

DOCKET SECTION

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

**RESPONSES OF UNITED STATES POSTAL SERVICE WITNES O'HARA
TO INTERROGATORIES OF UNITED PARCEL SERVICE
(UPS/USPS-T30-9 THROUGH T30-17)**

The United States Postal Service hereby files the responses of witness O'Hara to the following interrogatories of United Parcel Service, dated September 12, 1997:
UPS/USPS-T30-9 and T30-17.

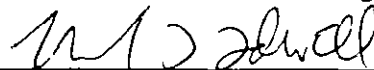
The interrogatories are stated verbatim and are followed by the responses.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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September 26, 1997

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-9. Please refer to your answers to UPS/USPS-T30-7 and UPS/USPS-T30-8 in this proceeding. You there state that it would be unacceptable to the Postal Service for any subclass of mail to have an FY 1998 after-rates ratio of revenue to incremental cost that was less than one "during the test year."

(a) Does this imply that it would be acceptable to the Postal Service for a subclass of mail to have a ratio of revenue to incremental cost less than one in any year after the test year?

(b) If the answer to (a) is yes, please explain why such a price would be economically efficient, cross-subsidy free, and, generally, fair and equitable.

(c) If the answer to (a) is no, (e.g., that in a year other than a test year it would be unacceptable to have a subclass with a rate that resulted in a ratio of revenue to incremental cost less than one), please explain how the rates that you propose in your testimony guard against such a result.

(d) If the answer to (a) is no, please explain how such a result is consistent with the testimony of witness Panzar in this proceeding. In your answer, please address (but not be limited to) Professor Panzar's principle stated on page 7, lines 13 through 21, that avoiding economic inefficiency requires not providing services that customers value less than the cost of the resources used to produce them. Please also address (but not be limited to) the statement by Professor Panzar, on page 8 of his testimony, that fair and reasonable postal prices require cross-subsidy free rates and therefore that prices cover incremental costs. Also, please address (but do not limit your answer to) Professor Panzar's conclusion on page 9, line 6, that prices which meet the incremental cost test also have a role to play in obtaining economic efficiency.

(e) Does Professor Panzar's principle that prices which meet the incremental cost test also have a role to play in obtaining economic efficiency apply only to the test year. If yes, why?

RESPONSE:

(a)-(e) My testimony specifically addresses only test-year revenues and costs.

This does not mean that the rationale for the incremental cost test presented by Professor Panzar applies only to the test-year, but it does mean that I have no basis for evaluating the relationship between revenues and incremental costs after the test-year. While one might expect inflation to result in increases in costs after the test-year, unit costs do not necessarily move in concert with overall inflation. For example, a variety of programs may reduce costs beyond

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

the test-year. Also, if mail-mix within a subclass shifts toward rate cells with an above average ratio of revenue to cost, this will tend to increase the ratio of revenue to incremental cost.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-10. Please refer to page 8 of your testimony and the example of the effect of worksharing on the recovery of non-attributed costs at lines 8 through 19 and the example on page 9, lines 1 through 12. Please confirm that the total contribution to the recovery of non-attributed costs provided by some type of mail before and after a change in total attributed costs is a way to evaluate fairness and equity. If not confirmed, please explain.

RESPONSE:

Confirmed for the example cited, in which the change in total attributed cost is due to differential growth in worksharing across subclasses. Not necessarily confirmed for other changes in total attributed cost (such as, for example, a change in total attributed cost due to differential volume growth across subclasses).

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-11. Please refer to page 13, lines 7 and 8 of your testimony, where you state that "[i]f revenue from a subclass equals or exceeds its incremental cost, then there is no cross-subsidy," and to your answers to interrogatories UPS/USPS-T30-7 and UPS/USPS-T30-8 in this proceeding. Does your testimony apply only to test years? Please explain your answer, including but not limited to an explanation as to how in some year other than a test year, a postal rate that is less than the incremental cost to provide that service would not involve a cross-subsidy to users of the applicable subclass of mail.

RESPONSE:

Please see my response to UPS/USPS-T30-9.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-12. Please refer to Section E, "Mark-ups and Coverages After A Reduction in Measured Cost," on pages 16-20 of your testimony. Please confirm that in prior proceedings when the Postal Rate Commission has utilized previously developed rates as a starting point for developing new rates, the Commission has used a mark-up index rather than a cost-coverage index. If not confirmed, please explain.

RESPONSE:

Confirmed, and in fact I began my own consideration of how to adjust previous rate-levels to the situation under the new costing method by using a mark-up index. It was only after arriving at results similar to those in Panel II of Table E-1 (p.18) that I came to understand the short-comings of the mark-up index in this situation.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-13. Please refer to Table E-1 on page 18 of your testimony.

(a) Please confirm that if a column were added that showed the percentage contribution made by Products A and B to recovery of non-volume variable costs, the revised table would be as follows:

**Table E-1. Effect of Holding Mark-Up Index or Coverage Index Constant,
With Changes in Measured Volume-Variable Costs**

I. Initial Situation, Before Changes in Cost Measurement

Product	Volume- Variable Cost	Contri- bution	Percentage Contribution	Revenue	Coverage	Mark-Up	Coverage Index	Mark-Up Index
A	33.3	22.2	66.7%	55.6	167%	67%	1.11	1.33
B	33.3	11.1	33.3%	44.4	133%	33%	0.89	0.67
Total	66.7	33.3	100.0%	100.0	150%	50%	1.00	1.00
Revenue Requirement				100.0				

II. Equal Reduction in Measured Costs, Previous Mark-Up Index Applied

Product	Volume- Variable Cost	Contri- bution	Percentage Contribution	Revenue	Coverage	Mark-Up	Coverage Index	Mark-Up Index = Initial
A	25.0	33.3	66.7%	58.3	233%	133%	1.17	1.33
B	25.0	16.7	33.4%	41.7	167%	67%	0.83	0.67
Total	50.0	50.0	100.1%	100.0	200%	100%	1.00	1.00

III. Equal Reduction in Measured Costs, Previous Coverage Index Applied

Product	Volume- Variable Cost	Contri- bution	Percentage Contribution	Revenue	Coverage	Mark-Up	Coverage Index = Initial	Mark-Up Index
A	25.0	30.6	61.2%	55.6	222%	122%	1.11	1.22
B	25.0	19.4	38.8%	44.4	178%	78%	0.89	0.78
Total	50.0	50.0	100.0%	100.0	200%	100%	1.00	1.00

If not confirmed, please explain.

(b) Please confirm that using the hypothetical example that is the basis for your Table E-1, a mark-up index would result in each product making

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

the same percentage contribution to the recovery of non-volume-variable costs before and after the reduction in volume-variable costs. If not confirmed, please explain.

RESPONSE:

(a) Confirmed.

(b) Confirmed; however, I believe that each subclass's contribution to non-volume-variable costs should be evaluated relative to its volume-variable costs; fixing each subclass' percentage share of non-volume-variable cost would exclude this important factor.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-14. You state on page 17 of your testimony, lines 7 and 8, that it is a "natural question" as to whether previously developed mark-ups and cost coverages could be used as "a starting point, at least" for developing new rate levels.

(a) Did you use previously-developed mark-ups and cost coverages as a starting point for your rate recommendations in this proceeding?

(b) Did you use previously-developed mark-ups and cost coverages as more than a starting point? Please explain.

RESPONSE:

(a)-(b) Yes; please see my testimony at page 19, line 15 through p. 20, line 7;

although I'm not certain I understand what distinction you mean to make between "a starting point" and "more than a starting point," I viewed the previously determined markups and cost-coverages as a critical point of reference in developing new rate levels.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-15. Please refer to your testimony, page 19, lines 15-17. Leaving aside the issue of whether the cost-coverage index or the mark-up index is the better way to adjust current rates to reflect cost-pool changes, please confirm that you assert that the development of new rates should begin by using the previously-developed cost coverages or mark-ups as a base. If not confirmed, please explain.

RESPONSE:

The nine criteria section of 3622(b) provide the fundamental basis for the development of new rates; previously-developed markups and cost coverages are a useful starting point because they have, under previous circumstances, been found to satisfy these criteria.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-16. Please explain your belief, as stated on page 19, lines 6 and 7 of your testimony, that fairness and equity require equal rate increases for Products A and B in the example embodied in your Table E-1, page 18.

RESPONSE:

In my example, the two products are equally affected by the change in costing methodology, and I conclude that the unequal rate changes that result from a mechanical application of the previous mark-up index are not "consistent with fairness and equity." I contrast this with the application of the previous coverage index, which does produce equal rate changes, and which I believe is consistent with fairness and equity. However, I do not go quite so far as to conclude that fairness and equity "require" equal rate changes; in my example the two products have different initial markups (and coverages), and I cannot rule out the possibility that a consideration of all the criteria would also lead to different rate changes.

**RESPONSE OF U.S. POSTAL SERVICE WITNESS O'HARA TO
INTERROGATORIES OF UNITED PARCEL SERVICE**

UPS/USPS-T30-17. Please refer to page 20 of your testimony, lines 11-15. Please explain why you believe Ramsey pricing provides a useful framework for demonstrating the effects of different pricing decisions and provides a sense of direction for postal pricing.

RESPONSE:

A fundamental question that postal pricing must resolve is how the revenue necessary to cover non-volume-variable costs should be assigned to the various subclasses; Ramsey pricing provides a framework for evaluating the relative costs, in terms of loss of economic efficiency, of different ways of doing this.

DECLARATION

I, Donald J. O'Hara, hereby declare, under penalty of perjury, that the foregoing Docket No. R97-1 interrogatory responses are true to the best of my knowledge, information, and belief.


Donald J. O'Hara

9.26.97
Date

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.


Michael T. Tidwell

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September 26, 1997