

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

RESPONSES OF UNITED STATES POSTAL SERVICE WITNESS O'HARA
TO INTERROGATORIES OF VALPAK DIRECT MARKETING SYSTEMS, INC.
AND VALPAK DEALERS' ASSOCIATION, INC.,
(VP/USPS-T31-2 THROUGH 6)

The United States Postal Service hereby files the responses of witness O'Hara to above-listed interrogatories, filed on July 14, 2006.

The interrogatories are stated verbatim and are followed by the responses.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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**RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS O'HARA
TO INTERROGATORY OF VALPAK**

VP/USPS-T31-2.

Please refer to your testimony starting on page 12, line 21, through page 13, line 5, where you discuss the Availability of Alternatives (criterion 5).

- a. Would you agree that the availability of alternatives, including other media (which you mention), should be reflected in the own-price demand elasticity as shown in your Table B-1 on page 11? Please explain any disagreement.
- b. In your opinion, would the ready availability of alternatives at reasonable cost, and having a high (in absolute value) own-price elasticity of demand, argue for an increase or a decrease in coverage? Please explain.

RESPONSE:

- a. Yes.
- b. The own-price demand elasticities in my Table B-1 were estimated from national data on subclass mail volume and the factors that influence it. In effect, each elasticity reflects the national average availability of alternatives for its subclass. With respect to value of service (criterion 2), a high (in absolute value) elasticity argues for a relatively low cost coverage.

In my understanding, except where it may be applied because of a general dearth of postal alternatives, Criterion 5 (availability of alternatives) is applied primarily when the availability of alternatives for some portion of population is substantially below the national average (e.g., because they reside in rural areas). In such cases, the limited availability of alternatives for a portion of population argues for a somewhat lower coverage than would be indicated by the same own-price elasticity accompanied by a more-nearly uniform availability of alternatives for all segments of the population.

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VP/USPS-T31-3.

Please refer to your testimony at pages 13-14 with regard to the degree of preparation (criterion 6).

- a. Please confirm that, if 50 billion pieces have an attributable cost of 10 cents each, they will cause the Postal Service to incur a total attributable cost of \$5 billion. If you do not confirm, please provide the correct amount.
- b. Please confirm that, if those 50 billion pieces convert to workshared mail with an attributable cost of 6 cents each, they will cause the Postal Service to incur an attributable cost of only \$3 billion. If you do not confirm, please provide the correct amount.
- c. Please confirm that, if these 50 billion pieces pay their attributable costs of \$3 billion, plus a contribution to institutional costs of \$2.5 billion, the total revenue from these pieces will be \$5.5 billion, or 11 cents per piece. If you do not confirm, please provide the correct amount.
- d. Please confirm that under the scenario that you describe on page 13, line 20, through page 14, line 7, (i) the 50 billion workshared pieces would result in the Postal Service incurring \$3 billion of attributable costs and earning \$2.5 billion towards its overhead — i.e., markup (or gross profit margin) of 83 percent; and (ii) the 50 billion on non-workshared pieces would cause the Postal Service to incur \$5 billion of attributable costs, while earning \$2.5 billion towards its overhead — i.e., a markup (or gross profit margin) of 50 percent. Please explain any non-confirmation.
- e. Comparing the situations described by (i) and (ii) in preceding part d, would you agree that the 50 billion pieces of non-workshared mail would cause the Postal Service to incur an additional \$2 billion of attributable costs in order to earn the same \$2.5 billion contribution to institutional costs? Please explain any nonconfirmation.
- f. If the market for mail service were competitive, and the Postal Service were operating in a business-like manner as part of a competitive industry, would you expect an outcome such as that described in preceding part e? Or would you expect competition to equalize the rate of return on workshared and nonworkshared mail? Please explain.
- g. Please discuss the extent to which the Postal Service should attempt to establish coverages and prices for its products in a business-like manner, and the extent to which the Postal Service should ignore (or override) any such consideration.

RESPONSE:

- a. Confirmed for volume-variable costs.
- b. Confirmed assuming all of the costs are volume-variable.

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RESPONSE TO VP/USPS-T32-3 (continued):

- c. Confirmed under the same assumption, although my testimony does not equate institutional cost contribution with gross profit margin.

- d. Confirmed under the same assumption.
For ease of use in later parts of this question, note that the postage paid is: \$5.5 billion (= \$3 + \$2.5) for workshared mail (83% markup), and \$7.5 billion (= \$5 + \$2.5) for nonworkshared mail (50% markup); a difference of \$2 billion.

- e. Confirmed under the same assumption.

- f. One preliminary point: This part of the question uses the term "rate of return" while referring to earlier parts of the question where the term "mark-up" is used. Although both are commonly stated as percentages, I do not understand them to be synonyms; to avoid unnecessary confusion I will not use rate-of-return in my response.

This part of the question posits that the Postal Service would be operating "as part of a competitive industry." This is a highly unrealistic assumption, but I will attempt to comply. The difficulty with the assumption is that, with the Postal Service's cost structure, marginal cost (= unit volume-variable cost) declines over the entire relevant range of output. This cost structure typically results in a "natural" monopoly of a single-firm (or perhaps a few firms that serve overlapping but not completely identical markets). If such a firm sets prices approximately equal to marginal cost, the revenue generated will not cover its

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RESPONSE TO VP/USPS-T32-3 (continued):

total cost. So the firm must price above marginal cost and, if not regulated or otherwise constrained, will tend to develop a price schedule that exceeds its total cost by the maximum amount possible (taking into account the extent to which higher prices make it economically attractive for its customers to substitute other materials or services for the monopolist's product).

The Postal Service's pricing is constrained by the break-even constraint, but there are many different possible price schedules that will generate the required revenue. The process for determining what set of prices will actually be put in place is governed by the Postal Reorganization Act and guided by the nine pricing criteria therein.

By contrast, firms in a competitive industry have a cost structure that may have declining marginal cost for small levels of output, but begins to display increasing marginal cost well before a firm's output is large enough to have a significant effect on the price generated by the market. As a result, such firms expand output no further than the point at which their marginal cost has risen to the market price. In a competitive industry, product prices tend to equal (not exceed) marginal costs, and the difference in price between two products tends toward the difference between their marginal cost.

So, if the Postal Service were operated in a business-like manner as part of a competitive industry, would I expect an outcome like that described in the earlier parts of this question? My answer is not necessarily. In your example, workshared mail costs the Postal Service \$2 billion less to process and deliver

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RESPONSE TO VP/USPS-T32-3 (continued):

(\$3 billion vs. \$5 billion) than nonworkshared mail, and the postage it pays is also \$2 billion less. This conforms to the tendency for price differences to equal cost differences in a competitive industry, but it does not conform to the tendency for prices to equal marginal cost.

Please see also my responses to VP/USPS-T31-4&5, which provide additional comments on the extent to which the results generated by competitive markets can be usefully applied to Postal Service pricing.

- g. The aspect of business-like pricing that I believe has the greatest relevance to postal pricing is the general tendency for price differences between similar products to reflect cost differences. In the current postal context, if the two products in question are very similar with respect to the nine pricing criteria, there may be little reason to ignore or override the competitive industry tendency for price differences to equal cost differences. If, however, two products differ significantly with respect to the nine criteria, there may be ample reason for price differences to be greater than or less than cost differences.

Also, if the breakeven constraint were to be relaxed somewhat and eight of the nine pricing criteria removed, leaving only criterion three (no cross-subsidy), the Postal Service could well arrive at a price structure that differs significantly from today's structure without necessarily coming any closer to the kind of price structure that tends to arise in a competitive industry.

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VP/USPS-T31-4.

Please refer to your testimony concerning Standard Regular and ECR mail at page 26, line 19, through page 30, line 20.

- a. You state that Standard Regular has a relatively low intrinsic value of service (at p. 27, l. 1) and Standard ECR also has a relatively low intrinsic value of service (at p. 28, ll. 22-23). Do you have any reason to believe that the intrinsic value of service for Standard Regular is distinguishably higher or lower than it is for Standard ECR? If so, please explain the basis for your answer.
- b. If rates for Standard Regular and Standard ECR were set in competitive markets, would the coverages likely be similar to those that you have proposed, or would competition tend to reduce the coverage on ECR and, perhaps, increase it on Standard Regular, so as to make the rate of contribution on each more equal? Please explain.

RESPONSE:

- a. No.
- b. I do not think competitive markets would tend to make the "rate of contribution" for Standard Regular and Standard ECR more equal. (I assume "rate of contribution" refers to percentage coverage and/or percentage markup).
Competitive markets generate prices that move toward marginal costs, and thus relationships between product prices that tend toward the differences in their marginal costs. As a result, in a competitive market, the cost-coverage for each product tends toward 100%. This in turn does mean that cost coverages for different products tend to be equal, but what is important is the 100% (price equals marginal cost for each product); not the equality.

For products, such as postal services, whose marginal cost of production declines as volume increases, the revenue that would be obtained by setting coverages at the 100% generated by competitive markets will not be enough to cover total cost. The shortfall can be made up by non-product-related income (e.g., appropriations), or by coverages that, on average, exceed 100%, as is currently the case for the Postal Service.

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RESPONSE TO VP/USPS-T32-4 (continued):

One way to cover total cost would be to apply the required system-average cost coverage to each product individually; this would obviously result in equal coverages for any pair of products. However, it is likely that the "best" way of covering total cost will not entail equal coverages across all products even when "best" is defined solely by economic criteria.

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VP/USPS-T31-5.

Your testimony lists the ratemaking criteria of the Postal Reorganization Act at page 8, and discusses them at pages 9-15.

- a. After taking these criteria into account, please explain the extent to which you believe the Postal Service or the Commission can set rates or rate relationships emulating those which would obtain in a competitive market?
- b. Do you believe that the likely outcome under competition constitutes a reasonable criterion, or yardstick, to use when evaluating whether rate levels and rate relationships are fair and equitable?

RESPONSE:

- a. Several of the criteria instruct the Postal Service and the Commission to consider factors that competitive markets do not consider (e.g., fairness and equity (criterion 1), the effect of rate increases on enterprises providing close substitutes (criterion 4), and ECSI value (criterion 8)). I believe it highly unlikely that a careful consideration of these factors could result in rates that emulate "those which would obtain in a competitive market."
- b. No, both for the reasons mentioned in my response to part (a) and because I think it would be extremely difficult to determine what "the likely outcome under competition" would be with sufficient accuracy to provide a usable yardstick.

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VP/USPS-T31-6.

Your testimony (USPS-T-31) states: "ECR mail has a very high degree of preparation by the mailer (criterion 6); even the basic rate category must be line-of-travel sequenced, and the high-density and saturation categories are walk-sequenced." (Page 30, lines 1-3.)

- a. Please confirm that ECR basic rate mail may be either in walk-sequence or line-of-travel sequence (see DMM section 243.6.3.1).
- b. Please explain the additional work for mailers associated with putting mail in line-of-travel sequence and walk-sequence.
- c. Please confirm that there is no requirement that any Standard Regular mail be either line-of-travel sequenced or walk sequenced. If you cannot confirm, please identify which Standard Regular must be line-of-travel sequenced or walk sequenced.

RESPONSE:

- a. Confirmed.
- b. For the sequencing standards that must be met to qualify for the ECR line-of-travel and walk-sequence rate categories, see DMM 245.6.0 (letters) and 345.6.0 (flats). The additional work for mailers associated with meeting these requirements might best be explained by mailer witnesses. Since all ECR rate categories are optional, the mailer's cost for doing this work is presumably less than the associated rate differences for the pieces mailed in these categories.
- c. Confirmed.