

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 ADVO, INC.  
AND MOTION FOR LATE ACCEPTANCE  
(ADVO/USPS-T11-1-8)

The United States Postal Service hereby provides responses of witness Panzar to the following interrogatories of Advo, Inc.: ADVO/USPS-T11-1-8, filed on September 15, 1997. The Postal Service also moves for late acceptance of these responses, which were delayed due to the high volume of recent discovery and the requirements of the witness's teaching schedule.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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October 1, 1997

Response of Postal Service Witness Panzar to ADVO Interrogatories

ADVO/USPS-T11-1. On page 4, you state that:

“There are two especially natural types of [volume] changes to consider. The first is an increment of one unit of mail volume of a particular subclass of service. . . the second type of volume change to consider is that of an entire mail subclass.”

Within a particular subclass of service, assume that (1) the final (end-to-end) service to the mailer/consumer can be supplied by two intermediate input services (e.g., transportation and delivery) and (2) one of the input services can be provided by either the USPS or a competitor.

(a) Should the input services be considered separately in the generation of efficient rates? Please explain.

(b) If the USPS faces competition in providing both input services (i.e., neither input service is perfectly inelastic), how should it price those services in order to generate efficient rates and still breakeven financially?

ANSWERS:

(a) It may be useful or necessary to analyze the “input services” separately in developing the marginal cost estimates upon which rates should be based, much as the Postal Service analyzes various cost components separately.

(b) I do not understand the question. Rates are typically developed for mail subclasses, not “input services” or cost components.

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ADVO/USPS-T11-2. On page 7, you state:

“In addition, the marginal cost pricing floor plays an important role in allocating output among firms when there are multiple providers of a service. Competitive rivals of the Postal Service would maximize their profits by selecting their output levels to equate their marginal costs to the market price. If that price were below the marginal cost of the Postal Service, productive efficiency could be improved by shifting output from the Postal Service to its rival(s).”

(a) Assume scale and scope economies for a multi-product firm and no perfectly inelastic service demands. Under what circumstances should one of the firm's services be efficiently priced at marginal cost (rather than average incremental cost) when the firm has competitors which provide equivalent, substitutable services? Please explain your response fully.

(b) For your response to (a), please explain whether the circumstances identified (pricing one service at marginal cost) would generate a cross-subsidy and, if so, (2) how a cross-subsidy would be compatible with efficient pricing.

ANSWERS:

(a) The question does not specify the notion of efficiency you have in mind. However, in the situation you describe, most notions of efficiency would require a service's price to equal its marginal cost whenever *both* of the following conditions hold: (1) The supply curve of competitive suppliers is perfectly elastic. (2) Marginal cost is at least as large as average incremental cost.

(b) There would be no cross-subsidy under the circumstances described in part (a).

## Response of Postal Service Witness Panzar to ADVO Interrogatories

ADVO/USPS-T11-3. On page 8, you describe the incremental cost test and state:

“ . . . if a service’s revenues do not cover the additional costs the enterprise incurs in providing it, the users of that service are receiving a subsidy from the enterprise’s other customers.”

(a) Does the incremental cost test also apply to USPS services which may be considered intermediate inputs (1) to a final (end-to-end) service which both the USPS and its competitors provide and (2) which competitors may separately produce or purchase from the USPS (e.g., transportation or sortation)? Please explain your response fully.

(b) For an intermediate input service which either the USPS or a competitor can produce (e.g., transportation or sortation), is the efficient comparison between (1) the competitor’s stand-alone cost for that input service and (2) the USPS’s incremental cost for that same input service? Please explain your response fully.

(c) Please describe the conditions under which it would be economically efficient for the USPS to price an intermediate input service (to a competitor who could also produce that input service) at marginal cost, when its marginal cost is less than its incremental cost.

### ANSWERS:

(a) The incremental cost test only applies to services which generate revenues. If the intermediate inputs you refer to are actually sold in the marketplace, the incremental cost test could be applied.

(b) I am not sure what you mean by the term “efficient comparison.” It is true that, from the point of view of industry cost minimization, whether an operation is most efficiently performed by the Postal Service or a competitor is determined by comparing the incremental cost of the former with the stand-alone cost of the latter.

(c) I presume the question means to assume a situation in which “its marginal cost is less than its *average* incremental cost.” It would be economically efficient for the Postal Service to sell the input service at marginal cost if there were a competitive sector with a perfectly elastic supply curve that also supplied the input service to the external market (but not the Postal Service). In that situation, efficiency would require that any external

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sales of the input by the Postal Service be made at marginal cost. Efficiency would also require that the average incremental costs *of the external sales* must be no larger than the price received. Note that the average incremental costs of the external sales can be less than the average incremental costs of the input service, taken as a whole.

Response of Postal Service Witness Panzar to ADVO Interrogatories

ADVO/USPS-T11-4. On page 9, you state:

“It is certainly possible, in principle to calculate the incremental costs of providing certain service quality attributes, such as daily delivery. While the results may be important for decision-making purposes, they have nothing directly to say about whether or not a service with given quality attributes is being subsidized.”

Please clarify this statement. If the level of service quality for a particular subclass causes non-volume variable costs which can be avoided if that subclass is eliminated, are those costs considered incremental to that subclass? Please explain fully.

ANSWER: Any costs which would be avoided if a subclass were eliminated are incremental to that subclass.

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ADVO/USPS-T11-5. On page 9, you state:

“From a social point of view, stand-alone provision would be desirable whenever the *stand alone costs* of independent provision of a mail service (or group of mail services) are less than the Postal Service’s incremental costs of that service (or group of services).”

(a) Within a particular geographic area, assume there is volume which a mailer can enter at either the USPS delivery office or at a competitive delivery carrier’s office. And, assume the competitor’s stand-alone delivery cost/rate is less than the USPS delivery rate. In that event, is the USPS rate for delivery of mail entered at the destination delivery office greater than the relevant stand-alone cost? Please explain.

(b) Please describe the conditions which are required in order to properly compare the Postal Service’s service incremental cost/rate to the stand alone cost/rate of a competitor. (For example, would the competitor have to provide the same geographic service coverage, the same level of service quality, the same worksharing discounts, etc.)

ANSWERS:

(a) In the hypothetical you describe, the USPS rate is higher than the stand-alone costs relevant for proper use of the *stand-alone cost test* used to test for cross-subsidization.

However, in any practical situation, it must be recognized that rates are based on a nationwide average of Postal Service costs. Thus, for any specific type of mail (or for any particular geographic area), it may be quite possible for a competitor’s stand-alone average costs to be lower than postal rates without necessarily being lower than the average incremental costs of the Postal Service. In that case, any failure of the stand-alone cost test would be due to rate-averaging, not Postal Service inefficiency.

(b) First, a clarifying comment. *Rates* would be compared to a competitor’s stand-alone average costs in order to test for cross-subsidization. Postal Service incremental costs would be the subject of such comparison for the efficiency reasons outlined in the quoted passage from my testimony. These are two different issues. For either purpose, it is important to compare “likes with likes.” That is, services with the same characteristics.

**Response of Postal Service Witness Panzar to ADVO Interrogatories**

However, the competitor need not have the same pricing options as the postal service, nor cover the same geographical areas in order for such tests to be meaningful.



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ADVO/USPS-T11-6. On pages 10-11, you state:

“Yet monopoly tariffs can still play an efficiency enhancing, signaling role by satisfying the constraints imposed by the incremental cost test. If the monopolist’s prices are set below per unit incremental costs, firms with superior productive techniques would be inefficiently deterred from entering the market. Their entry would necessarily improve social efficiency by decreasing the total resource cost of providing industry services. In addition, the monopoly could be required to lower prices on its remaining services and still break even.”

Does this statement apply also to prices for services which are intermediate inputs (e.g., transportation or sortation) to final (end-to-end) products? If not, why not?

ANSWER: Yes, subject to the clarification introduced in my response to ADVO/USPS-T11-3 (c). That is, the price should be compared to the average incremental cost of external sales, not the firm’s entire production of the intermediate input .

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ADVO/USPS-T11-7. In evaluating the incremental costs of a subclass, is it ever appropriate to consider the costs that could be eliminated by reconfiguring the system in the absence of that subclass. Please explain your answer, including a description of the kinds of circumstances where it would and would not be appropriate to consider such reconfiguration savings as incremental costs.

ANSWER: Yes, to the extent the reconfiguration could be considered part of a reasonable operating plan. I have not investigated the details of the operating plan sufficiently to be able to provide specific circumstances.

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ADVO/USPS-T-11-8. Assume that there are functions or operations in the postal system that are used predominantly, but not exclusively, by a single subclass of mail. Further assume that these functions or operations are not essential to maintaining the quality of service afforded to other subclasses, and that the system could be reconfigured to eliminate such functions in the absence of that subclass. In that circumstance, would it be appropriate to treat the non-volume variable costs of such functions as incremental to that subclass? Explain your answer.

ANSWER: No. To the extent that there are other subclasses of mail in the hypothetically eliminated operation, the cost of handling that mail in the remaining operations needs to be accounted for.

**DECLARATION**

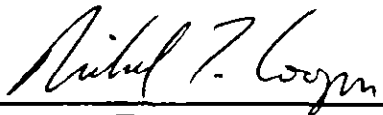
I, John C. Panzar, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.

  
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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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October 1, 1997