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

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POSTAL RATE COMMISSION
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Postal Rate and Fee Changes, 1997) Docket No. R97-1

OFFICE OF THE CONSUMER ADVOCATE
INTERROGATORIES TO UNITED STATES POSTAL SERVICE
WITNESS PETER BERNSTEIN
(OCA/USPS-T31-1-10)
August 4, 1997

Pursuant to sections 25 and 26 of the Rules of Practice of the Postal Rate Commission, the Office of the Consumer Advocate hereby submits interrogatories and requests for production of documents. Instructions included with OCA interrogatories 1-7 to the United States Postal Service dated July 16, 1997, are hereby incorporated by reference.

Respectfully submitted,

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OCA/USPS-T31-1. Please refer to your direct testimony. At page 70, Table 13 shows a net change in consumer surplus from Ramsey Pricing of $1.023 billion.

a. Confirm that your analysis measures consumer surplus in dollars across all classes.

b. If confirmed, would it be appropriate to say that for purposes of your analysis, one dollar of positive consumer surplus to the mailer of a first-class letter is equal to one dollar of positive consumer surplus to a mailer of Standard Enhanced Carrier Route ("ECR") mail?

c. If (b) is confirmed, does this mean that your analysis treats consumer surplus homogeneously, i.e., that consumer surplus (of, say, one dollar) has the same value to all classes of mailers?

OCA/USPS-T31-2. Table 13 shows substantial reductions in consumer surplus under Ramsey pricing for mailers of First-Class Letters, Periodicals Non-Profit, Periodicals Regular, Standard Regular, and Standard Non-Profit Mail, and substantial gains in consumer surplus for mailers of Priority Mail and Standard ECR Mail.

a. To what extent were changes in distribution of income and costs between households and businesses taken into account in your analysis?

   (i) For example, did you evaluate the effect on households that would occur if households had less income to spend?

   (ii) Did you examine the distributional changes to determine whether the outcomes were consistent with the criteria of 39 U.S.C. §3622(b)? (You may wish to refer to pages 1-10 of the direct testimony of Donald J. O'Hara, which discusses these criteria.)

b. To what extent were changes in distribution of income and costs between non-profit institutions and businesses taken into account in your analysis?

 (i) For example, did you evaluate the effect on non-profit institutions that would occur if non-profit institutions had less income to spend?

 (ii) Did you examine the distributional changes to determine whether the outcomes were consistent with the criteria of 39 U.S.C. §3622(b)?

c. To what extent were changes in distribution of income and costs between publishers of periodicals and other businesses taken into account in your analysis?

 (i) For example, did you evaluate the effect on such publishers that would occur if they had less income to spend?

 (ii) Did you examine the distributional changes to determine whether the outcomes were consistent with the criteria of 39 U.S.C. §3622(b)?

(d) Do you regard Ramsey pricing of postal services and products to be fully compatible with the criteria of 39 U.S.C. §3622(b)? Please fully explain your answer.

OCA/USPS-T31-3. Do you regard dollars spent on mailing to be equal to the value that households place on, or receive from (i.e., consumer utility) such mail? In answering this question, please refer to the following example. Assume that mailer A mails a bank statement via First-Class Mail to householder A, mailer B sends an advertising flier via Standard ECR to the same householder, and mailer C sends a periodical using an appropriate Periodicals rate. Also assume for purposes of discussion that all three mailers expended the same amount in postage (including costs they expended on workshare). In responding to this question, please refer to the 1995 Household Diary Study, which contains references to the reactions of households to various classes of mail (e.g., Reactions to Advertising Mail By Class at III-10, Attitudes Towards and Treatment of Advertising Mail at III-24, Reaction to Third-Class Bulk Regular Mail at VI-55, etc.).

OCA/USPS-T31-4. Does your analysis of consumer surplus take into account externalities? For example, suppose that consumers do not read or do not find useful "x" percent of some types of mail, which then has to be discarded. Discarding mail, it may be argued, imposes costs on the recipient of such mail, either directly (some jurisdictions charge for refuse collection on a per-piece basis) or indirectly (e.g., the municipality must spend tax dollars disposing of refuse). Please comment.

OCA/USPS-T31-5. Please refer to page 49. You state: "In this testimony, the Ramsey prices are compared to an illustrative break-even rate schedule based on the Postal Rate Commission's (PRC) recommended mark-ups in R-94-1, applied to 1998 Test Year costs and adjusted to satisfy the Ramsey net revenue requirement of $25,850." Various tables in your testimony than use the R94-1 methodology. To fully understand the impact of adopting Ramsey pricing, however, it would seem to be necessary to have other rate schedule comparisons for evaluation.

a. Please supply alternate tables that compare your Ramsey pricing methodology rate schedule to the rates actually proposed by the Postal Service in this proceeding.

b. Please also supply separate tables for Docket No. R90-1 (the last truly comprehensive and conventional rate increase proceeding) and Docket No. R87-1 (the case which fully developed the relative markups used as benchmarks in later rate cases). Each table should show the rates under the original Postal Service proposal, the rates under a Ramsey pricing analysis, and the rates recommended by the Commission in the proceeding.

OCA/USPS-T31-6. Please refer to page 8 of your direct testimony. You state: "Economic theory argues that product price should equal product marginal cost, defined as the additional cost associated with a one unit increase in production. If the Postal Service were to set product price equal to marginal cost (which is essentially equal to per piece volume variable cost), product revenues would be less than total costs, equal to total volume variable costs plus common costs." Please now refer to the following quotation from an economics textbook [Robin W. Boadway, Public Sector Economics (1979), pp. 36-37]:

> The analysis of the efficiency of competitive markets requires that firms' technologies exhibit constant or decreasing returns to scale. If increasing returns to scale exists in an industry up to relatively high levels of output, the competitive analysis of market behavior breaks down for two reasons. First, the market structure of such

> an industry would not be such as to induce competitive behavior. Because of the increasing returns or economies of scale, large firms would force small firms out of business by producing at a lower cost, and ultimately the industry would end up as a monopoly if the scale economies continued to large enough outputs. Since monopoly pricing does not set prices equal to marginal costs, the overall Pareto-optimal conditions are violated and efficiency of resources allocation is not attained.
>
> A second problem arises when increasing returns to scale prevail. Even if a competitive market structure did exist or if firms could be coerced into behaving as firms in a competitive industry do, the private sector could not profitably sustain marginal cost pricing. With increasing returns to scale, the average cost curves of a firm will everywhere slope downward, [footnote omitted] yielding marginal costs that are less than average costs. *Pricing at marginal cost would be equivalent to pricing below average cost and therefore firms would be unable to cover costs.* Because of this the private sector could not behave according to Pareto-optimizing rules.

Is the material cited from your testimony on page 8 consistent with (i.e., perhaps a shorthand version of) the Boadway excerpt? If not, please explain.

OCA/USPS-T31-7. Please refer to page 38. You state: "It is assumed that in the range of volumes being considered, volume variable cost per piece, and therefore marginal cost, is constant *for every mail product.*" [Emphasis added.] Upon what empirical evidence do you base this assumption?

OCA/USPS-T31-8. You state on page 33 that "Ramsey prices depend on own- and cross-price elasticities of demand." At Table 6, you use cross-price elasticities for postal products and services only.

a. Are cross-price elasticities of non-postal products and services relevant? If not, why not?

b. In Table 6 you show cross-price elasticities between various classes of mail, but for Priority Mail you do not indicate the Express Mail cross-price elasticity, whereas you do give the reciprocal figures. Please explain.

OCA/USPS-T31-9: On page 38 you state: "The incremental cost of a product is the cost that the Postal Service would save if the product were eliminated entirely. In addition to covering the product's volume variable costs, postal prices (Ramsey or otherwise) should generate sufficient revenues to cover the product's incremental cost. If not, the Postal Service and mailers would be better off if the product were discontinued." On page 39 you state: "As it turns out, Express Mail and Registry mail have Ramsey prices that generate revenues below incremental costs. Consequently, the prices of these two products are constrained above their Ramsey prices so that revenues cover incremental costs."

a. If the Commission were to adopt Ramsey pricing, would it be your position that the Postal Service should propose eliminating these classes? Please explain.

b. What is the "third-best" pricing rule when both a break-even constraint and an incremental-cost coverage constraint are binding? Please show the derivation of this rule.

OCA/USPS-T31-10. Please refer to pages 68-69. You state: "However, because the cross-price elasticities between postal products are generally quite small or non-existent, the resulting shift in the demand curves are also quite small. Consequently, the actual gains to consumers will not be substantially different from the estimated gains presented in this section." On page 37, Table 6, the cross-price elasticities between Express Mail and Priority Mail, and between Standard B Parcel Post and Priority Mail are .46 and .45 respectively. Please explain why this does not affect the reliability of your estimates of change in consumer surplus.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

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