

Before The  
POSTAL RATE COMMISSION  
WASHINGTON, D.C. 20268-0001

Experimental Rate and Service Changes )  
to Implement Negotiated Service Agreement )  
with Capital One Services, Inc. )

Docket No. MC2002-2

RESPONSE OF WITNESS JOHN C. PANZAR  
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE  
(USPS/JCP-T1-1-7)

The response of John C. Panzar to interrogatories of the United States Postal Service, dated January 24, 2003 is attached. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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**USPS/JCP-T1-1.** Using the concepts elaborated in your written testimony, please define the input or inputs relevant to the Capital One Services, Inc. Negotiated Service Agreement at issue in this proceeding. Please provide as full and precise a description as possible.

RESPONSE:

My testimony did not address the details of Capital One's use of mail services. My analysis focused on the general economic principles involved when quantity discounts and other types of optional tariff offerings are used for the sale of inputs. It is my understanding that Capital One uses First-Class Mail as an input for serving its customers and soliciting new ones.

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**USPS/JCP-T1-2.** If it were demonstrated that the competitors of Capital One Services, Incorporated currently do not utilize the input or inputs at issue in the NSA, how would this affect your testimony? Please explain fully.

RESPONSE:

It would not significantly affect my analysis. A discount offered to a large user would adversely impact its competitors. As I describe in my testimony, the negative impact results from the effects of the discount on the output market. These will remain even if the other users do not purchase the input in question. Thus, for example, even if Capital One were the only credit card firm using First-Class Mail, its competitors would still be harmed if it received a discount. Its competitors would still tend to reduce their purchases of other mail services, adversely affecting the profits of the Postal Service.

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**USPS/JCP-T1-3.** Is it possible that existing workshare discounts currently give a competitive advantage to large volume mailers? Please explain your answer fully.

RESPONSE:

While that may be possible, it would be a function of the characteristics of each mailer's mail. Since workshare discounts are available to all qualifying mailers, it is also possible that a small volume mailer could have a slight competitive advantage by virtue of the characteristics of its mail, *e.g.*, greater depth of presort.

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**USPS/JCP-T1-4.**

- a. Do you agree that one of the inputs provided to credit card companies by the Postal Service is the ability to reach potential new customers through advertising? If you do not agree, please explain.
- b. Do you agree that the Postal Service has no monopoly in providing this input, as credit card companies have available (and in fact utilize) a variety of other advertising channels besides direct mail (e.g., TV and radio commercials, newspaper and magazine ads, billboards, etc.) to reach potential customers? If you do not agree, please explain.
- c. Regardless of your answer to the above questions, if it were demonstrated that the Postal Service did not have a monopoly with respect to the inputs it provides to credit card companies, how would this affect your testimony? If you are unsure of how it might affect your testimony in terms of formal economic models, please discuss how it might affect your testimony intuitively.
- d. Hypothetically, if, as a result of an NSA with one credit card company, the credit card company entering the NSA increased its advertising expenditures on direct mail, but commensurately reduced its advertising expenditures in other media, with no net change in its overall advertising expenditures, how would this affect the analysis in your testimony?
- e. Hypothetically, if, as a result of an NSA with one credit card company, the credit card company entering the NSA increased its advertising expenditures on direct mail, but commensurately reduced its advertising expenditures in other media, with a net reduction in its total advertising expenditures, but no net change in the total number of responses received from potential customers reached via all advertising media combined, how would this affect the analysis in your testimony?
- f. Hypothetically, if any reduction in advertising expenditures by all other credit card companies that resulted from an NSA with one credit card company were limited to expenditures on other advertising channels (i.e., there were no reduction in the other credit card companies' level of direct mail advertising), how would this affect the analysis in your testimony?

**RESPONSE:**

- a. Yes.

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- b. I would agree that alternatives exist; however, the Postal Service has a statutory monopoly in providing this particular input.
- c. My testimony would be essentially unaffected. Because the Postal Service has a monopoly over letter mail no other firm can offer an identical substitute. As a result, all the effects explained in my testimony would continue to apply.
- d. My analysis would not be affected. One of the effects of a price reduction for one input is to reduce the quantities purchased of substitute inputs.
- e. I interpret the hypothetical to mean that the output of the favored firm remained unchanged. In that case, there would be no effect on market conditions or the firm's competitors. However, the conditions of the hypothetical are not likely to be satisfied by a profit-seeking firm. When a firm's cost structure is improved at the margin, it tends to expand its output, to the detriment of its competitors.
- f. In that case, one could directly evaluate the effect of the NSA on Postal Service profitability, without worrying about any indirect effect on mail volumes. However, competitors would continue to be harmed by the NSA because of the effects on market conditions in the credit card industry.

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**USPS/JCP-T1-5.**

- a. Do you agree that different company-specific advertising strategies to attract new customers are among the means by which credit card companies compete? If you do not agree, please explain.
- b. Do you agree that credit card companies do not use advertising inputs in fixed proportion to outputs? If you do not agree, please explain.
- c. Regardless of your answer to the above questions, if it were demonstrated that credit card companies do not use the inputs provided by the Postal Service in fixed proportion to outputs, how would this affect your testimony? If you are unsure of how it might affect your testimony in terms of formal economic models, please discuss how it might affect your testimony intuitively.
- d. Hypothetically, if, despite the existence of an NSA with one credit card company, all other credit card companies maintained their previous levels of advertising, including direct mail advertising, how would this affect the analysis in your testimony?
- e. Hypothetically, if additional direct mail advertising by the NSA credit card company stimulated *more* advertising by competing credit card companies, how would this affect the analysis in your testimony?

**RESPONSE:**

- a. While I am not an expert on the credit card industry, the premise seems likely.
- b. Since, as noted, I am not an expert on the credit card industry, I have no basis either to agree or disagree.
- c. I do not believe that it would affect my testimony in any significant respect.  
  
Intuitively, all of the identified effects would remain.
- d. Again, in that case, one could directly evaluate the effect of the NSA on Postal Service profitability, without worrying about any indirect affect on mail volumes.

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However, competitors would continue to be harmed by the NSA because of the effects on market conditions in the credit card industry.

- e. This is an extremely unlikely hypothetical in the context of any economic model with which I am familiar. For it to hold would require that either: (i) advertising is a normal input for the NSA company but an inferior input (that decreased with output) for its competitors or (ii) advertising is an inferior input for the NSA company but a normal input for its competitors. *If* (i) were to hold, the only change in my testimony would be that the indirect effects on the Postal Service profits would be positive instead of negative. Competitors would still be harmed by the NSA. *If* (ii) were to hold, one would expect the output market price to increase because a decrease in the price of an inferior input causes output to contract. This would harm final consumers, but benefit competitors.



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**USPS/JCP-T1-6.** Hypothetically, if the discounted rates available under an NSA with one credit card company allow that company to target solicitations to a group of potential customers that currently are not being targeted by that company or any of its competitors (because the expected response rate from this group of potential customers would not justify expense of the mailings at the current uniform undiscounted rate), would not the result of this expansion of the potential customer base cause the NSA to benefit the Postal Service and the NSA credit card company, with no material impact on other credit card companies? Please explain your answer fully.

RESPONSE:

As I understand it, the hypothetical posits a situation in which the discount enables the favored company to expand service to a new market, unrelated to that served by its competitors. Then, it is true that its competitors would not be harmed by the favored firm's use of the discount *in the new market*. However, this conclusion would require that the new market constituted the *only* use of the discount. This strikes me as unlikely.

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**USPS/JCP-T1-7.**

- a. Do you agree that, to the extent that some credit card companies use First-Class Mail for solicitation mailings, while others rely almost exclusively on Standard Mail for their solicitation mailings, the credit card companies do not use homogenous direct mail advertising inputs? If you do not agree, please explain. What effect might this have on the analysis in your testimony?
- b. Hypothetically, if the Postal Service enters an NSA regarding First-Class Mail rates with one credit card company that relies heavily on First-Class Mail for advertising, and if any resulting decrease in direct mail advertising by other credit card companies is experienced almost exclusively in Standard Mail, and if, even with the NSA discounts, the average contribution (P-MC) from each additional piece of First-Class Mail is greater than the average contribution of the lost pieces of Standard Mail, how would this affect your testimony? If you are unsure of how it might affect your testimony in terms of formal economic models, please discuss how it might affect your testimony intuitively.

**RESPONSE:**

- a. I agree. However, as indicated above, this fact does not significantly affect my analysis. All of the forces described in my testimony would continue to operate.
- b. Intuitively, the hypothesized situation would make it easier to conclude that the NSA was profitable for the Postal Service, but the effects on competitors would remain.