

DOCKET SECTION

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

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

RESPONSE OF UNITED STATES POSTAL SERVICE  
WITNESS PANZAR TO INTERROGATORIES OF  
UNITED PARCEL SERVICE  
(UPS/USPS-T11-7-17)

The United States Postal Service hereby provides responses of witness Panzar to the following interrogatories of United Parcel Service: UPS/USPS-T11-7-17, filed on September 12, 1997.

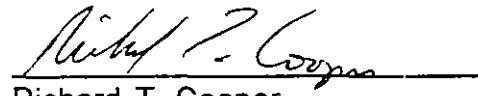
*Each interrogatory is stated verbatim and is followed by the response.*

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.  
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September 26, 1997

RESPONSES OF POSTAL SERVICE WITNESS PANZAR  
TO INTERROGATORIES OF UNITED PARCEL SERVICE

UPS/USPS-T11-7. Please refer to page 28 of your testimony, lines 14-19. Please confirm that the concept of economic efficiency used in your analysis is that associated with the short-run economic efficiency of mailing decisions affecting volume-variable costs, as opposed to a long-run concept of economic efficiency that would consider investment decisions. If not confirmed, please explain how distortions of longer-run decision making, such as potential investment decisions, are measured in your concept of markups of price over marginal costs, which you refer to as unit volume variable costs on line 15

ANSWER: Confirmed. However, it should be pointed out that it is *always* the so-called "short-run" costs that are relevant for economic efficiency. For it is these that reflect the real resources used as a result of consumers' purchase decisions.

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**UPS/USPS-T11-8.** On page 6 of your testimony, from lines 5 through 22, you describe the reasons why it would be "economically inefficient for price to be set below marginal cost" (line 16). Please confirm that the positions you set out in the referenced section apply for each subclass of mail at each and every point in time at which the postal rate for that subclass is in effect. If not confirmed, please explain.

**ANSWER:** Not confirmed. In theory, it is literally true that inefficiency occurs when purchases occur at a price below marginal cost, even momentarily. However, in practice, peaks and valleys in mail volumes mean that marginal costs vary frequently, while prices are in effect for a period of years. Thus when evaluating principles for rate-making, the relevant comparison will always be between price and some sort of average measure of marginal cost.

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UPS/USPS-T11-9. On page 7 of your testimony at lines 13 and 14, you state that "estimates of marginal costs can be used by the rate-making authority to avoid . . . providing services which consumers value less than the resources used to produce them." Please confirm that if at any point in time the Postal Service charges the user of any subclass of mail a rate that is less than the cost of the resources used to provide that service, economic inefficiency results. If not confirmed, please explain.

ANSWER: Not confirmed, for the reasons stated in my to UPS/USPS-T11-8.  
above.

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**UPS/USPS-T11-10.** Please refer to page 7 of your testimony, lines 19-21. Please confirm that the proposition you set forth there applies at each and every point in time. If not confirmed, please explain.

**ANSWER:** Not confirmed, for the reasons stated in my response to

**UPS/USPS-T-11-8, above.**

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**UPS/USPS-T11-11.** Please refer to page 8 of your testimony, lines 3 through 23, where you state that the requirement for fair and reasonable postal rates requires that the postal rate schedule be free from cross-subsidy and that cross-subsidy free rates should meet the incremental cost test. Please confirm that for any specific subclass of mail the conclusions you state in the referenced testimony apply at each and every point in time when the rate for that subclass of mail is in effect. If not confirmed, please explain.

**ANSWER:** *Not confirmed, for the reasons stated in my response to UPS/USPS-T-11-8, above.*

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UPS/USPS-T11-12. Please refer to page 10, lines 23-25, and page 11, lines 1-4, where you state that if a monopolist's prices are set below per unit incremental costs, economically efficient entry of firms with superior productive techniques would be deterred.

(a) Please confirm that your conclusion holds true even if a firm is not a monopolist. If not confirmed, please explain.

(b) Please confirm that these principles and conclusions apply to each and every subclass of mail at each and every point in time in which a price for that subclass of mail service is in effect. If not confirmed, please explain.

ANSWERS:

(a) Confirmed.

(b) Not confirmed, for the reasons stated in my response to UPS/USPS-T-11-8, above.

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**UPS/USPS-T11-13.** Please refer to pages 13 through 16 of your testimony, where you discuss deriving economically relevant marginal and incremental cost measures from Postal Service accounting data.

(a) Please confirm that any estimates of marginal or incremental costs derived from historical accounting data will always be subject to uncertainty. If not confirmed, please explain.

(b) Please confirm that any estimates of price elasticities for subclasses of mail service or revenue projections based on historical accounting data will always be subject to uncertainty. If not confirmed, please explain.

(c) Please explain how the uncertainty associated with cost, elasticity and revenue estimates and projections should be reflected in postal rate-making.

**ANSWERS:**

(a) Confirmed.

(b) Confirmed.

(c) I am not aware of any analysis which explicitly introduces such uncertainties into an analysis of postal rate-making. In the absence of such explicit modeling, standard practice is to base analyses and recommendations on the mean (expected) values of the variables in question.



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**UPS/USPS-T11-14.** Please refer to pages 16 through 20 of your testimony, Section II C and D. Assume that the Postal Service were to announce that it intended to implement in the test year significant cost reduction initiatives, or significant changes in its product offerings, or significant changes in its operating plan, or some other significant change. How should such changes be reflected in the marginal and incremental cost estimates for the test year?

**ANSWER:** The correct methodology for the calculation of marginal and incremental costs is not altered as a result of the types of changes you hypothesize. Whatever the overall operating environment of the Postal Service, the incremental costs of a particular increment in mail volumes is calculated as the difference between the total costs of the Postal Service, with and without the increment in question. When the increment at issue is one typical unit of volume of a particular mail subclass, the result is an estimate of the marginal cost of that subclass. Thus, the calculation of marginal and incremental costs involves *cost differences*, not *cost levels*. Therefore, the fact that changes in the test year operating environment is anticipated to lead to differences in cost *levels* does not necessarily invalidate marginal and incremental cost calculations based on historical data.

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UPS/USPS-T11-15. Please refer to page 28 of your testimony, lines 11 to 19. Assume that for a given subclass of mail (call it subclass X) the effective rate was set so that it was precisely equal to incremental cost and therefore, as you define it, the rate is cross-subsidy free. (For this question assume that the incremental cost of the subclass is greater than its marginal cost).

- (a) What benefits, if any, would flow to users of other subclasses of mail as a result of the Postal Service providing the specified mail subclass X?
- (b) What benefits, if any, result from the provision of a mail service at a price precisely equal to incremental cost?
- (c) In the hypothesized situation, what advice would you offer the Postal Service with respect to the price it should charge for subclass X?
- (d) Under what circumstances, if any, should the Postal Service continue to offer subclass X as a mail service, if the price charged merely recovered its incremental cost?

ANSWERS:

- (a) By hypothesis, the users of other subclasses of mail would be no better or worse off than if subclass X were provided by some other firm (at the same price).
- (b) There are benefits which accrue to the consumers of the service whenever the Postal Service enjoys economies of scope. That is, whenever its incremental costs of providing the volumes in question are less than the costs of an alternative supplier. The consumers benefit from being able to purchase the service at the average incremental cost of the Postal Service rather than at the higher average cost of the alternative suppliers.
- (c) The hypothetical does not provide sufficient data on which to base any specific advice.
- (d) Whenever it enjoys economies of scope, for the reasons explained in my answer to part (b).

**RESPONSES OF POSTAL SERVICE WITNESS PANZAR  
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**UPS/USPS-T11-16. (a) Please list all Postal Rate Commission decisions which you read, either in whole or in part, before you prepared your testimony.**

**(b) In those instances where you have read only part of a Commission decision, please identify those portions of each such decision which you read before you prepared your testimony.**

**ANSWERS:**

**(a) The purpose of my testimony was to explain economic costing principles and their relationship to Postal Service accounting practices and procedures.**

**While I have read parts of various Postal Rate Commission decisions in the past, I do not recall consulting those decisions before preparing my testimony.**

**(b) NA.**

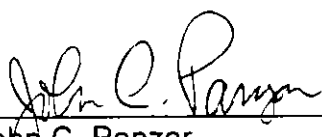
**RESPONSES OF POSTAL SERVICE WITNESS PANZAR  
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**UPS/USPS-T11-17.** Identify all sections of the Postal Reorganization Act which you read in connection with the preparation of your testimony.

**ANSWER:** The purpose of my testimony was to explain economic costing principles and their relationship to Postal Service accounting practices and procedures. While I have read parts of the Postal Reorganization Act in the past, in preparing my testimony I referred only to the passages that I quoted.

**DECLARATION**

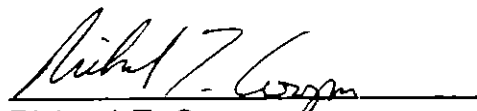
I, John C. Panzar, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

  
\_\_\_\_\_  
John C. Panzar

Dated: 9/26/97

## 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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