

DOCKET SECTION

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

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POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

RESPONSE OF UNITED STATES POSTAL SERVICE
WITNESS PANZAR TO INTERROGATORIES OF
THE NEWSPAPER ASSOCIATION OF AMERICA
AND MOTION FOR LATE ACCEPTANCE
(NAA/USPS-T11-6-10)

The United States Postal Service hereby provides responses of witness Panzar to the following interrogatories of the Newspaper Association of America: NAA/USPS-T11-6-10, filed on September 16, 1997. The Postal Service also moves for acceptance of these responses one day late, which were delayed due to the recent high volume of interrogatories and the teaching schedule of the witness.

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

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-2993; Fax -5402
October 1, 1997

Response of Postal Service Witness Panzar to NAA Interrogatories

NAA/USPS-T11-6. Please provide an economist's definition of

a. Short-run marginal costs.

b. Long-run marginal costs.

ANSWERS:

a. To an economist, short-run marginal costs refer to the cost of producing an additional (marginal) unit of a particular product or service when some of the firm's productive inputs are not free to vary.

b. To an economist, the term "long-run" refers to a situation in which all of the firm's productive inputs may be freely varied. Thus, long-run marginal costs refer to the cost of producing an additional (marginal) unit of a particular product or service when all of the firm's productive inputs may be freely varied.

Response of Postal Service Witness Panzar to NAA Interrogatories

NAA/USPS-T11-7. For optimal pricing (based on marginal costs), is it preferable as a matter of economic theory to use short-run or long-run marginal costs? Please explain.

ANSWER: One should attempt to base prices on the marginal costs that will actually be incurred by the firm to serve a sustained increase in volume over the time period during which the prices will be in effect. Taken literally, this would require that some version of short-run marginal costs should be used. The particular version of short-run marginal cost which should be used depends upon a determination of which of the firm's productive inputs can and cannot be varied over the time period during which the rates are to be in effect.

Response of Postal Service Witness Panzar to NAA Interrogatories

NAA/USPS-T11-8. Please confirm that incremental costs are a measure of cost causality. If you cannot confirm, please explain why not.

ANWER: Confirmed. Incremental costs are *one* measure of cost causality.

Response of Postal Service Witness Panzar to NAA Interrogatories

NAA/USPS-T11-9. Please refer to page 3, lines 19-26 of your testimony. What would be an example of a change in Postal Service operations that would render invalid the implicit assumption that the process by which historical cost data were generated would continue to be valid in the future?

ANSWER: I am not sufficiently knowledgeable about anticipated future developments in postal technology to give a specific real-world example. However, a simple hypothetical will illustrate the issues involved. Of equal importance, it will demonstrate that major changes in operations, in and of themselves do not necessarily drastically alter the results of calculations based on historical data.

Suppose that, currently, the Postal Service operates its own fleet of trucks to provide short-haul transportation. Assume that the fixed costs of this cost component are \$500 million per year and that the variable costs are 2 cents per piece. Then, assuming all subclasses require short-haul transportation, marginal and average incremental costs of that cost component have historically been calculated at 2 cents per piece. Suppose, however, that in the test year, the Postal Service plans to contract-out this function at a fixed rate of 2.1 cents per piece. In this hypothetical situation, the relevant test year marginal and incremental costs for the short-haul transportation cost component should be calculated at 2.1 cents per piece. Notice, however, that although a major change in Postal Service operations, involving hundreds of million dollars of expenditure, the impact on component marginal and incremental costs can be quite minor. This is a point of general importance: it is the effect on marginal and incremental costs caused by changes in Postal Service operations that are relevant for pricing purposes. These may be quite minor, even when the total magnitude of cost savings is substantial.

Response of Postal Service Witness Panzar to NAA Interrogatories

NAA/USPS-T11-10. Assume a subclass having volume variable costs of 100 and specific fixed costs of 20.

- a. Confirm that, under the approach of your testimony, the marginal costs [f]or subclass X would equal 100.
- b. Please confirm that, under the approach of your testimony, the incremental costs of subclass X would equal 120.
- c. Assume further that a cost coverage of 125 is assigned to subclass X. Please confirm that if this cost coverage were applied to the volume variable costs, subclass X's target revenue would equal 100.
- d. Assume again that a cost coverage of 125 is assigned to subclass X. Please confirm that if this cost coverage were applied to the incremental costs, subclass X's target revenue would equal 125.
- e. Assume instead that a cost coverage of 120 is assigned to subclass X. Please confirm that if this cost coverage were applied to the volume variable costs, subclass X's target revenue would equal 96.
- f. Assume again that a cost coverage of 120 is assigned to subclass X. Please confirm that if this cost coverage were applied to the incremental costs, subclass X's target revenue would equal 120.

ANSWERS:

- a. Not confirmed. My testimony establishes the equivalence between *per unit* volume variable costs and marginal costs. Your hypothetical does not specify the number of units.
- b. Not confirmed. The hypothetical does not provide enough information to calculate incremental costs.
- c. Not confirmed. I assume that the term "cost coverage of 125" refers to a ratio of revenues to costs of 1.25. However, in that case, the target revenue would equal 125, not 100.

Response of Postal Service Witness Panzar to NAA Interrogatories


d. Not confirmed. The hypothetical does not provide enough information to calculate incremental costs.

e. Not confirmed. 100 times 1.20 equals 120, not 96.

f. Not confirmed. The hypothetical does not provide enough information to calculate incremental costs.

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.

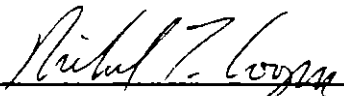


John C. Panzar

Dated: 9-30-97

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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