
25 reveal that quite often, the Commission, as well as

1 participants in this process, talk about the economic value  
2 of service as one way of measuring value of service.

3 And the main contribution, I'm hoping to be able  
4 to try to make in this proceeding is to indicate that when  
5 you do that, it can certainly be appropriate, but it  
6 involves some special assumptions, and the special  
7 assumptions are exactly what you mean by value of service,  
8 and it's the incremental, not the gross value.

9 And I think there is value to thinking of things  
10 both ways, but at the end of the day, certainly you do want  
11 to take price elasticities of demand into account when  
12 figuring out how much contribution an individual service can  
13 provide.

14 Q So, if we could go to the top of page 8 of your  
15 testimony, where, again, on the same general topic, you say  
16 it has been suggested in the present rate case and in  
17 preceding rates cases, that both the intrinsic value and  
18 what has been called the economic value of a mail service  
19 should be considered in assessing the service's value to  
20 centers and recipients.

21 And then in your footnote, to clarify, I suppose,  
22 who it was you were saying had suggested this, you cite only  
23 the testimony of Postal Service's witnesses that you, in  
24 fact, could have cited to Commission recommended decisions  
25 and opinions for that same proposition, correct?

1           A     I think that's correct, yes. Again, just to point  
2 out, the one reason I'm concerned about over-using the own  
3 price elasticity of demand as a measure of value of service  
4 is because when you do that, you introduce a consideration  
5 which runs exactly contrary to my interpretation of  
6 3622(b)(5), which is considering the alternatives that  
7 individuals have.

8                     In my opinion, what that criterion is saying is  
9 that when mailers have alternatives, it's legitimate to set  
10 higher markups and higher rates for those services, because  
11 mailers will not be harmed as badly because they do have  
12 these alternatives.

13                    When you start using the own price elasticity of  
14 demand as a measure of value of service, it tells you just  
15 the opposite; what it says is that high elasticity means low  
16 value of service, and, therefore, low rates and low rate  
17 increases.

18                    So, this directly opposite conclusion is  
19 introduced by thinking of value of service in terms of the  
20 own price elasticity of demand is one reason that I  
21 recommend focusing more on the gross value of service and  
22 then using the own price elasticity of demand when setting  
23 markups.

24           Q     Earlier in our conversation you testified that you  
25 hadn't really studied First Class Mail, periodical, Standard

1 A mail, or the other subclasses of Standard B in terms of  
2 their intrinsic value of service; is that correct?

3 A That's correct.

4 Q So, on what basis could you assess the relative  
5 intrinsic value of service of the subclasses for which you  
6 propose cost coverages?

7 A What I was focusing on in my evaluation of the  
8 value of service, the gross value of service, is the  
9 particular features that these individual services provide.

10 Q But those are all relative measures; are they not?

11 A They can be relative to other Postal services, or  
12 they can stand on their own.

13 Q In what sense can they stand on their own?

14 A That faster speed is better, more reliable service  
15 is better.

16 Q Faster than what?

17 A Faster than it used to be, for example; for  
18 example, in the Parcel Post delivery, if average time to  
19 delivery increases, then that would indicate an increase in  
20 the gross value of service.

21 Q So, is it your testimony that in enacting  
22 3622(b)(2) and mentioning certain specific factors of  
23 intrinsic value, Congress intended that the comparisons only  
24 be made within the same subclass over time, rather than  
25 between subclasses?

1 A No, that's not my testimony.

2 Q So, then I guess I return to the same question:  
3 If it's necessary to make comparisons between subclasses to  
4 place things like which mode of transportation subclasses  
5 receive and whether or not they get collection service, or  
6 their priority of delivery, how is it possible to make those  
7 assessments without being aware of what the facts with  
8 regard to the other subclasses are?

9 A As always, the more information you have, the  
10 better. I just didn't want to present myself as an expert  
11 on these other classes.

12 I have a cursory understanding of some relative  
13 dimensions of comparisons across these different mail  
14 subclasses, but I don't want to represent myself as an  
15 expert on these other classes.

16 Q Well, let's explore your cursory understanding  
17 then again. You started with the subclasses for which you  
18 proposed cost coverages, I presume, which were Priority Mail  
19 and Parcel Post, is that correct?

20 A Yes, it is.

21 Q And did you draw any conclusions, for example,  
22 with respect to First Class mail as to whether the  
23 intrinsic, what the intrinsic value of those two subclasses  
24 was relative to First Class mail?

25 A My testimony does talk about a number of different

1 features of Priority Mail versus First Class, for example,  
2 and based upon those features that I have studied I would  
3 conclude that Priority Mail had a higher value of service.

4 Q Did you make a similar comparison between Parcel  
5 Post and Priority Mail and Periodicals mail?

6 A Between Parcel Post --

7 Q Parcel Post and Periodicals mail.

8 A My rough understanding there is that they are both  
9 deferred delivery type products, but I have not done a  
10 comprehensive assessment of all the differences between  
11 Parcel Post and the other Standard B mail subclasses.

12 Q I'm sorry -- that is useful information but my  
13 question was regarding Periodicals and Parcel Post.

14 A I'm sorry, Periodicals and Parcel Post.

15 Q Was that -- your answer was intended to apply to  
16 Periodicals and Parcel Post?

17 A Yes.

18 Q So you did some intrinsic value of service  
19 comparisons between First Class and Priority Mail and Parcel  
20 Post and First Class and you did some intrinsic value of  
21 service comparisons for Periodicals relative to Parcel Post,  
22 presumably for Priority Mail as well?

23 A I'm sorry, I am not sure what you mean or what  
24 that question is.

25 MR. McKEEVER: Mr. Chairman, it is a compound

1 question. I think some of it is also contrary to the  
2 testimony, but if counsel could break it down into the  
3 separate comparisons he is talking about I think it would be  
4 helpful.

5 BY MR. KOETTING:

6 Q Sure. Let's start with Priority Mail. I think  
7 you indicated that you compared -- you at least did some  
8 analysis comparing intrinsic value of service of Priority  
9 Mail with First Class mail, correct?

10 A That is correct.

11 Q Priority Mail -- did you do a comparison of  
12 intrinsic value of service between Priority Mail and  
13 Periodicals?

14 A Certainly not to the extent that I did with First  
15 Class mail.

16 Q But you did it to some extent?

17 A I acquired a rough knowledge, cursory knowledge,  
18 as I think was the term I used before, of the basic features  
19 of services like Periodicals.

20 Q Okay. Parcel Post -- again, did you compare that  
21 with First Class mail?

22 A Not explicitly to the extent that I did in my  
23 testimony for Priority Mail, but yes, I certainly thought  
24 about the differences in the features.

25 Q What about Periodicals and Parcel Post?

1           A     Again, when we get to services other than Priority  
2 Mail and Parcel Post that is where my characterization as a  
3 cursory understanding comes into play, and I did compare my  
4 fairly detailed knowledge of Parcel Post and Priority Mail  
5 with my cursory knowledge of the other mail services.

6           Q     Okay, so now based on your cursory information  
7 about Periodicals and First Class mail, can you answer my  
8 earlier question about do you have an opinion whether or not  
9 First Class mail has a higher intrinsic value of service  
10 than Periodicals?

11          A     Based upon that cursory understanding, I would say  
12 that First Class has a higher intrinsic value.

13          Q     And as we established earlier, I believe, First  
14 Class has a higher in absolute value own price elasticity  
15 and therefore a lower economic value of service, correct?

16               MR. McKEEVER: Mr. Chairman, are we now back to  
17 Periodicals Regular or Periodicals as a whole, because I  
18 believe the chart makes it clear that the answer differs  
19 depending on what you are talking about.

20               MR. KOETTING: Periodicals Regular.

21               MR. McKEEVER: Thank you.

22               THE WITNESS: I'm sorry, I lost track of your  
23 question.

24               BY MR. KOETTING:

25          Q     Would you agree that the own price elasticity

1 reported for First Class mail is higher in absolute value  
2 than the estimated own price elasticity for Regular  
3 Periodicals?

4 A Yes, I would.

5 Q And therefore that would suggest that in terms of  
6 economic value of service First Class mail has a lower  
7 economic value of service than Regular Periodicals, correct?

8 A Yes. That's tautological given that the economic  
9 value of service is essentially the inverse of price  
0 elasticity of demand.

1 Q So applying intrinsic measures as we just went  
2 through, in which you I believe concluded that First Class  
3 has a higher intrinsic value, and applying economic measures  
4 of value of service you have just agreed that First Class  
5 has a lower, would that be yet another rationale for a  
6 distinction between the two measures of value of service?

7 A I'm sorry, you said I agreed that it has a  
8 lower -- a lower what?

9 Q Economic value of service based on own price  
0 elasticity.

1 A I'm sorry to do this to you again, but I lost  
2 track of the question. Once again?

3 Q Well, let's go back and start over.

4 First Class has the higher own price elasticity  
5 and absolute value and therefore the lower economic value,

1 correct?

2 A That is correct.

3 Q And we just agreed that it has a higher intrinsic  
4 value, correct?

5 A Correct.

6 Q So when we are comparing these two subclasses we  
7 reach diametrically opposite conclusions depending on  
8 whether we look at intrinsic measure of value of service or  
9 an economic measure of value of service, correct?

10 A We get different answers, yes.

11 Q And my question is, wouldn't that be yet another  
12 example of a rationale as to why it is important in the  
13 ratemaking process to distinguish between these two  
14 measures?

15 A It is important if your definition of value of  
16 service is the incremental value of service, which I believe  
17 I have indicated a number of times now, yes.

18 But the own price elasticity is really a measure  
19 of how much, giving you a measure of how sensitive demand is  
20 to prices that would be influenced by the availability of  
21 competitors' comparable services as well as the intrinsic  
22 characteristics of the product itself.

23 Q If we could turn to your response to Postal  
24 Service Interrogatory 52, subpart (a).

25 A Yes.

1 Q Do you have that, Dr. Sappington?

2 A Yes, I do.

3 Q In that subpart response, you assert that, with  
4 respect to the ability of competitors to use Postal rates as  
5 an umbrella for their own rates, your assertion is that what  
6 competitors can do is unimportant relative to what  
7 competitors do do. Do you accept that characterization of  
8 your response?

9 A Yes, I do.

10 Q Let's look at your response to Postal Service  
11 Interrogatory 47(b). In the second paragraph there, you  
12 assert that, in contrast to the Postal Service, private  
13 enterprises pay corporate profit taxes, correct?

14 A That is correct, yes.

15 Q Would you agree that whether competitors are  
16 potentially subject to pay corporate profit taxes is  
17 unimportant relative to whether they actually do pay  
18 corporate profit taxes?

19 A Important or unimportant for what purpose?

20 Q For the same purposes that you must believe it is  
21 important to the fact that they pay them, because you  
22 mention it in your interrogatory response.

23 A Yes. The answer I give to Interrogatory  
24 USPS/UPS-T-6-47 talks about what potential benefits may  
25 arise if a private competitor serves a mailer rather than

1 the Postal Service. And one of the potential advantages I  
2 mention there is that because private competitors pay taxes,  
3 that is of some value, it goes in to the Treasury and can be  
4 used for a variety of purposes by the government. So, yes,  
5 I would agree that what is important is whether they do pay  
6 taxes or not.

7 Q Would you agree that private sector competitors,  
8 unlike the Postal Service, have an incentive to structure  
9 their business, for example, by using offshore subsidiaries  
10 to avoid paying corporate profit taxes?

11 A I am not an expert on offshore deals.

12 MR. McKEEVER: I will object, Mr. Chairman. It is  
13 going way far afield, I think, from the testimony here. But  
14 I guess Dr. Sappington has answered the question, so we will  
15 leave it stand. But I would hope that counsel would stick  
16 within the testimony.

17 MR. KOETTING: Mr. Chairman, the witness is the  
18 one who brought up paying corporate taxes. I believe it is  
19 totally within the scope of his testimony. If Mr. McKeever  
20 and the witness are dissatisfied with the offshore  
21 subsidiaries, let me just rephrase the question and  
22 eliminate that portion of it.

23 MR. McKEEVER: Mr. Chairman, the question has been  
24 asked and answered. I guess we can go on to the next  
25 question.

1 MR. KOETTING: He has only answered it in the  
2 context of the offshore subsidiaries.

3 BY MR. KOETTING:

4 Q So I would restate the question, Dr. Sappington.  
5 Would you agree that private sector competitors, unlike the  
6 Postal Service, have an incentive to structure their  
7 business to avoid paying corporate profit taxes?

8 MR. McKEEVER: Objection, Mr. Chairman. I don't  
9 believe that has one whit to do with setting proper Postal  
10 rates. The mere fact that the witness mentions that private  
11 enterprise pays taxes doesn't mean that we can go into  
12 extensive questioning on tax laws and how people can manage  
13 their tax bills or anything of that sort. This is well  
14 beyond the scope of this witness' testimony.

15 CHAIRMAN GLEIMAN: Mr. Koetting, I agree and I  
16 would like you to move on, please.

17 BY MR. KOETTING:

18 Q Well, let me state it hypothetically then. Would  
19 you agree that if private sector competitors can avoid  
20 paying corporate profit taxes, that under the circumstances  
21 you describe in your response to Interrogatory 47(b),  
22 increased demand for competitive services caused by Postal  
23 rate increases, that cause competitors' earnings to rise,  
24 will not benefit this country's citizens if they don't pay  
25 the corporate profit taxes?

1 MR. McKEEVER: Objection, Mr. Chairman. Again, I  
2 think whether it is hypothetical or not, we are well beyond  
3 the scope of this witness' testimony. The point that Dr.  
4 Sappington made in his response is a relatively  
5 straightforward and simple one and doesn't involve getting  
6 us into any questions of the sort that counsel has posed.

7 CHAIRMAN GLEIMAN: Counsel, I am going to have to  
8 agree with Mr. McKeever again, and I would like you to move  
9 on.

10 MR. KOETTING: I will be happy to move on, Mr.  
11 Chairman. I believe this was an entirely relevant line,  
12 given the witness' testimony, but we will move on.

13 CHAIRMAN GLEIMAN: Well, it won't be the first  
14 time I was in error, I am sure, nor the last. And I sure  
15 people will take the time to point it out if they reach that  
16 conclusion.

17 BY MR. KOETTING:

18 Q Dr. Sappington, if you could please refer to your  
19 response to Postal Service Interrogatory 52(b).

20 A I have that here.

21 Q There you state that it is always appropriate for  
22 the Commission to consider evidence that rate increases by  
23 competitors limit the ability of Postal Service customers to  
24 protect themselves from Postal rate increases. In the  
25 context of that statement, I would like to talk a little bit

1 about customers' ability to protect themselves.

2 Would you agree, and I know it has been discussed  
3 quite a bit today that, whether it is publicly available or  
4 not, there must at least, in theory, exist information as to  
5 what type of competitor customers are offered negotiated  
6 rate by competitors, under what terms those rates are  
7 offered, and, similarly, there would be information as to  
8 what types of customers are excluded from obtaining  
9 negotiated rates, would you agree that that type of  
10 information must exist?

11 A I don't have any firsthand knowledge of that so I  
12 can't confirm that assertion.

13 Q Which part of it can't you confirm?

14 A That the data is there and --

15 Q Well, let me go back then. Is it your testimony  
16 that there are no negotiated rates offered by Postal Service  
17 competitors?

18 A No.

19 Q That is not your testimony?

20 A That's correct.

21 Q You are willing to acknowledge that there are  
22 negotiated rates offered to competitors by some of their  
23 customers?

24 A No, I think your question was, is it my testimony  
25 that they do not exist? And that is not my testimony.

1 Q Okay. Are you willing to acknowledge that they do  
2 exist?

3 A As I said, I don't have any firsthand knowledge  
4 that they do.

5 Q Well, again, whether or not your knowledge is  
6 firsthand or not, would you agree that you are aware that  
7 they exist? Are you simply saying you don't have an opinion  
8 on that because you lack firsthand information?

9 MR. MCKEEVER: Mr. Commissioner, that is just what  
10 he said, he doesn't have any information. I will object  
11 that it has been asked and answered. And if counsel would  
12 ask questions that the witness can answer, instead of trying  
13 to make argument or points that he can argue in brief, if he  
14 thinks it is relevant, then I think we will proceed faster.  
15 But it has been asked and answered. The witness said he had  
16 no knowledge.

17 MR. KOETTING: Well, if --

18 COMMISSIONER LeBLANC: Mr. Koetting, he has  
19 answered the question. If you want to try to restate it, he  
20 will tell you whether or not he has any further knowledge of  
21 it, but he has answered the question. If you want to try to  
22 restate it one more time, we will allow that.

23 MR. KOETTING: I think I am trying to move on to  
24 the next step.

25 COMMISSIONER LeBLANC: Fine. Let's keep going.

1 BY MR. KOETTING:

2 Q If such negotiated agreements were to exist, would  
3 you agree that the Commission's ability to consider evidence  
4 that rate increases by competitors limit the ability of  
5 Postal Service's customers to protect themselves from Postal  
6 increases, the Commission's ability to consider that would  
7 be impaired without that information?

8 A Would you remind me again exactly what information  
9 you're referring to?

10 Q Information as to which types of customers can  
11 obtain these negotiated agreements and which customers are  
12 excluded from obtaining these types of service agreements  
13 and the terms of the negotiated agreements as well.

14 A Okay. And then the question is, if the Commission  
15 does not have access to that information, is the Commission  
16 impaired in its decisionmaking?

17 Q Well, is it impaired in its ability to consider  
18 whether rate increases by competitors limit the ability of  
19 Postal Service customers to protect themselves from postal  
20 rate increases?

21 [Pause.]

22 A I am just thinking in my own mind about the word  
23 impaired. I'm not certain about that, but I think as a  
24 general rule, the more information a decisionmaker has, the  
25 better off the decisionmaker will be. And so if we're

1 talking about information or anything else, you do want to  
2 think about both the benefits and the costs, and I think  
3 there may be some benefits to the Commission to having this  
4 information, but there may also be costs associated with  
5 trying to gather it.

6 There's also a question in my mind about exactly  
7 how useful it would be because, again, I don't know anything  
8 about these contracts, but my suspicion would be that they  
9 are quite complex. It's not just saying, here's a discount  
10 off the published rate; might have different restrictions on  
11 delivery times and when these rates are in effect and so on,  
12 and then trying to summarize all that information, plus the  
13 fact that they may change over time quite rapidly may make  
14 it extremely hard to try to sort of get a good feel for  
15 what's really out there, and consequently, there may be  
16 large costs associated with collecting and trying to analyze  
17 this information. In the end, you may not end up with a  
18 whole lot more useful information.

19 Q Would you agree that in terms of economics, the  
20 purpose of these types of agreements which you just  
21 discussed in general terms is to allow the company to  
22 discriminate amongst its customers?

23 MR. McKEEVER: Mr. Chairman, again I'm going to  
24 object. I think we're well beyond the scope of proper cross  
25 examination here. The witness has not testified about any

1 such agreements and said he doesn't even have firsthand  
2 knowledge that they exist or what's in them. And I don't  
3 see where this is going to assist anybody in setting proper  
4 postal rates, but it's certainly beyond the scope of this  
5 witness's testimony.

6 MR. KOETTING: I disagree, Mr. Chairman. The  
7 witness this morning volunteered that he was aware of  
8 Department of Justice guidelines about secret agreements and  
9 the economics literature on those agreements, and I'm asking  
10 him in terms of economic theory, isn't the purpose of these  
11 types of agreements to discriminate among customers.

12 CHAIRMAN GLEIMAN: My recollection of this morning  
13 is that the witness did admit that he was aware of an  
14 article and there was some questioning and it may have been  
15 in a journal that he has some involvement with as an editor  
16 or on a board or something like that, or review panel. I  
17 don't remember whether I have all the facts exactly  
18 straight. But if the witness can answer, let's let the  
19 witness answer on this one.

20 THE WITNESS: I'm sorry, I've lost track of the  
21 question again.

22 BY MR. KOETTING:

23 Q Sure. The question is, isn't in fundamental  
24 economic terms the purpose of these types of agreements in  
25 which there is a published tariff but then negotiated rates

1 that are set different than the published tariff, the  
2 purpose of those is to discriminate amongst the different  
3 customers? If it makes you feel any better, discriminate in  
4 a non-pejorative sense.

5 A Well, I think the politically correct usage of the  
6 term now is price differentiation as opposed to  
7 discrimination.

8 Also, just to be clear, I believe what I testified  
9 to this morning was something called a most favored customer  
10 clause, which is not private. It's a public statement of  
11 policy and that is what the Department of Justice in the  
12 article that I mentioned refers to.

13 So again, I don't have any firsthand knowledge and  
14 I don't want to state that this is the purpose when I'm not  
15 sure, but it's conceivable that that is one of the possible  
16 uses of price differentiation.

17 Q Well, when you use the term price differentiation,  
18 I would submit it's virtually tautological that the purpose  
19 is to offer different prices to different customers. Why  
20 else would you have negotiated agreements other than the  
21 published tariff other than to offer different prices to  
22 different customers?

23 MR. McKEEVER: Mr. Chairman, if it's tautological,  
24 then I'm not sure that counsel has any need to ask the  
25 question, but he has been asking questions that do call for

1 tautological answers, and so I would object to such  
2 questions, though I guess there is none pending now.

3 CHAIRMAN GLEIMAN: I don't think there was a  
4 question pending, either. There was a statement that was  
5 made by counsel.

6 MR. KOETTING: My question -- the witness stated  
7 he wasn't aware of whether or not price differentiation was  
8 the reason for price differentiation, and I was asking him  
9 whether or not in fact what he was stating was -- his  
10 uncertainty couldn't be sustained in light of the  
11 tautological definition he has provided that he is now  
12 calling these things price differentiation.

13 MR. McKEEVER: Well, Mr. Chairman, I don't believe  
14 that properly characterizes the transcript, but we can see  
15 that when we get the transcript.

16 CHAIRMAN GLEIMAN: I still don't know whether  
17 there is a question pending.

18 MR. McKEEVER: I don't, either.

19 CHAIRMAN GLEIMAN: Were you putting the question  
20 again?

21 MR. KOETTING: Yes, indeed, Mr. Chairman. Does  
22 the witness agree that the purpose of price differentiation  
23 is price differentiation?

24 THE WITNESS: That certainly sounds tautological  
25 to me, so I certainly can't disagree with a tautological

1 statement.

2 BY MR. KOETTING:

3 Q And assuming that competitors do engage in price  
4 differentiation, do you agree that that fact should cause  
5 the Commission to be more cautious about reaching any  
6 general conclusions that mailers in the subclass that face  
7 competition from those competitors can protect themselves  
8 from the adverse consequences of postal rate increases?

9 A I hate to do this to you again, but I didn't  
10 follow the whole question.

1 Q Believe me, you're not the first.

2 Would you confirm that if indeed the existence of  
3 these price differentiation agreements were shown, that  
4 should make the Commission more cautious about reaching any  
5 general conclusions that mailers in the subclass potentially  
6 -- that compete with private sector competitors who can  
7 potentially offer these, that those customers in those  
8 subclasses can protect themselves from the adverse  
9 consequences of postal rate increases?

20 MR. McKEEVER: Mr. Chairman, we are talking about  
21 agreements providing discounts, I take it, to mailers,  
22 users?

23 MR. KOETTING: That would be correct.

24 MR. McKEEVER: Thank you.

5 THE WITNESS: I forgot exactly how you phrased the

1 question, but let me try to answer it to the best of my  
2 recollection.

3 If there are these agreements or procedures by  
4 which certain mailers get discounts, then I think that would  
5 provide comfort to the Commission that, in fact, the mailers  
6 can protect themselves because they can negotiate these  
7 discounts.

8 BY MR. KOETTING:

9 Q Would that hold true whether or not all customers,  
10 all mailers in the subclass could negotiate the agreements  
11 or only -- or if -- would it continue to hold true if less  
12 than all of the mailers in the subclass had the opportunity  
13 to negotiate these agreements?

14 A Yes, it would continue to be true that if some of  
15 the mailers can negotiate discounts, the Commission can take  
16 comfort in that fact.

17 Q Do you think that the Commission -- would you  
18 agree that in evaluating how much of a rate increase can  
19 reasonably be imposed on customers of a competitive service  
20 under the circumstances that we've just described in which  
21 some but not all customers can potentially make these  
22 negotiated agreements, that the Commission should focus its  
23 analysis to protect those customers with the least ability  
24 to switch to the competitor?

25 A I think as a general principle, the Commission's

1 protections should be targeted toward captive ratepayers,  
2 first class letter users in particular. In considering what  
3 are appropriate mark-ups and so on, well, of course, it also  
4 has to consider the welfare of all customers.

5 Q Aren't people who lack the ability to negotiate  
6 discounted agreements with competitors much more captive  
7 than those who can?

8 A I wouldn't use the word much, but they are more  
9 captive, but quite likely much less captive than first class  
10 letter users.

11 Q Okay. Well, let's get off of the negotiated  
12 agreements, but let's stay on the general topic of the  
13 ability of mailers to switch to competitors.

14 Would you agree that the ability of a mailer who  
15 is only going to send one piece of parcel post or one piece  
16 of priority mail -- a package, one package -- if they were  
17 to utilize the Postal Service, those would be the two  
18 subclasses they might consider. Would you agree that their  
19 ability might -- to switch to a competitor might be affected  
20 by the amount of time they would have to drive to enter the  
21 competitor's facility?

22 MR. McKEEVER: I apologize, Mr. Chairman, I just  
23 don't understand it. If I could ask for it to be rephrased  
24 or just restated, not necessarily rephrased.

25 MR. KOETTING: Well, let me try to restate it. I

1 think that might work better.

2 BY MR. KOETTING:

3 Q The Rate Commission you're suggesting should be  
4 cognizant of whether or not there are alternatives for  
5 particular subclasses, correct, available at reasonable  
6 cost? Is that consistent with your testimony?

7 A Yes. That would be one factor the Commission  
8 should consider, yes.

9 Q So one of the things that they want to consider in  
10 terms of the reasonable alternatives is it has to be at a  
11 comparable cost, I believe. Is that a limitation that you  
12 think is important?

13 A I would say that the more similar the cost, the  
14 closer the substitutes.

15 Q Okay. Now what I would like to explore might be  
16 differences other than price, or differences that might not  
17 be apparent if we only look at published tariffs, for  
18 example.

19 Would you agree that a mailer who has a single  
20 package, and if they want to mail it with a competitor  
21 without paying a pick-up charge, that they might have to  
22 drive a significant difference to the competitor's facility  
23 to enter that?

24 A That's a logical possibility, but I believe that  
25 the -- most competitors do have pick-up boxes and things of

1 that sort, so a customer wouldn't necessarily have to drive  
2 to their facilities.

3 Q Wouldn't competitors also -- competitor services  
4 for package shipping also be available at retail facilities,  
5 what we refer to in the Postal Service as commercial  
6 mail-receiving agencies, outfits like Mailboxes, Etc.?  
7 Would those be another option for people to mail -- ship  
8 their parcels by something other have the Postal Service?

9 A Yes, I believe they are.

10 Q Do you know whether or not those types of  
11 facilities charge mailers the published rate for the  
12 competitor product or do they also include a surcharge for  
13 the services that they provide?

14 A I'm not certain about that.

15 Q If they were to include surcharges, would the  
16 amount of that surcharge be something that the Commission  
17 would want to keep in mind in determining whether or not  
18 mailers in this subclass have the ability to switch to  
19 alternatives and protect themselves from postal rate  
20 increases?

21 MR. MCKEEVER: Mr. Chairman, is Mr. Koetting also  
22 positing that surcharges are imposed if the mailer takes to  
23 the same Mailboxes, Etc. outlet a package to be sent by the  
24 Postal Service? I believe that practice exists as well.

25 CHAIRMAN GLEIMAN: I think we'll leave that one

1 for redirect. I heard what his question was and I think he  
2 was talking about competitors in this instance. If he wants  
3 to pose the other question, he can; and if you want to pose  
4 the other question later on redirect, you may.

5 MR. MCKEEVER: I thought he was comparing  
6 something, Mr. Chairman. I was trying to get the  
7 comparison. But I apologize if he wasn't.

8 CHAIRMAN GLEIMAN: I don't think he's doing it  
9 yet, but maybe he will now if it suits his purposes.

10 THE WITNESS: If you wouldn't mind just restating  
11 the question so I could be sure of what comparison you are  
12 making?

13 BY MR. KOETTING:

14 Q Well, I am not sure I was making a comparison. I  
15 was asking you whether or not the Commission, as you  
16 acknowledge -- you know, again, we started with your  
17 statement: It is always appropriate for the Commission to  
18 consider evidence that rate increases by competitors limit  
19 the ability of Postal Service customers to protect  
20 themselves from postal rate increases.

21 In that context, focusing specifically on the  
22 ability of Postal Service customers to protect themselves  
23 from postal rate increases and the Commission's evaluation  
24 of how well customers can do that, would you agree that it's  
25 necessary for the Commission to take account of any other

1 charges such as surcharges for convenient retail facilities  
2 that the competitor -- that the customer might have to pay  
3 if they are trying to protect themselves from a postal rate  
4 increase by switching their business to the customer?

5 A Yes, the Commission would need to take into  
6 account the surcharges on competitive products and any  
7 corresponding surcharges on Postal Service products that  
8 things like Mailboxes, Etc. might charge.

9 Q And would you agree that those types of charges  
10 are not likely to be incurred by a large commercial shipper  
11 who is utilizing a competitor that has a pickup charge --  
12 pickup charge -- large volume virtually disappears, in  
13 substance, therefore, the impact of these types of  
14 surcharges is based primarily on the small, single-piece  
15 mailers?

16 A I'm not clear on what you mean by the  
17 characterization that these charges essentially disappear.

18 Q On a per-piece basis, they become de minimis?

19 A If the volume is sufficiently large.

20 Q Correct. If you could please refer to your  
21 response to Postal Service Interrogatory 54?

22 [Pause.]

23 Now, this question involved the hypothetical that  
24 was originally set forth in your response to Question 42(a),  
25 correct?

1 A I believe that is correct, yes.

2 Q Could you look at Subpart (b) to your response to  
3 Question 54?

4 A I have that here.

5 Q We asked if a necessary implication of your  
6 hypothetical was that the cross price elasticity is greater  
7 than the own price elasticity, and you responded that since  
8 the own price is negative and the cross price is positive  
9 when the products are substitutes, the positive cross price  
10 always exceeds the negative own price.

11 Is that a fair summarization of your response?

12 A I believe so, yes.

13 Q Let me try to improve that question slightly, and  
14 I think you know what's coming.

15 The change that I have in mind to Subpart (b) --  
16 to our question's Subpart (b), is to insert the phrase, in  
17 absolute value, after the phrase, must exceed, so that what  
18 I am now asking is if a necessary implication of the way you  
19 have structured your hypothetical is not only that the cross  
20 price elasticity must exceed the own price elasticity, but  
21 it must also exceed it in absolute value.

22 Do you understand my question?

23 A I understand your question. I didn't understand  
24 your introduction that I knew what was coming. In fact, I  
25 was confused by your question. I didn't know what you were

1 after here.

2 It will take me a while to review the hypothetical  
3 and then try to work through this. I can do that, if you'd  
4 like.

5 Q Well, I think that you might find, if you look at  
6 -- the salient facts are stated in Subpart (a) of Question  
7 54, and then if you just re-answer Subpart (b), relying on  
8 those facts, but inserting the qualifier of must exceed in  
9 absolute value.

10 A Those facts alone wouldn't allow me to answer the  
11 question, because it doesn't tell you how responsive the  
12 volume is. We know the volume goes one way for one service  
13 and the other way for the other.

14 But what would matter to talk about cross price  
15 elasticities, we need a measure of the sensitivity of volume  
16 changes to the price changes.

17 So I certainly can't answer it based upon just  
18 what's in (a).

19 Q Well, we've got the price of both services, A and  
20 B, both increasing by 20 percent, correct?

21 A Yes, that's correct.

22 Q And the volume of Service A decreases, and in your  
23 hypothetical, the volume decreases for this mailer, and this  
24 is a limited mailer in question, increases from one to zero,  
25 correct?

1 MR. McKEEVER: Mr. Chairman, I think that's what  
2 Dr. Sappington said, he had to go back to the --

3 MR. KOETTING: That's fine, if he's comfortable  
4 doing that. I'd ask him to do that. That might be  
5 necessary. I'd hope that it was not, but perhaps I was  
6 unduly optimistic.

7 CHAIRMAN GLEIMAN: Dr. Sappington can take what  
8 time he needs, if he feels comfortable trying to answer the  
9 question.

10 Mr. Koetting, while Dr. Sappington is reviewing  
11 the material and trying to put together an answer to your  
12 question, can you give me a sense of how much longer you  
13 might go?

14 MR. KOETTING: Not too much, maybe another 20-25.

15 CHAIRMAN GLEIMAN: Okay, I'm just trying to decide  
16 whether to tell people to get their car keys out of their  
17 cars.

18 MR. KOETTING: No, we're getting close. We're  
19 approaching -- the end is in sight; let's put it that way, a  
20 few more lines.

21 THE WITNESS: I don't think I'm going to be able  
22 to answer your question because the example that I  
23 constructed in 42 talks about an indivisible item, so  
24 elasticities are only defined in continuous settings, so I  
25 don't think elasticities are even going to be well defined

1 here, so I'm not going to be able to answer the question  
2 that you posed, unless we're going to talk about left-hand  
3 derivatives, and right-hand derivatives, and I don't think  
4 we want to get into that.

5 BY MR. KOETTING:

6 Q I guess you've thrown me a loop here, because  
7 we're talking about the same hypothetical that you responded  
8 to in Subpart (b) before I stuck in the words, in absolute  
9 value.

10 Can you explain to me why simply confining the  
11 question to an absolute value suddenly means that you can't  
12 talk about the elasticities in this context?

13 A Yes, because there's no question when we were  
14 talking about positive versus negative numbers. You know  
15 one is bigger than the other, but now we have to compare  
16 magnitudes, so we'd actually have to calculate them, and we  
17 can't calculate elasticity measures in a discrete setting  
18 like this.

19 Q Well, we don't have to calculate them to know  
20 whether one is greater than the other.

21 A I think we do, if they have the same sign.

22 Q But they don't have the same sign. I thought that  
23 that's what you stated here.

24 A Yes, but now you've asked me to talk about  
25 absolute value, and so, de facto, they have the same sign

1 now.

2 When they didn't have the same sign, I didn't need  
3 to do the calculations; that's how I could answer Part (b)  
4 as I did.

5 But now I think you're asking me to take away the  
6 fact that I know they have different signs, and now asking  
7 me to calculate an elasticity which I can't do with a  
8 discrete example of this sort.

9 Q Well, then let's look at your response to Postal  
10 Service Interrogatory Number 43, which also addresses the  
11 same hypothetical.

12 Do you have that?

13 A Yes, I do.

14 Q The original hypothetical in Question 42 was  
15 focused on an individual facing a limited budget purchase  
16 Postal services and how that individual might response to a  
17 rate increase for their preferred premium postal service,  
18 and in your response to Number 53 you shift the focus a bit  
19 from an individual consumer to an individual in charge of a  
20 company's shipping department who has to operate within a  
21 fixed annual budget.

22 Is that a fair summarization of your response to  
23 53?

24 A That was a component to my answer to 53.

25 Q Okay. That was a new component, correct, relative

1 to 42, where you were not talking about the shipping  
2 manager, you were talking about the individual consumer,  
3 so --

4 A In both cases they are individuals with fixed  
5 budgets so there is a different name on them but I believe  
6 the concept is the same.

7 Q Right, but you have shifted the focus from an  
8 individual consumer to a shipping manager, correct? That is  
9 all I am asking.

10 A Right.

11 Q Let's talk about the shipping manager on a budget  
12 a little bit.

13 First of all, would you agree that unlike its  
14 competitors the Postal Service cannot unilaterally change  
15 its rates rapidly?

16 A My understanding is that once the rates are set by  
17 the Commission they are set until the next rate hearing.

18 Q And that the process by which the Commission sets  
19 rates, this process that we are all sitting in this  
20 afternoon engaged in, lasts a year or more, does it not?

21 A I am not certain how long these last. That is not  
22 a prediction of how long I will be here, I hope.

23 Q Well, let's say stories about the rate filing to  
24 support a January 2001 rate increase were in the postal  
25 trade presses early as last summer, the summer of 1999, were

1 they not?

2 A I am not sure. I don't read the trade press.

3 Q But your shipping manager conceivably might read  
4 the trade press?

5 A My shipping manager?

6 Q The shipping manager in your hypothetical?

7 A Oh, in the hypothetical -- I couldn't rule that  
8 out as a possibility.

9 Q Okay. Well, let's not focus on that. The case  
10 was actually filed in early January of 2000, correct?

11 A I believe so, yes.

12 Q And the rate implementation that has been widely  
13 assumed is January of 2001, correct?

14 A I believe so, yes.

15 Q So we are talking about a period of a year just  
16 after the process finally gets out of the gates, correct?

17 A That sounds about right.

18 Q So if the shipping manager really believed that  
19 the value to the company of continuing to use the more  
20 expensive Postal Service A was so great, she would have had  
21 an opportunity sometime over the course of the year to go to  
22 the people in her company who allocate the budget and argue  
23 her case for a higher budget to cover the cost of the  
24 expected increase in the rate for Service A, correct?

25 A I couldn't rule that out as a logical possibility.

1 Q And those budget decisionmakers would then weigh  
2 the relative value to the company of all alternative uses of  
3 funds and not limit it exclusively to the postal uses of  
4 those funds, correct?

5 A They might well do that.

6 Q And if the budget people don't agree with the  
7 shipping manager and if the company consequently stops using  
8 Postal Service A and substitutes less expensive Postal  
9 Service B, it would be because the company as a whole has  
10 decided that the value differential between Service A and  
11 Service B is no longer as great as the rate differential,  
12 correct?

13 A I didn't follow all that.

14 Q Sure. I'll read that again.

15 If the budget people don't agree with the shipping  
16 manager's argument to increase her budget to allow her to  
17 continue to use the service that she believes is  
18 appropriate, the premium Service A, and if the company  
19 consequently stops using Postal Service A and substitutes  
20 Postal Service B, that would be because the company as a  
21 whole has decided that the value differential between  
22 Service A and Service B is no longer as great at the rate  
23 differential between Service A and B, correct?

24 A Presuming that that is the way companies operate  
25 in a rational manner, fully considering all the benefits and

1 costs of each activity on an ongoing basis, that would seem  
2 correct.

3 Q And that is a fairly conventional assumption in  
4 economic analysis, isn't it?

5 A Not in studies that look at bureaucracy.

6 Q Well, we are talking about a company here, not a  
7 bureaucracy, correct?

8 A There's lots of bureaucracy in companies.

9 [Laughter.]

10 BY MR. KOETTING:

11 Q Well, I am pleased to hear that.

12 Well, let's return to what we were discussing.

13 However, as you said, that is certainly a possible way that  
14 it could be if people are behaving rationally, and if the  
15 company collectively made that decision based on its  
16 assessment of the value differential between Service A and B  
17 and the new rate differential between Service A and Service  
18 B, isn't that exactly the kind of information we obtained in  
19 aggregate by looking at the price elasticities of the  
20 various postal products?

21 A The price elasticities contain lots of information  
22 affected by many different factors. They may provide some  
23 information along the lines you are suggesting.

24 Q Well, isn't this exactly the kind of information  
25 they are designed to provide, how people weigh the value

1 differential of products and their alternatives versus the  
2 rate differential?

3 A They are designed to measure the responsiveness of  
4 volume to price.

5 Again, I think the important concept here is  
6 really outlined in the -- on page 5 of -- I'm sorry, it's on  
7 subpart (e), that the concept is really I think quite simple  
8 and it doesn't rely on any particular fixed budget, which I  
9 think was the original intent of your question, but it  
10 really relies upon the fact that it is at some point when  
11 postal prices rise so high that it starts cutting into what  
12 are essential other expenditures, be they electricity and  
13 rent for a firm or be they food and housing and clothing for  
14 an individual household that at some point a mailer may  
15 shift from a more preferred service to a less preferred  
16 service in order not to have to curtail its consumption of  
17 these other valuable commodities.

18 Q But they would only do that if they were rational  
19 because they value the consumption of those other  
20 commodities more than they value the consumption of the  
21 premium Postal service that they had previously been  
22 consuming, correct?

23 A If your definition of value now is another concept  
24 of value, which is net value, which is the gross value of  
25 service less the price actually paid for it.

1           As I tried to make clear in my answer, the concept  
2 of value I was using is the gross value of service, so they  
3 may switch to a less preferred postal product in terms of  
4 gross value because it is -- the more preferred one in terms  
5 of gross value has become just too expensive, so you may  
6 switch from a service for which you have a high gross value  
7 to one for which you have a low gross value because when you  
8 compare the prices the preferences get reversed in terms of  
9 net value.

10          Q     And therefore you would expect to see in that  
11 instance the net values being reflected in the price  
12 elasticities of those two products, correct?

13          A     That would be one of the factors reflected in the  
14 price elasticity of demand, yes.

15          Q     If we could look at page 14 of your testimony.

16          A     Yes.

17          Q     Lines 11 through 12 there, you say, institutional  
18 costs are the costs that remain after all attributable  
19 (incremental) costs have been assigned to their relevant  
20 mail subclasses, do you see that?

21          A     Yes, I do.

22          Q     And I would like to focus on the statement as if  
23 it was pertaining directly to incremental costs, so that it  
24 would therefore read, institutional costs are the costs that  
25 remain after all incremental costs have been assigned to

1 their relevant mail categories. That is still a fair  
2 reading of the statement, correct?

3 A I would prefer to talk about it in terms of  
4 attributable costs.

5 Q Yeah, I but I would prefer the term -- to talk it  
6 in terms of incremental, so let's focus on that, please. It  
7 is in your testimony, correct?

8 A The word "incremental" is there in parentheses,  
9 yes.

10 Q Well, maybe we can try to cut to the chase by  
11 asking you why it is you would prefer to talk it in terms of  
12 attributable? Because we might be going to the same place.

13 A The reason I felt more comfortable focusing on  
14 attributable costs is because I am thinking of the process  
15 which I am more familiar with, which is how the Commission  
16 assigns costs to individual service classes, and I am not an  
17 expert on the new proposals of the Postal Service on  
18 incremental costs.

19 Q Well, you have quite a bit of your testimony on  
20 incremental costs, correct, at least the theory thereof?

21 A Yes, I do.

22 Q Okay. Well, you didn't go where I was going, so  
23 we will have to go the hard road. Would you agree that  
24 incremental costs for subclasses are not additive?

25 A Could you define "additive," please?

1 Q Sure. If we have the incremental cost of subclass  
2 A calculated in conformance with the way you describe it in  
3 your testimony, and we have the incremental cost of subclass  
4 B, calculated as described in your testimony, and that  
5 general process by which those are calculated would be to  
6 try to estimate the effect on total Postal Service costs of  
7 removing the entire volume of subclass A, correct, that is  
8 how you would attempt to estimate the incremental cost of  
9 subclass A?

10 A That's right.

11 Q And, similarly, you would go through the same  
12 process for subclass B, correct?

13 A Correct.

14 Q Okay. Now, if I want to calculate or estimate the  
15 incremental cost of combined subclasses A and B, such that I  
16 want to calculate the change in the Postal Service's total  
17 costs when I remove subclasses A and B simultaneously, would  
18 you agree that the sum -- that the amount I get when I do  
19 that aggregate calculation will be different than the sum  
20 that I get if I simply add the results of the first two  
21 exercises where I have attempted to estimate the incremental  
22 cost of those subclasses individually?

23 A I believe they could be different, yes

24 Q Under what circumstances wouldn't they be  
25 different?

1           A     If they are completely independent products, I  
2 believe then they might be the same.

3           Q     Could you definite "completely independent  
4 products" for me?

5           A     They have no costs in common.

6           Q     Okay. That wouldn't apply to any particular  
7 Postal Service products, would it?

8           A     I am not an expert on costing within the Postal  
9 Service.

10          Q     Well, would you agree that, fundamentally, Postal  
11 products go through some level of mail processing, some  
12 level of transportation, some level of delivery, so that the  
13 chances of you having a product that goes through none of  
14 those is virtually zero?

15          A     I wouldn't want to place any characterization like  
16 that on it since I am not an expert. But I will -- my  
17 rudimentary knowledge is such that I think that there are  
18 many mail services which do share some costs.

19          Q     Right. And, basically, if we look at the graph on  
20 page 15 of your testimony, --

21          A     I have that here.

22          Q     And to avoid the problem we just encountered in  
23 terms of types of costs, let's just assume there is only one  
24 type of cost here that we are trying to take cognizance of.  
25 What happens, for example, if, within the volume that you

1 show on the horizontal axis between zero and V zero, let's  
2 assume that, in fact, that is reflecting the aggregate  
3 volume of three subclasses, A, B and C, are present in this  
4 cost pool, so to speak -- are you with me?

5 A Not entirely. When you say we have only one type  
6 of costs, I am not sure what you meant by that. Also, I am  
7 not clear on how you are aggregating volumes, if they are  
8 different services.

9 Q Well, let's assume that what we were talking about  
10 is that volume really is the volume of a cost driver in a  
11 cost pool. Let's say that the only costs are mail  
12 processing costs, hypothetically, and the cost driver is  
13 pieces. Are you with me so far?

14 MR. McKEEVER: Mr. Chairman, I am going to object,  
15 or at least request an offer of proof from counsel. If he  
16 really wants to talk about mail processing testimony, he had  
17 his opportunity with Postal Service Witness Neels was here.  
18 And I don't have any objection to questions on the theory of  
19 incremental costs or anything of that sort. Dr. Sappington  
20 has said, in response to a number of interrogatory answers  
21 that are in the record, that he is not an econometrician, he  
22 is not a Postal Service costing expert, he hasn't evaluated  
23 the Postal Service incremental costs.

24 I don't know whether the Postal Service is  
25 attempting to get some validation of their incremental cost

1 effort through this witness or not, but I think an offer of  
2 proof might be appropriate here since we are starting to  
3 talk about specific types of Postal Service costs.

4 MR. KOETTING: Mr. Chairman, we can assume the  
5 cost pool is any type of cost pool that Mr. McKeever would  
6 prefer. It has nothing to do with mail processing, per se,  
7 transportation, delivery, we are just simply talking about  
8 Figure 1 on page 15 that has a marginal cost curve, and it  
9 shows volume. And I am asking the witness to assume that  
10 the volume represents an aggregate volume that is comprised  
11 of components of various subclasses, three subclasses in my  
12 hypothetical, A, B and C, which are the cost driver for that  
13 cost pool, whatever it is.

14 I don't think that anything that Mr. McKeever says  
15 constitutes any basis to do anything except move forward at  
16 this point.

17 MR. McKEEVER: My problem, and, Mr. Chairman, we  
18 can go ahead with the next question, but my problem is that  
19 Dr. Sappington has said he is not an expert on Postal  
20 Service costing, but on the theory, we are okay.

21 CHAIRMAN GLEIMAN: He has said that here in the  
22 hearing room, too, fairly recently. So let's go ahead with  
23 the question and see if he can answer it.

24 BY MR. KOETTING:

25 Q Are you with me so far on the hypothetical?

1           A     I think so, although I do want to point out that  
2     you are sort of testing the limits of my knowledge of Postal  
3     costing when you talk about cost drivers and cost pools and  
4     things of that nature.

5           Q     I am hoping that as we go through, that you will  
6     see where I am going, and that is not going to be problem,  
7     but if it is, let me know and we will work through it.

8           A     All right.

9           Q     If you look at the horizontal axis and there is  
10    zero to V zero, and let's just assume that there are three  
11    subclasses that are involved here and half of that volume  
12    amount is subclass A, and 25 percent is B, and 25 percent is  
13    C, and, again, those numbers are totally arbitrary and not  
14    going enter into the calculation necessarily in any  
15    quantitative sense. If you were going to calculate the  
16    incremental cost, at least in that cost pool, for subclass  
17    A, you would start at the point on the cost curve where the  
18    vertical line up from V zero cost is the cost curve and you  
19    would move, since subclass A, under my hypothetical, is half  
20    of the volume, you would move back halfway towards the  
21    origin on the vertical axis and then you would see where you  
22    were on the cost curve, correct?

23          A     I'm sorry, I am not following you anymore. In  
24    particular, I am not sure what you mean by the half, the  
25    quarter, the quarter. Is this a fixed proportions

1 technology or something?

2 Q This is just volume. The volume that is being  
3 shown on this is, under this hypothetical, an aggregation of  
4 three subclasses' volumes.

5 A Right. And what I am not clear on is where is  
6 each of the pieces of the different volumes showing up on  
7 this graph. I just have one dimension on my axis, so I am  
8 having trouble turning that into a three-dimensional  
9 picture.

10 Q They are all on the same dimension. What I am  
11 saying in this hypothetical, pieces are pieces are pieces.  
12 So, --

13 A So for every unit that implicitly is there on my  
14 axis, you are saying that unit consists of one-half A plus  
15 one-quarter B plus one-quarter C?

16 Q No, I am saying of all the units between zero and  
17 the point V sub zero, half of those units are subclass A,  
18 one-quarter are subclass B, one-quarter are subclass C.

19 A Okay. And what I am just trying to be clear on is  
20 which quarter is A, which quarter is B and which quarter is  
21 C, or which half is A. I'm sorry.

22 Q Well, that is I think exactly the point that I am  
23 trying to get at. When you calculate the incremental cost,  
24 if you are calculating it for the 50 percent subclass, you  
25 move -- start at the point where V sub -- the vertical line

1 up from V sub zero cost is a cost curve, and you move back  
2 up the cost curve so that you are taking account not only of  
3 the area in the rectangle B, but also that portion of the  
4 area in triangle A that is under the cost curve. So that  
5 you are taking account not only of the marginal cost, the  
6 cheapest piece that is the last piece of the aggregation  
7 that you are processing, you are moving up the cost curve to  
8 take account of the fact that as you remove pieces of a  
9 particular subclass, for example, subclass A, each piece  
10 that you remove is getting -- it represents a consecutively  
11 more expensive piece that gets removed, and, thus, increases  
12 the incremental cost, correct?

13 A I think that sounds correct, if the volume you're  
14 talking about for (a) is located at v-zero and going halfway  
15 back to the origin.

16 Q Well, under the hypothetical, all these pieces are  
17 fungible within this particular cost pool, within this  
18 operation. The technology is such that each piece gets  
19 handled identically, and it doesn't make any difference,  
20 which subclass it's in, so that there's no place on that  
21 line that corresponds to that subclass.

22 But when you -- the nature of the incremental cost  
23 exercise is to start removing the pieces from where you're  
24 at, and then moving up the cost curve; isn't that correct?

25 A Right, but I understand you're trying to calculate

1 now, the incremental cost of Service A.

2 Q Correct.

3 A So if I'm taking away Service A, and I'm moving  
4 from V-zero, halfway to the origin, it seems to me that then  
5 therefore has to be the volume of Service A.

6 Q Okay. I think that's right, as far as we go.

7 Now, when we calculate the -- to calculate the  
8 incremental cost of Subclass B, we start at the exact same  
9 place; don't we, and move back up the same cost curve, but  
10 we only go half as high?

11 A No, I don't think so, because you just told me  
12 that it's A's volume that's located next to V-zero.

13 So now, if B's then comes closer to the origin,  
14 that's where I'd start doing my incremental cost  
15 calculation.

16 MR. MCKEEVER: Mr. Chairman, this is exactly the  
17 type of situation that the Commission rule envisions, I  
18 think, when it contemplates that parties provide, in advance  
19 of testimony, such complex illustrations.

20 And it might be that we could have responded more  
21 ably and more quickly if we had been provided with this  
22 ahead of time. I guess I have no objection to counsel  
23 continuing along this line, but I might suggest that if the  
24 Postal Service would prefer to put this in writing, we  
25 certainly would prefer to answer it that way. It's a very

1 complex hypothetical.

2 MR. KOETTING: I agree that we're getting bogged  
3 down here. Let me try to cut to the chase and see if I can  
4 made headway, and if not, we'll call it a day.

5 CHAIRMAN GLEIMAN: With or without taking Mr.  
6 McKeever up on his offer?

7 MR. KOETTING: I don't think we're going to resort  
8 to written, so it will be oral or nothing.

9 BY MR. KOETTING:

10 Q I'm simply trying to go back to the fact that the  
11 reason that incremental costs are not additive is because  
12 when we calculate the incremental cost for Subclass A, we  
13 start by assuming that the cheapest units on the cost curve  
14 are the ones that go away as we move up the cost curve.

15 And when we start over --

16 A I'm sorry, if I can just interrupt for one second?  
17 When you say we assume this, you're assuming as a general  
18 principle, or as using the Postal Service's methodology.

19 Q As a general principle.

20 A I don't think that's true, in general. You need  
21 to identify clearly where it is -- where on that axis, the  
22 volume is that you're talking about.

23 Q Even in the context of a situation where the cost  
24 pool, are the units are fungible?

25 A I believe so, yes.

1 Q So, let's say, for example, I have a bottling  
2 plant, and I have three different sizes of bottles that are  
3 three different products; three different sizes of bottles,  
4 but all I'm looking at is the capping operation.

5 And the cost curve for the capping operation looks  
6 as presented here in your Figure 1, and I want to figure out  
7 what happens to the capping operation if Subclass A, which  
8 is half of my bottles, goes away.

9 I move halfway up the cost curve, and I sum the  
10 area in the Rectangle B, and the area in the Triangle A that  
11 are under the cost curve.

12 That's how I would calculate the incremental cost  
13 for the capping cost of Subclass A in that context. Are you  
14 with me?

15 A Yes. That would tell you to calculate the  
16 incremental cost of a particular half of your bottles, yes.

17 Q Okay, now, I'm back to the status quo. I've got  
18 the same operation, I've got the same total volume of  
19 bottles that I'm capping.

20 And now I come along and I say, okay, now I want  
21 to figure out the incremental cost of a different bottle  
22 size, which we'll call Subclass B, which is only 25 percent.

23 And I say what happens when I take that 25 percent  
24 out? To calculate the incremental cost, I move a quarter of  
25 the way up the cost curve, and I sum, again, the portion of

1 the Rectangle B and the portion in the Triangle A.

2 Are you with me?

3 A I think I'm beginning to follow you, yes, and I  
4 think that sounds correct.

5 Q Okay, and the reason that I don't get the same  
6 answer when I -- if I were to add those two numbers in terms  
7 of the incremental costs that I've calculated, is I would  
8 get, if I simultaneously calculated incremental costs by  
9 assuming that Subclass A and B have both been removed  
10 simultaneously, is, instead of twice moving up that lower  
11 portion of the cost curve closer to the lowest marginal  
12 cost, I have to go farther on up to account for the fact  
13 that I'm really at that point, three-quarters of the way up  
14 the cost curve, and I am, in essence, now removing more  
15 expensive units; is that correct?

16 A If I'm understanding your basic logic, that does  
17 sound correct.

18 Q Okay, and that's -- I'm just trying to present an  
19 explanation of why it is that the costs as we described, are  
20 not additive, and I think we've now established the reason  
21 why, in this context, in any event, that's not the case.

22 So, again, going back to the statement on page 14  
23 of your testimony, if I'm using incremental, rather than  
24 attributable costs, isn't it going to follow that the pool  
25 of institutional costs can no longer be defined as the costs

1 that remain after all incremental costs have been assigned,  
2 in the sense that if you're saying all incremental costs  
3 have been assigned to the relative subclasses, that you are  
4 summing the individual incremental costs estimated for each  
5 of the subclasses?

6 A I see what you're saying there, and the point of  
7 that sentence is simply that there are attributed costs and  
8 non-attributed costs, and I was just trying to make the  
9 distinction between those two.

10 Q But would you agree that if Postal costs behave in  
11 the manner that we've just gone through, in other words,  
12 incremental costs are not additive, that using incremental  
13 rather than attributable costs injects an element of  
14 ambiguity in the definition of the institutional cost pool?

15 MR. McKEEVER: I'm going to object, Mr. Chairman,  
16 to the implication, I guess, that attributable and  
17 incremental are different, which I think I got in that  
18 question, because at least the witness made an identity in  
19 this sentence.

20 MR. KOETTING: Well, let's ask the witness.

21 BY MR. KOETTING:

22 Q In your view, are attributable costs and  
23 incremental costs identical?

24 A They don't need to be, in complete generality, but  
25 that was the sense in which I was referring to them there.

1 Again, it was just a very simple point. I'm not  
2 trying to get into any of the details here, just trying to  
3 make this differentiation between costs that are  
4 attributable and those that are not.

5 Q Right, but you would agree, would you not, that in  
6 your testimony, that you have identified the fact that  
7 incremental costs can vary substantially from attributable  
8 costs when attributable costs are defined as the Postal Rate  
9 Commission has, volume variable costs, plus specific fixed  
10 costs; do you not?

11 A I don't think I offer any characterization about  
12 the magnitude of the differences between the two, just that  
13 they may differ.

14 Q Well, I would direct your attention to page 17,  
15 lines 10 through 12. If marginal costs vary substantially  
16 with volume, as in Figure 1, then an approximation that  
17 omits area A may understate incremental costs substantially.

18 Is that correct? That's still your testimony?

19 A Yes, it is.

20 Q Okay. And would you agree that the Commission's  
21 definition of attributable costs, which is volume variable  
22 plus specific fixed costs, does omit Area A from its  
23 consideration of what it calls attributable costs?

24 A Yes. I believe that's the point of my testimony  
25 here.

1 Q So to that extent, there is at least the  
2 possibility that attributable cost as defined by the  
3 Commission and incremental cost may, to use your term --  
4 well, you say more than -- you say that they may understate  
5 incremental cost substantially.

6 A Right, if marginal costs vary substantially with  
7 volume.

8 Q And the direction of that is always the same,  
9 right? It's not as if sometimes it's an overstatement and  
10 sometimes it's an understatement? It's always going to be  
11 an understatement, correct?

12 A I believe that's the case if there are economies  
13 of scale.

14 MR. KOETTING: I think we are done, Mr. Chairman.  
15 Thank you very much, Dr. Sappington.

16 THE WITNESS: Thank you.

17 CHAIRMAN GLEIMAN: Thank you, Mr. Koetting.

18 Is there any follow-up?

19 [No response.]

20 CHAIRMAN GLEIMAN: No follow-up questions from the  
21 bench? There are no questions from the bench.

22 Mr. McKeever, would you like some time with your  
23 witness to prepare for redirect?

24 MR. MCKEEVER: Just a few minutes, Mr. Chairman.  
25 Five should do it.

1 CHAIRMAN GLEIMAN: Okay. Five it is.

2 [Recess.]

3 CHAIRMAN GLEIMAN: Mr. McKeever?

4 MR. McKEEVER: We have no redirect, Mr. Chairman.

5 CHAIRMAN GLEIMAN: Well, if you have no redirect,  
6 that means that we may be done for the day. Let me see.  
7 There are no more witnesses on the list.

8 Dr. Sappington, that completes your testimony here  
9 today. We appreciate your appearance, your contributions to  
10 our record. We thank you and you're excused.

11 THE WITNESS: Thank you, Mr. Chairman.

12 CHAIRMAN GLEIMAN: This concludes today's hearing.  
13 We'll reconvene tomorrow morning, July the 20th, at 9:30  
14 a.m. We'll receive testimony from Witnesses Merriman,  
15 Schick, Glick, Haldi, Neels and Crowder, and my colleagues  
16 and I will take a five-minute break and then we will  
17 reconvene in the conference room for briefing.

18 Thank you all. You all have a good evening.

19 [Whereupon, at 5:12 p.m., the hearing recessed, to  
20 reconvene Thursday, July 20, 2000, at 9:30 a.m.]

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