

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

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

RESPONSE OF UNITED STATES POSTAL SERVICE
WITNESS PANZAR TO INTERROGATORIES OF
VAL-PAK DEALERS' ASSOCIATION, INC., VAL-PAK DIRECT MARKETING
SYSTEMS, INC., AND CAROL WRIGHT PROMOTIONS, INC.
(VP-CW/USPS-T11-1-4)

The United States Postal Service hereby provides responses of witness Panzar to the following interrogatories of Val-Pak Dealers' Association, Inc., Val-Pak Direct Marketing Systems, Inc., and Carol Wright Promotions, Inc.: VP-CW/USPS-T11-1-4, filed on August 29, 1997.

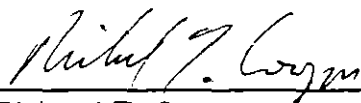
Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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September 12, 1997

RESPONSE OF POSTAL SERVICE WITNESS JOHN C. PANZAR TO THE
INTERROGATORIES OF VAL-PAK AND CAROL WRIGHT

VP-CW/USPS-T11-1. Prior to your testimony in this docket, have you previously testified or published articles that deal with the subject of how to measure or estimate incremental costs? If so, please provide full citations to each publication or testimony that deals with your views on the economically correct estimation of incremental costs.

ANSWER: Much of my published research over the past twenty years has dealt with the *concept* of incremental costs, including its proper definition and application. (See, for example, Contestable Markets and the Theory of Industry Structure (1982/1988), co-authored with Baumol and Willig and "Theoretical Determinants of Firm and Industry Structure," Chapter 1 in the Handbook of Industrial Organization (1989), edited by Schmalensee and Willig.) However, neither that work, *nor my direct testimony*, attempts to measure or construct estimates of incremental costs based upon actual data. That task is left to the testimony of Witness Takis.

I have made illustrative calculations to demonstrate how one might carry out such an exercise using Postal Service data. The paper, "Using USPS Accounting Data for Pricing Decisions and Subsidy Analysis," was presented at an international postal conference in Daun, Germany in June 1992. A copy of that unpublished paper was provided as a Library Reference (USPS-LR-F-349) in Docket No. R90-1. A similar paper, co-authored with Michael Bradley and Jeffrey Colvin, "Issues in Measuring Incremental Cost in a Multi-Function Enterprise," was published in *Managing Change in the Postal and Delivery Industries*, (1997), edited by Michael Crew and Paul Kleindorfer.

Finally, my Rebuttal Testimony in R90-1 dealt with marginal (unit volume variable) and incremental costs. Again, I did not provide estimates of either in my testimony. Rather, much as in my testimony here, I explained the importance of conceptually distinguishing between the two concepts for rate-making purposes.

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VP-CW/USPS-T11-2. Your testimony, at page 2, notes that you are examining “two related, but different ways of looking at what causes the Postal Service’s costs,” essentially (i) marginal costs, and (ii) incremental costs. Of the two different ways of looking at what causes the Postal Service’s costs, do you have any recommendation regarding which should be treated by the Commission as attributable costs? If so, please state your recommendation, along with all reasons that support your recommendation.

ANSWER: “Attributable costs” is a postal term, not an economic concept. Sometimes, such as when it referred to as the basis for pricing markups, it seems to be used as a synonym for marginal costs. Other times, when referred to in conjunction with concerns about cross-subsidization, it seems to be used as a synonym for (average) incremental costs. Thus, the postal concept of “attributable costs” should sometimes be interpreted as (what economists would call) marginal costs, while in other contexts, incremental costs are clearly the relevant concept. In other words, I do not recommend that the Commission choose either marginal costs or (average) incremental costs as the definition of unit attributable costs. Both measures are important for the Commission to fulfill its rate-making responsibilities.

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VP-CW/USPS-T11-3. Are you aware of other industries (or firms) where studies or analyses have been made to estimate both incremental costs and marginal costs in a manner generally similar to those presented by the Postal Service in this docket? If so, please so indicate and provide references to such studies.

ANSWER: Studies designed to measure incremental and/or marginal costs have been used extensively in telecommunications and other regulated industries. I have not been closely enough involved with the details of such studies to know whether or not any may have been "generally similar to those presented by the Postal Service in this docket."

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VP-CW/USPS-T11-4. Please refer to your testimony at page 29, where you state that “marginal costs, and not average incremental costs, are the economically correct base to which any necessary mark-ups should be applied.” In prior omnibus rate cases, the Commission has used a mark-up index when reaching its recommended decisions concerning the appropriate coverage for each subclass; see, for example, Docket No. R90-1, pp. IV-4 to IV-5.


- a. Is it your opinion or recommendation that the index used by the Commission is an appropriate reference point for determining coverage? Please explain your answer.
- b. Unless your answer to preceding part (a) is affirmative, what index, if any, should the Commission use to compare and evaluate mark-ups from one omnibus rate case to the next? Please explain.

ANSWERS:

- a. I have not studied the “mark-up index” used by the Commission in prior omnibus rate cases. The quoted portion of my testimony was directed at explaining the economically appropriate *starting point* from which *any* mark-up methodology should be applied. This starting point should be marginal costs for any rate-setting procedure that is required to meet a break-even constraint. The mark-ups themselves may be designed according to many criteria, one of which is economic efficiency (Ramsey pricing).
- b. My testimony was not intended to instruct the Commission on how best to set mark-ups in any particular case nor have I studied the issue of how to “compare and evaluate mark-ups from one omnibus case to the next.”

DECLARATION

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

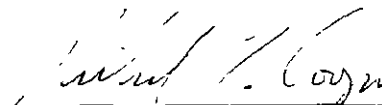


John C. Panzar

Dated: 9-12-97

CERTIFICATE OF SERVICE

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



Richard T. Cooper

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