

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

RATE AND SERVICE CHANGES TO IMPLEMENT
BASELINE NEGOTIATED SERVICE AGREEMENT WITH
WASHINGTON MUTUAL BANK

Docket No. MC2006-3

**RESPONSE OF UNITED STATES POSTAL SERVICE
WITNESS AYUB TO INTERROGATORIES OF THE OFFICE OF CONSUMER
ADVOCATE (OCA/USPS-T1-25-27)**

June 23, 2006

The United States Postal Service hereby provides the responses of witness Ayub to the following interrogatories of the Office of Consumer Advocate: OCA/USPS-T1-25-27, filed on May 25, 2006. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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June 23, 2006

**RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES
OF THE OFFICE OF CONSUMER ADVOCATE**

OCA/USPS-T1-25. This interrogatory seeks to carry out the “Panzar” test for the Washington Mutual Bank (WMB) NSA. Please refer to your testimony at page 25-29, the “Value Factors/Elements.”

- a. Please provide the First-Class own-price elasticity of demand for WMB. If you are unable to provide WMB’s own-price elasticity of demand, please have WMB provide it. Please show all calculations, including inputs to all calculations and citations to any references used.
- b. Please provide the cross-price elasticity of demand for letters migrating from Standard Mail to First-Class Mail for WMB. If you are unable to provide WMB’s cross-price elasticity of demand, please have WMB provide it. Please show all calculations, including inputs to all calculations and citations to any references used.
- c. If you or WMB is unable to provide the own-price or cross-price elasticity of demand requested in subparts (a) and (b), above, please provide the own-price or cross-price elasticity of demand that you recommend be used in the “Panzar” test. Also, please explain your reasoning in recommending the own-price or cross-price elasticities recommended.

RESPONSE:

a.–c. I believe that the relevant elasticities are the own-price elasticity for WMB’s First-Class Mail and the elasticity of WMB’s First-Class Mail with respect to the discount between First-Class Mail and Standard Mail (rather than the cross-price elasticity).

To calculate these elasticities, we would like to solve the following equation:

$$Q_0 = Q_1 \times \left(\frac{p_0}{p_d} \right)^{\epsilon_p} \times \left(\frac{d_0}{d_d} \right)^{\epsilon_d}$$

where Q_0 is the before-rates First-Class Mail volume (450 million)

Q_1 is the after-rates First-Class Mail volume (713 million)

p_0 is the before-rates average marginal price (.324)

p_d is the after-rates average marginal price (.274)

¹ See Opinion and Further Recommend Decision, Docket No. MC2004-3, Chapter V, An Alternative Model, at 29.

² See Chapter V, An Alternative Model, at 36.

**RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES
OF THE OFFICE OF CONSUMER ADVOCATE**

d_0 is the before-rates average marginal discount between First-Class Mail and Standard Mail (.12)

d_d is the after-rates average marginal discount (.07)

ϵ_p is the own-price elasticity

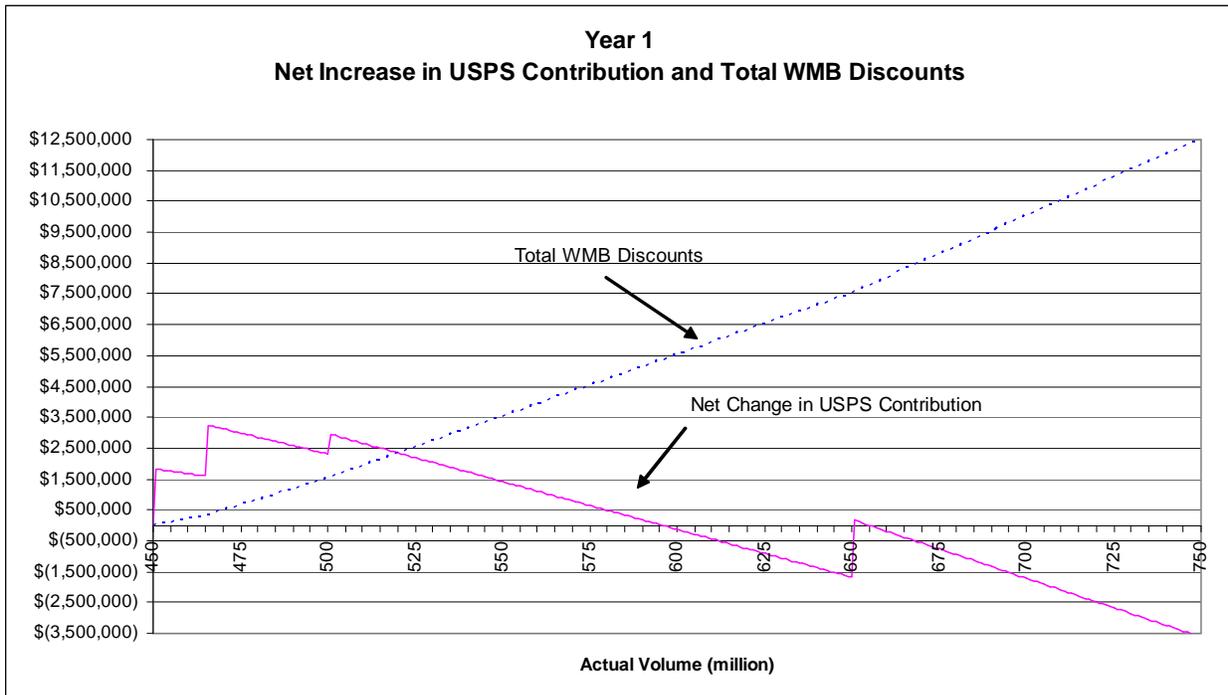
ϵ_d is the discount elasticity

However, because we have only one equation, it is impossible to calculate these elasticities. According to witness Rapaport's testimony, WMB makes mailing decisions based primarily on the relative prices of First-Class Mail and Standard Mail (WMB-T-1, p. 7 *et seq.*), which seems to indicate that the discount elasticity is a larger factor in WMB's mailing decisions, but this is the only guidance we have.

**RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES
OF THE OFFICE OF CONSUMER ADVOCATE**

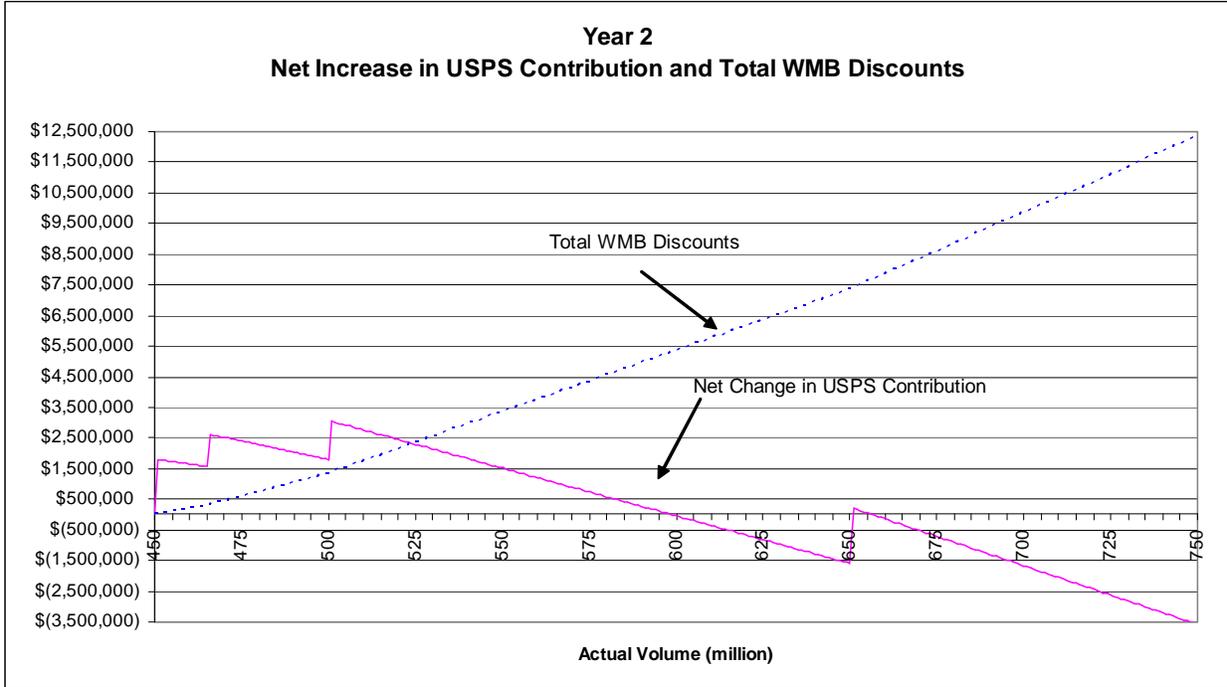
OCA/USPS-T1-26. This interrogatory seeks information that could be used to reduce financial risk to the Postal Service from the Washington Mutual Bank (WMB) NSA. Please refer to your testimony, Appendix A, the following charts entitled “Net Increase in USPS Contribution and Total WMB Discounts” for Years 1, 2, and 3 of the WMB NSA, and the accompanying electronic Excel file “OCA Exh1_Panzar Test-WMB.”

- a. In Year 1, for volumes up to 596 million or between 651 million and 655 million, please confirm that the Postal Service will not lose First-Class Mail contribution under the WMB NSA, according to the Panzar test. If you do not confirm, please explain, and show all calculations and all sources used.

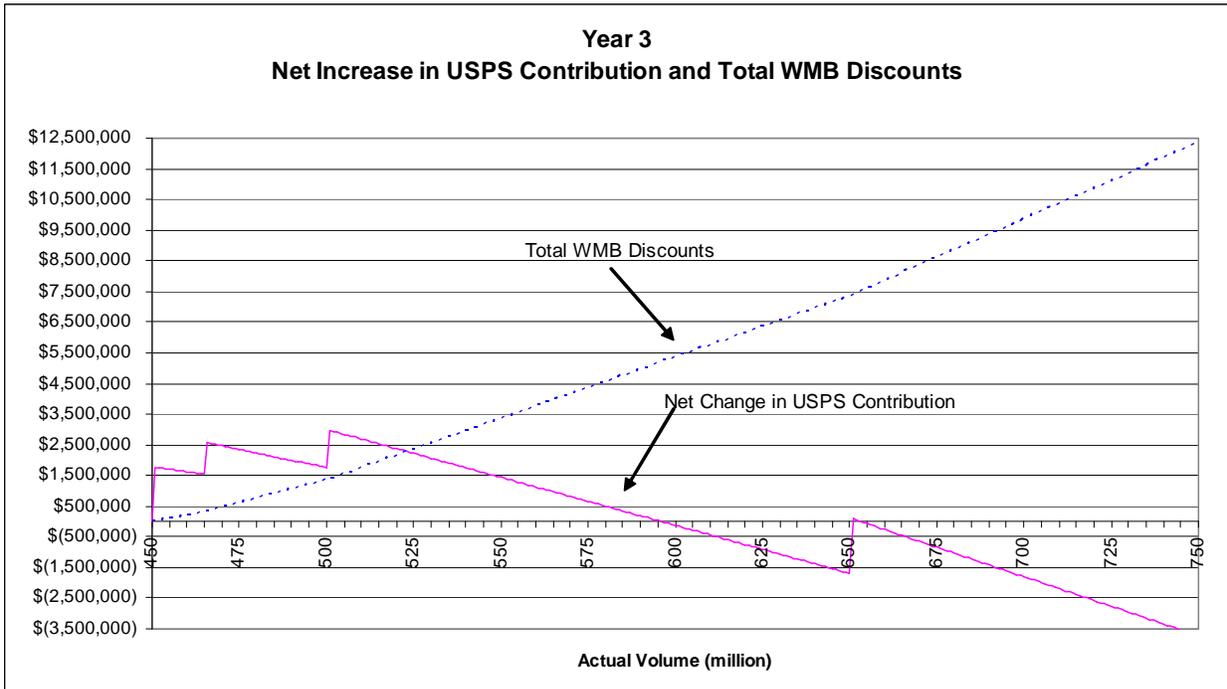


- b. In Year 2, for volumes up to 599 million or between 651 million and 657 million, please confirm that the Postal Service will not lose First-Class Mail contribution under the WMB NSA, according to the Panzar test. If you do not confirm, please explain, and show all calculations and all sources used.

RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES OF THE OFFICE OF CONSUMER ADVOCATE



- c. In Year 3, for volumes up to 596 million or between 651 million and 654 million, please confirm that the Postal Service will not lose First-Class Mail contribution under the WMB NSA, according to the Panzar test. If you do not confirm, please explain, and show all calculations and all sources used.



**RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES
OF THE OFFICE OF CONSUMER ADVOCATE**

RESPONSE: Confirmed that the calculations in the attached worksheet appear to have been performed correctly. However, the conclusions that have been drawn from these calculations depend completely on a set of underlying assumptions that are impossible to support. For example, the model supplied uses the own price elasticity of First-Class Mail presort as a proxy for Washington Mutual Bank's (WMB's) price elasticity for all points along WMB's demand curve. This is unlikely for several reasons: WMB uses First-Class Mail for several different purposes – acquisition, billing, and customer communication – each of which is likely to have a different own-price elasticity. Furthermore, as WMB's volume increases, the relative proportions of the different types of First-Class Mail will change, thereby affecting the overall weighted average own-price elasticity. Thus, an elasticity based on some type of weighted average, if one were to attempt to develop such an estimate, would vary with volume. The attached worksheet to this interrogatory does not account for these potential volume shifts and their effect on own-price elasticity.

RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES OF THE OFFICE OF CONSUMER ADVOCATE

OCA/USPS-T1-27. This interrogatory seeks information on the application of the “Panzar” test in order to identify technical issues involving the use of cross-price elasticities. Please provide a “Panzar” test based upon WMB’s before rates and after rates volumes under the proposed NSA, including the use of any cross-price elasticities of demand (if applicable). Also, please provide an explanation of your understanding of how cross elasticities would be applied in the “Panzar” test.

RESPONSE:

I have not performed a “Panzar test” on the WMB NSA, and it is not immediately obvious how such an analysis could be carried out.

As proposed by the Commission, the “Panzar test” requires testing for the inequality:

$$(p_d - c) \times (Q_1 - Q_0) - (p_0 - p_d) \times (Q_0 - Q_T) > 0 \quad (\text{eq. 1})$$

where p is price, c is marginal cost, Q is volume. The subscripts 0, 1, T, and d refer, respectively, to before-rates, after-rates, threshold, and discount. See Opinion and Further Recommend Decision, Docket No. MC2004-3 at 28. Equation 1, however, applies only where there is no migration between rate categories or subclasses that would affect the value of NSA. In the WMB NSA, such a migration is an important part of the deal, so we would need a modified version of Equation 1 that takes into account the conversion of Standard Mail letters to First-Class Mail:

$$(p_{Fd} - c_F) \times (Q_{F1} - Q_{F0}) - (p_{F0} - p_{Fd}) \times (Q_{F0} - Q_{FT}) - (p_S - p_S) \times (Q_{S0} - Q_{S1}) > 0 \quad (\text{eq. 2})$$

where the additional subscripts F and S indicate, First-Class Mail and Standard Mail. The additional element “ $-(p_S - c_S) \times (Q_{S0} - Q_{S1})$ ” in Equation 2 eliminates the “double counting” of contribution from Standard Mail that is converted to First-Class Mail as a result of the NSA.

**RESPONSE OF USPS WITNESS AYUB TO INTERROGATORIES
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The Commission proposes testing the basic inequality expressed in Equation 1 by calculating:

$$Q_0 = Q_1 \times \left(\frac{p_0}{p_d} \right)^{\epsilon_p} \quad (\text{eq. 3}),$$

(where ϵ represents elasticity) for a wide range of Q_1 . See Opinion and Further Recommend Decision, Docket No. MC2004-3 at 28. Generalizing this form to account for migration of pieces, however, is not straightforward. From Equation 2, it is obvious that in the WMB case, it will be necessary to estimate not only the before-rates volume of First-Class Mail, Q_{F0} , but also the change in Standard Mail, $Q_{S0}-Q_{S1}$. Equation 3 cannot provide any such estimate using cross-price elasticities. Using a discount elasticity, similar to the one used by Witness Thress in Docket No. R2006-1 to model shifts between First-Class presort mail and Standard Mail regular (Docket No. R2006-1, Testimony of Thomas Thress, USPS-T-7, at 19), Equation 3 can be expanded to:

$$Q_0 = Q_1 \times \left(\frac{p_0}{p_d} \right)^{\epsilon_p} \times \left(\frac{d_0}{d_d} \right)^{\epsilon_d} \quad (\text{eq. 4})$$

where d represents the average discount between the price WMB pays for First-Class Mail letters and Standard Mail letters. This form does make more explicit the fact that First-Class Mail volumes change because of the change in the relationship between the prices for First-Class Mail and Standard Mail, but it fails to provide any information about the corresponding volume change in Standard Mail. Thus, in my opinion, the “Panzar test” cannot be easily generalized to account for cross-price effects.

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.

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