

# 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

## RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS PANZAR TO INTERROGATORIES OF UNITED PARCEL SERVICE (UPS/USPS-T11-18-21)

The United States Postal Service hereby provides responses of witness Panzar to the following interrogatories of United Parcel Service: UPS/USPS-T11-18-21, filed on September 17, 1997.

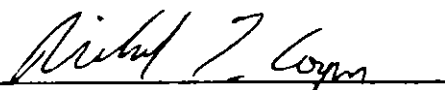
Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.  
Chief Counsel, Ratemaking



Richard T. Cooper

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October 1, 1997

RESPONSE OF POSTAL SERVICE WITNESS PANZAR TO INTERROGATORIES OF  
THE UNITED PARCEL SERVICE

UPS/USPS-T11-18. Your recommendation that incremental cost be used to establish pricing floors, but not used as the basis for pricing markups, is based on the theory of contestable markets with free entry and no sunk costs. This theory posits a knife-edge response of entrants to provide a service having a postal price that exceeds its stand-alone costs or to provide a service when the postal price of other services fall short of their incremental costs. Please refer to page 10, lines 3-11, of your testimony. You state that real-world markets are not so contestable as to exhibit in actuality the knife-edge behavior of entrants expected from the contestable market theory. Do you agree that the marginal distortion of the decision making of potential entrants in practice should be addressed in evaluating the deviation of postal prices from incremental costs? If you agree, please explain and distinguish the practical consequences of postal pricing when an entrant must incur sunk costs from theoretical contestable markets. If you disagree, please explain why.

ANSWER: I am not sure what you mean by the term "marginal distortion." If you mean the distortion of entrants' production decisions *at the margin*, this issue is already addressed by the requirement that Postal Service prices be at least as great as marginal costs. This *marginal cost price floor* prevents the Postal Service from acquiring units of volume more efficiently produced by a price-taking competitive entrant.

I disagree with the statement that my recommendation of the use of average incremental cost as a price floor is based on the theory of contestable markets. The need for a price floor is to prevent potential entrants and other entrepreneurs from receiving an incorrect signal about the social resources actually used in the provision of the service in question. To take an extreme example, if mousetraps were given away, why would anyone exert any effort trying to build a better one? Indeed, such price floor regulations would be unnecessary in a perfectly contestable market because prices below average incremental costs would attract the entry of a firm seeking to replace the incumbent. Their role in postal rate-making is to provide some of the benefits of contestability to postal markets even though entry and exit are not perfectly free in reality.

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UPS/USPS-T11-19. Please refer to lines 1 through 10 on page 8 of your testimony. What specifically are the strictures to which you are referring when you refer to "such" strictures in stating on lines 9-10 that "the economics literature has come to interpret such strictures as requiring that the rate schedule be free from *cross-subsidy*."

ANSWER: I was referring to the "fairness" provisions contained in most regulatory statutes. Such statutes also tend to contain requirements that rates for regulated services cover their costs and not burden the users of other services. My point was that the cited portions of the Postal Reform Act have many parallels in other industries.

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UPS/USPS-T11-20. Please refer to lines 9 through 11 on page 10 of your testimony.  
What do you mean by a "true" competitive advantage in that sentence?

ANSWER: I meant markets in which the Postal Service can win some or all of the  
business because it is the most efficient producer, not because of any statutory entry  
barriers.

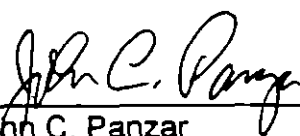
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UPS/USPS-T11-21. Please refer to pages 8-10 and lines 1 through 22 on page 11 of your testimony. What is the difference, if there is any, between incremental costs and stand-alone costs?

ANSWER: Incremental costs refer to the additional costs which result from adding a service (or group of services) to an existing set of services. Stand-alone costs refer to the costs of providing a service (or group of services) separately.

## DECLARATION

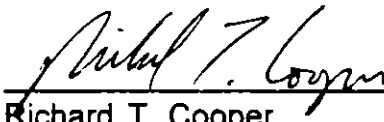
I, John C. Panzar, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

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

Dated. 10-1-97

## 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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