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

POSTAL RATE AND FEE CHANGES, 2006   )   Docket No. R2006-1

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
FIRST INTERROGATORIES AND REQUESTS FOR
PRODUCTION OF DOCUMENTS TO PITNEY BOWES INC.
<u>WITNESS JOHN C. PANZAR (VP/PB-T1-1-11)</u>
(September 26, 2006)

Pursuant to sections 25 and 26 of the Postal Rate Commission rules of practice, Valpak

Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. hereby submit

interrogatories and document production requests. If necessary, please redirect any

interrogatory and/or request to a more appropriate witness.

Respectfully submitted,

_____
William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for:
  Valpak Direct Marketing Systems, Inc. and
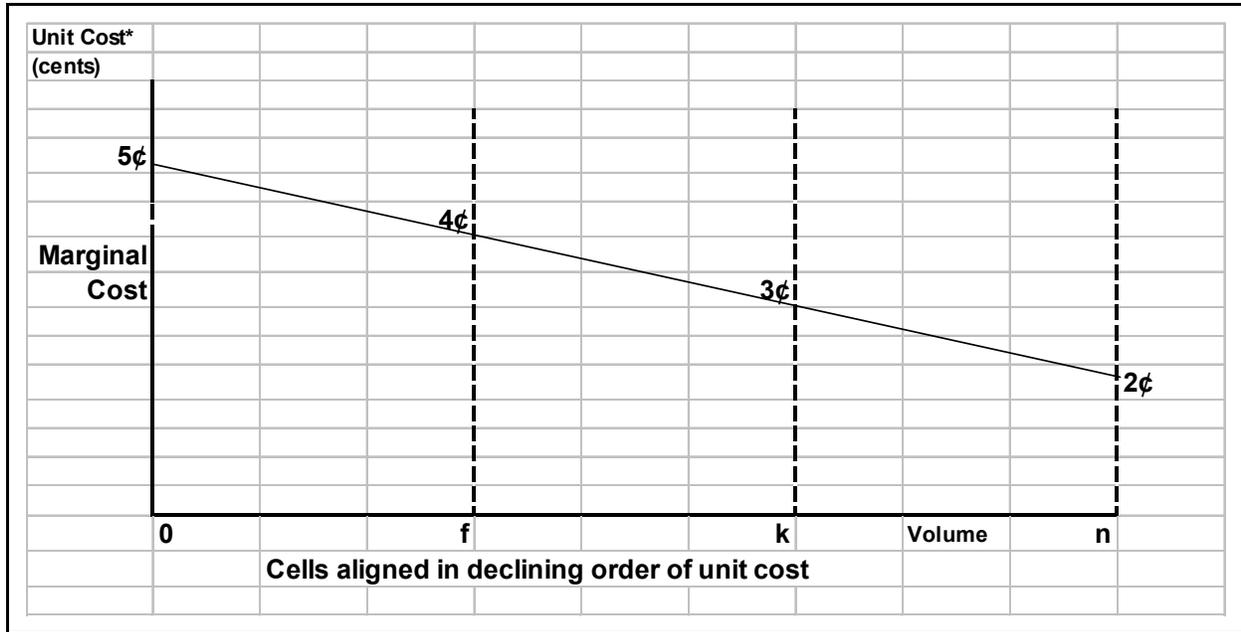 Valpak Dealers' Association, Inc.

VP/PB-T1-1.

Please refer to your testimony, PB-T-1, p. 28, l. 21 to p. 29, l. 2, where you say: "It is my understanding that the current practice of the Postal Rate Commission is to base the calculation of avoided costs on attributable costs. Below, I explain why this is the theoretically correct approach." The purpose of this interrogatory is to clarify various costing concepts, particularly as they relate to your testimony.

Consider a postal administration producing product A (*e.g.*, letters), among others, which is being considered for **one** worksharing discount, for a category defined in terms of downstream entry. Assume that the volume of product A is a continuous flow, period after period, with unchanged characteristics, and that it is partitioned into n cells. Each cell contains the same number of pieces, a number that is not small. All pieces in a given cell have the same marginal cost. The marginal cost of the pieces in a cell is the additional cost divided by the number of additional pieces, under a small reduction in the rate applicable to the pieces in the cell, *ceteris paribus*, consistent with the notion of a rate-induced volume change. Assume that each cell has the same price elasticity of demand. The cells are aligned and numbered according to the postal administration's marginal cost of handling the pieces in the cell, so that the marginal cost of the pieces in cell 0 is 5¢, in cell 1 is just under 5¢, in cell f is 4¢, in cell k is 3¢, and in cell n is 2¢. The cost information for these cells is shown in the graph in the Attachment to this interrogatory. These costs are upstream costs only; they do not include any costs for the downstream-entered product being considered. For convenience, it is assumed that $f = 1/3n$ and $k = 2/3n$, and that the cost curve is linear.

As described, when handling all pieces in all n cells, the postal administration's **average** volume variable cost is 3.5¢, which is the marginal cost for additional volume of the same mix as in cells 0 to n; *i.e.*, a weighted average of the marginal costs of the pieces in all n cells. Thus, if a small rate decrease were applicable to all pieces in all cells, the additional cost divided by the additional volume is 3.5¢. The volume variable cost is the average marginal cost (over all cells) multiplied by the total volume in all n cells. The average volume variable cost is the volume variable cost divided by the total volume, which also equals the average marginal cost. The order in which these values are developed is immaterial. The volume variable cost is attributed.

    a.   Within the framework of this example and the assumptions made, is this description of marginal cost, average marginal cost, average volume variable cost, volume variable cost, and attributable cost consistent with your understanding of the postal administration's costs and with how you use these terms in your testimony? If it is not, please explain, in terms of this example and the graph in the Attachment, what the postal administration's costs represent and how you use the terms in your testimony.

    b.   Based on the information provided, as displayed in the graph in the Attachment, can you provide any guidance on what the appropriate discount should be for mail that will bypass the upstream operations and become a downstream-entered product? If you can, please provide that guidance. If you cannot, please explain why not, identifying any information about the postal administration that is missing.

Figure 1: Upstream Costs of Postal Service Product A

Unit Cost*
(cents)

5¢

Marginal
Cost

4¢

3¢

2¢

0   f   k   Volume   n

Cells aligned in declining order of unit cost

*Average variable cost = unit attributable cost = marginal cost

VP/PB-T1-2.

Please assume the initial situation described in VP/PB-T1-1, shown in the graph in the

Attachment thereto, and add the assumptions that (i) the ordering and the numbering of the

volume cells is **also** aligned with the propensity of volume in the cells to be of interest to

potential competitors and, further, that (ii) the costs of all potential competitors are the same as

the postal administration's costs. That is, if an interested competitor processes and

downstream-enters the pieces *in cell k*, his cost for doing so is 3 cents.

Based on the above information, can you provide any guidance on what the appropriate

discount should be for the downstream-entered product? If you can, please provide that

guidance. If you cannot, please explain why not, identifying any information about the postal

administration or the potential competitors that is missing.

VP/PB-T1-3.

Please assume the situation described in VP/PB-T1-2, with its added assumptions,

except that a 3¢ discount has been allowed for downstream entry, after which all of the volume

in cells $k+1$ through n left the postal administration to become handled by competitors and

downstream-entered. In this situation, suppose consideration is being given to whether 3¢ is

the correct discount.

   a.   Would you agree that the unit attributable cost avoided when the pieces in cells

        $k+1$ through n leave the postal administration is 2.5¢? If not, please explain.

   b.   When viewed as a "make or buy" decision, which you discuss on p. 16 of your

        testimony, would you agree in this situation that competitors are being paid 3¢

to supply services that the postal administration could supply for an average of 2.5¢? If you agree, please discuss the advocacy of this outcome. If you do not, please explain.

c.   Would you agree that the average volume variable cost (= unit attributable cost = average marginal cost) of the pieces in cells 0 through k, which are still being processed by the postal administration, is now 4¢? If you do not agree, please explain.

d.   Would it be your view that in this situation the postal administration's costing systems would give an estimated average volume variable cost of 4¢? If you believe the postal administration's costing systems would provide an estimate of some other cost, please explain, in terms of the graph, what that cost would be.

e.   In connection with the situation described here, please explain what you recommend as "the theoretically correct approach" to setting the discount. That is, what is the correct discount level and why is it correct?

f.   Please assume that the discount is increased from 3¢ to a new level of 4¢, and that all pieces in cells f + 1 through k leave the postal administration. Do you agree that the new level of average marginal cost of the postal administration would be 4.5¢? Please explain any disagreement.

g.   In your analysis, which underlies your recommendations, have you made any assumptions about the actual shape of the **postal administration's** cost curve (shown in the attachment to VP/PB-T1-1 to be a continuous straight line [a

straight line being a curve with an infinite radius])? If so, please explain what those assumptions are.

h.   In your analysis, which underlies your recommendations, have you made any assumptions about the actual shape of the **potential competitors'** cost curves? If so, please explain what those assumptions are. In discussing any cost curve for potential competitors, maintain the assumption that the cells are lined up in the order of their potential interest to competitors and allow the curve to be above or below that of the postal administration.

VP/PB-T1-4.

Please assume that the cells shown in the Attachment to VP/PB-T1-1 and explained in VP/PB-T1-1 are aligned both with the marginal cost levels of the postal administration and, at the same time, with the propensity of the pieces in the cells to be of interest to potential competitors, but assume in addition that the costs of all potential competitors (i) differ from those of the postal administration, and (ii) when displayed on the graph in the Attachment form a straight line that is 1¢ below the cost curve of the postal administration.

a.   If the discount is set at 3¢ under these conditions, would you agree that:

(i)   All volume in cells $f + 1$ through n would leave the postal administration;

(ii)   the unit incremental cost avoided for pieces that leave would be 3¢; and

(iii)   the average marginal cost of pieces that remain in the postal

administration would be 4.5¢? If you disagree with any of the above,

please explain.

b.   In this situation, please explain what you would recommend as the theoretically

correct discount level.

VP/PB-T1-5.

Within the framework of the situation explained in VP/PB-T1-1 and as shown in the

Attachment thereto, please maintain the alignment of the cells according to the costs of the

postal administration and the linear cost curve of the postal administration, but assume nothing

is known about the costs of potential competitors or which pieces are of the most interest to

potential competitors. Please assume also that the discount is set at 3¢.

a.   In this situation, would you agree that it is not possible to predict which volume

cells might be taken by a competitor? Please explain any disagreement.

b.   Would you agree that, if some volume in cells k through n is taken by a

competitor, it is possible for the competitor to be spending 2.8¢ to handle some

mail that the postal administration could handle for under 2.8¢? If you do not

agree, please explain.

c.   Would you agree that, if some volume in cells f through k is taken by a

competitor, it is possible that the competitor will be spending 3¢ or less to

handle mail that would cost the postal administration between 3¢ and 4¢ to

handle? If you do not agree, please explain.

d.   Do you agree that if all volume in cells k+1 through n [average variable cost

= 2 to 3 cents] and some of the volume in cells f through k [average variable

cost = 3 to 4 cents] leave the postal administration, the average marginal costs

for pieces that remain in the postal administration will be above 4¢? If you do

not agree, please explain.

e.   If consideration is being given to changing the discount under these conditions,

what discount would you recommend and why?

f.   Please discuss any and all reasons you can provide for expecting that potential

competitors might be able to process the volume in some cells at a lower cost

than the postal administration, but not the volume in other cells.

VP/PB-T1-6.

Please refer to your testimony, PB-T-1, page 45, where you discuss rate differences

between the categories of letters and flats **within** a given subclass, and page 47, where you

discuss reasons for emphasizing ECPR considerations **within** subclasses instead of Ramsey

considerations. If it makes a difference, the letters and flats at issue in this question are those

in the subclasses of Commercial Regular, Nonprofit Regular, Commercial ECR, and Nonprofit

ECR, all bulk categories used primarily by business and nonprofit organizations.

a.   Please explain further the differences you see in the cost information required

for Ramsey instead of ECPR in terms of (i) whether one is a cost difference and

the other is not (PB-T-1, p. 49, l. 7), (ii) whether one is at a margin and the

other is not (PB-T-1, p. 49, l. 8), and (iii) if at a margin, how that margin is defined and described.

b.   If a cost difference for ECPR purposes is taken as the difference between a cost for one category and a cost for the other, please explain any and all ways in which you see a difference in the cost information required for the two approaches.

c.   You suggest (PB-T-1, p. 49, ll. 8-10) that ECPR can be followed "using only the costing systems of the Postal Service" and, presumably, that following Ramsey requires some different information which might not be available. Please explain specifically any cost information needed for Ramsey that is not available from the "costing systems of the Postal Service."

d.   (i)   Do you agree that on a regular basis the Postal Service has developed estimates of subclass-level elasticities? Please explain any extent to which you disagree.

(ii)   Absent information that the elasticities of any included categories, such as letters and flats, are different from the elasticity of the subclass, please explain any reasons you believe exist for not setting rates as though the category elasticities were the same as the subclass elasticity.

e.   Do you agree that if letters and flats were split into two subclasses, their elasticities then would become particularly relevant under the factors of section 3622(b) of the Act? Please explain any extent to which you disagree. Note: being relevant should not be taken to mean that they are the only consideration.

f.   (i)   Suppose letters and flats are kept in the same subclass and there is no

reason to believe that their elasticities differ. If there is an interest in

setting rates based on notions of economic efficiency, please explain the

role that the cross elasticity should play in deciding on the level of the

passthrough (*i.e.*, whether it should be above or below 100 percent and

whether it should be above or below the cost coverage of the subclass).

(ii)   If it were believed to be the case that the cross elasticity between letters

and flats is not high, would this cause you to back away from your

recommendation of 100 percent passthrough and move toward a

passthrough above 100 percent and maybe toward one approaching the

cost coverage of the subclass? If not, please explain.

g.   Assume that a subclass has a cost coverage of 170 percent. Recognizing that if

ECPR were used, a lower-cost, workshared category within the subclass would

have a coverage higher than 170 percent, as you discuss at PB-T-1, p. 48, l. 16:

(i)   Do you agree that ECPR will always yield a coverage on the non-

workshared category that is lower than 170 percent? If you do not

agree, please explain.

(ii)   Under ECPR, do you see a significant risk that the workshared category

will be cross subsidizing the non-workshared category, as you discuss

could occur, PB-T-1, p. 49, ll. 11-17? If so, please explain the level of

that risk and the factors associated with it. If not, please explain.

(iii)   Do you agree that if the passthrough of the cost difference between the

two categories were 170 percent, the risk of a cross subsidy existing

would be minimized? If you do not agree, please explain.

VP/PB-T1-7.

Please refer to your statement, PB-T-1, p. 50, ll. 2-3, that "ECPR facilitates the

application of noncost factors on a subclass by subclass basis while maintaining incentives for

efficient worksharing within a subclass."

a.   Please explain any and all ways using ECPR to set rate differences between

categories **within** a subclass "facilitates the application of noncost factors" to

establishing cost coverages **across** subclasses (*i.e.*, for the various subclasses).

b.   Should your testimony be taken to mean that the non-cost factors should or

could be applied to the passthrough between categories **within** subclasses, and

therefore be a basis for moving the passthrough above or below 100 percent? If

yes, please explain which factors might suggest such a movement, and explain

why 100 percent is the ideal reference point for such consideration, instead of

some other passthrough, such as the subclass cost coverage. If no, please

explain your position.

c.   Please explain whether your advocacy of 100 percent passthroughs between

categories within a subclass should be taken to mean that the non-cost factors in

the Act are not particularly relevant to such rate differences.

VP/PB-T1-8.

Please refer to your statement, PB-T-1, p. 50, ll. 4-7, that "the use of ECPR is much better suited to a constantly changing and evolving postal industry. In particular, it allows relatively straightforward adjustments to reflect changing worksharing technology without the need to obtain information on changing demand elasticities."

a. Is it your position that if demand elasticities are believed to be changing, it is better to select a technique that neglects them than to approach the question of how much they are changing or which direction they are changing? If not, please explain.

b. Please consider a subclass with a coverage of 170 percent, which has two categories, and focus on two alternative situations: (i) the passthrough between the two categories of the cost difference into rates is 100 percent, and (ii) the passthrough between two categories of the cost difference into rates is 170 percent. If, due to technology, the cost difference (however measured) between the two categories declines, please explain why it is easier to adjust in situation (i) than (ii). If that is not your position, please explain.

c. Suppose, using the best information available on costs, elasticities, and other factors, the passthrough of a cost difference into a rate difference, between two categories within the subclass, is set initially at 140 percent. If a few years later, it becomes known that the cost difference is lower, due to technology, but it is not known whether the elasticity relationships have changed, please explain: (i) any reservations you would have about the advocacy of setting the new rates

at a passthrough of 140 percent of the new cost difference, and (ii) whether you

believe that, in anticipation of this problem of not knowing how the elasticity

relationships might change, it would be better to set the passthrough at 100

percent in the initial ratesetting exercise.

VP/PB-T1-9.

At page 48, lines 8-10, of your testimony, please refer to your reference to a "belief a

service highly valued by its customers can and should bear a greater percentage markup of

price over marginal cost."

    a.   Please explain the preference in this belief for a "percentage mark up" instead

            of some other markup, such as an absolute amount per piece.

    b.   Please explain how it can (or should) be determined whether a product or

            service is "highly valued."

VP/PB-T1-10.

Please refer to your testimony PB-T-1 at pp. 16-26, where you discuss the Efficient

Component Pricing Rule, discounts that promote efficiency, and preservation of contribution to

overhead costs.

    a.   Within a subclass such as Standard Regular, please assume that (i) a 1.0 ounce

            letter — that is presorted to 5-digits has a barcode, is fully automatable, and is

            entered at a DSCF — has a total unit attributable cost of 10 cents, (ii) a 15

            ounce parcel-shaped piece — that is minimally presorted, does not have a

barcode, and is entered at an origin facility — has a total unit attributable cost of $1.10 (*i.e.*, the cost difference between the letter and parcel is $1.00), and (iii) the average unit contribution desired from the subclass (based on application of all the non-cost criteria in 3622(b), when divided by total volume of the subclass, is $0.15. In your recommendation that intra-subclass pricing should reflect 100 percent of attributable cost differences, would it be correct to infer that your recommended rates for the letter and the parcel, respectively, would be $0.25 and $1.25? If this is not a correct interpretation of your analysis, please explain.

b. Within a subclass such as parcel post, please assume that (i) the total unit attributable cost of a 1-pound machinable parcel, entered in its destination office, is $1.50, (ii) the total unit attributable cost of a 69-pound non-machinable parcel for delivery to zone 8 is $50.00, and (iii) the average unit contribution desired from the subclass (based on an application of all the non-cost criteria in 3622(b)) is $2.00. In your recommendation that intra-subclass pricing should reflect 100 percent of the difference in attributable cost, would it be correct to infer that your recommended rate for the 1-pound machinable parcel entered in its destination office should be $3.50, and the rate for the 69-pound machinable parcels to zone 8 should be $52.00 (*i.e.*, the difference in rates, $48.50, is equal to the difference in attributable cost)? If this is not a correct interpretation of your analysis, please explain.

VP/PB-T1-11.

Please refer to your testimony PB-T-1 at p. 20, ll. 6-14 and p. 23, ll. 3-12. In your discussion, upstream costs are classified as either fixed (F_U) or volume variable (c_U). Suppose that a small (1 percent) decline in volume results in a unit reduction in cost of 5.0 cents (*i.e.*, the marginal cost of small changes in volume is 5.0 cents). Further, suppose that some costs are "lumpy" — that is, they are not fixed costs of operating the network for all levels of volume — and if volume declines by some larger amount, say 5 to 6 percent, the average unit avoided cost is 7.0 cents. Finally, assume that the Commission is considering a discount increase that is forecast to result in an increase in workshared volume of 6 to 7 percent and a corresponding reduction in the volume that would need upstream processing.

    a.   Under these circumstances, would you define the marginal cost as 5.0 cents (*i.e.*, the change in average unit cost that results from a small change in workshared volume), as 7.0 cents (*i.e.*, the change in average unit cost expected to result from the projected rate-induced change in workshared volume), or as some other amount? Please explain your answer.

    b.   Under the above-described circumstances, should the 2.0 cent difference in unit avoided cost that results from workshared volume changes larger than 1.0 to 2.0 percent be included in marginal cost, or be excluded from the computation of marginal cost but be included in incremental cost? Please explain your answer.

    c.   If "lumpy" (*i.e.*, discontinuous) cost changes are excluded from marginal costs, but are included as incremental costs, under these circumstances please explain

why the appropriate measure of per unit avoided cost is marginal cost, not

average incremental cost, as discussed in your testimony at p. 29.