

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

POSTAL RATE AND FEE CHANGES, 2006 )

Docket No. R2006-1

RESPONSES OF VALPAK DIRECT MARKETING SYSTEMS, INC. AND  
VALPAK DEALERS' ASSOCIATION, INC.  
WITNESS ROBERT W. MITCHELL TO INTERROGATORIES OF  
ADVO, INC. (ADVO/VP-T1-1-14)  
(October 6, 2006)

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc.  
("Valpak") hereby submit responses of witness Robert W. Mitchell to the following  
interrogatories of Advo, Inc.: ADVO/VP-T1-1-14, filed on September 22, 2006. Each  
interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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to Interrogatory of Advo, Inc.**

**ADVO/VP-T1-1.**

On pages 42ff, you discuss economic efficiency and the recognition of value in ratemaking. On page 44 (lines 13 ff), you state that: "The concept of value, as developed to a high level of agreement through economic writings beginning as early as 1850, is central to explaining and understanding the decisions made by consumers, whether individuals or firms."

- (a) Please explain whether the term "value" as you use it could also be called "utility."
- (b) Please explain whether the term "[consumer] surplus" (e.g., page 46, line 19) can also be termed as total utility minus total consumer cost at a particular price point.

Response:

- (a) Basically, yes. Several observations may be helpful.

When attention is directed to notions of economic efficiency, the usual formulation is to say that  $U$  is a function of the quantities of the goods consumed. That is, the utility (or the happiness level, or the value received) depends on how much of good  $A$  is consumed, how much of good  $B$ , and so on. Then a budget constraint is imposed, under the presumption that buyers have limitations on what they can spend. This constraint is very simple; it just says that the sum of the price of  $A$  times the quantity of  $A$ , the price of  $B$  times the quantity of  $B$ , ... , and so on, is equal to the total number of dollars available to spend. This is a very general and very basic formulation, with which no one could argue.

Given this formulation, simple though it may be, it is possible, using the logic of mathematics, to maximize  $U$ , subject to the budget

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constraint, and see if there are implications for what the prices should be. Fortunately, implications exist and they turn out to be reasonably simple, at least in concept, even though they do include cross elasticities. Specifically, the implications are that the prices should bear a well-defined relation to the ordinary market demand curve and its elasticities. In the case where the cross elasticities are zero, or, as a practical matter, low, the implication is that the distance of the prices above marginal costs should be inversely related to the absolute value of the own-price elasticities, the relationships involved being commonly referred to as following the inverse elasticity rule. Importantly, the distance of the prices above the marginal costs must be measured in percentage terms. This was essentially noted, for example, in the footnote of Professor Stigler referenced on page 105 of my testimony, lines 17 and 18.

Once it becomes clear that demand curves are important to maximizing utility, two refinements to thinking become possible. The first is that the demand curves, being a quantification of how much the market actually would purchase at various prices, allows the utility to be measured in dollars, with the area under the curves (from 0 up to the quantity purchased) usually referred to as the *value* received by the buyers. The second is that some of the buyers are firms instead of individuals. Since firms are inanimate objects, it is common to think of

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the benefits to them as involving dollars instead of utility. Assuming competition in the economy, the fact that benefits accrue to firms is not a limitation on the theory, because benefits to firms make their way to final consumers. (Almost no one argues that an agency like the Postal Service should make presumptions about how the private economy *should* work, look for flaws of one kind or another, and attempt to correct for those flaws by moving prices in one direction or the other from their otherwise appropriate level.)

- (b) Yes. If a consumer receives value of \$150 from purchasing an item, but must part with \$98 during the purchase, the consumers surplus is \$52. Similarly, a firm can receive surplus, generally referred to as producers surplus, which, *ceteris paribus*, adds to profits, whether profits are positive or negative.

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**ADVO/VP-T1-2.**

On pages 73 ff, you discuss "value of the mail service actually provided each class or type of mail service . . . "

- (a) Please confirm that at a particular price point, the marginal utility of the mail to a mailer determines price sensitivity at that price point. If you cannot, please explain your response.
- (b) Please confirm that, at a particular price point, demand (marginal utility) determines that mailer's price sensitivity at that price point. If you cannot, please explain your response.
- (c) Please confirm that the greater the price sensitivity of the mailer at a particular price point (ceterus paribus), the more consumer total utility and surplus (total utility minus total cost) increase as price decreases. If you cannot, please explain your response.
- (d) Please confirm that, the lower the price sensitivity of a mailer at a particular price point (ceterus paribus), the less consumer utility and surplus (total utility minus total cost) decline as price increases. If you cannot, please explain your response.

Response:

- (a-d) I believe all of these can be confirmed, although it might in some cases be better to refer to percentage changes instead of to absolute changes. In applying them to actual situations, I reserve judgment on whether the implications of particular terms would require clarification. For example, one could argue that a "mailer's price sensitivity" determines demand, instead of the other way around. Also, the market demand curve is a collection of the behavior of both actual buyers and potential buyers, making it important to keep in mind that (1) it is just as important to recognize new buyers as it is to think about existing buyers that might change the quantity they purchase, and (2) no one would

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expect all buyers in a market to behave in the same way. *See also* my  
response to ADVO/VP-T1-1.

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**ADVO/VP-T1-3.**

On pages 59-60, you discuss private delivery alternatives and describe the large number of free community newspapers that are delivered privately now and the number of private carriers that you have spoken with. On page 82 (lines 22-26), you state: "Much of the mail that is candidate for being handled by alternative carriers weighs more than 3.3 ounces, and therefore pays the pound rates of either ECR or Regular. Private carriers have less difficulty competing for relatively heavy mail than for relatively light mail." On pages 84-85, you discuss the types of Standard mail that may be carried by private competitors: merchandise, pieces over 24 pages, and saturation pieces whose addresses can be removed.

- (a) Based on your experience, please describe the extent to which the free papers are letter-shaped (as opposed to flat-shaped).
- (b) Based on your experience, please describe the extent to which private carriers deliver individual letter-shaped pieces (as opposed to flat-shaped pieces or letter-shaped pieces within a flat-shaped piece).
- (c) Please confirm that the private delivery exception for pieces over 24 pages applies to "books and catalogs consisting of 24 or more bound pages" (See 39 C.F.R. §310.1(a)(7)(v)).
- (d) Based on your experience, please describe the extent to which books and catalogs with 24 or more bound pages are letter-shaped (as opposed to flat-shaped), and the extent to which any such letter-shaped books and catalogs are delivered privately.

Response:

The items I mentioned on page 84, lines 4-5 of my testimony were intended to be examples of items which are excluded from the Private Express Statutes, not an exhaustive list. Further, I note that the use of the word "letter" in the Private Express Statutes is likely not the same as "letter" or "letter shaped" as used in mail classification.

- (a) My experience suggests that almost all "free papers" are flat-shaped.

Also, the free papers I have seen tended to be relatively heavy and could

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not be converted into letter-shaped pieces. I have seen some free papers that weigh over 16 ounces, specifically in the case of harvest editions, which are published in the fall. I represent my experience for what it is, not as a comprehensive market survey.

- (b) My experience suggests that the private delivery of letter-shaped pieces is limited, perhaps very limited. This does not mean that more would not be delivered if there were a change in the mailbox rule.
- (c) Your statement appears to be generally correct, but omits reference to telephone directories and I note there is no clear definition of “bound” in the regulation. I have not presented myself as an expert on how the Private Express Statutes should be interpreted and applied; instead, I have simply presented my understanding of these matters, as applicable to rate development. I note that § 310.1(a)(7) lists items that “are not letters within the meaning of” the Private Express Statutes, but it does not say that all items not in the list *are* letters. A footnote at the beginning of this section begins: “Several of the items enumerated in this paragraph (a)(7) do not self-evidently lie outside of the definition of ‘letter.’” I would presume it to be the case, whether the Postal Service has determined it or not, that some items *not* enumerated also lie outside of the definition, whether self-evident or not.

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- (d) I have no experience to suggest that a significant proportion of books and catalogs with 24 or more bound pages are letter-shaped, although I have seen a number of booklets that are letter-shaped and that, when sent through the mail, are tabbed. Whether some of these are delivered privately, I do not know.

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**ADVO/VP-T1-4.**

Please explain the difference between the TYBR attributable ECR/NECR cost of \$3,189,042,000 in cell E8 of sheet "Inputs" of VP-RWM-Workpaper-8 and the USPS witness Waterbury D report (TYBR PRC Version) of \$3,189,157,000 in ECR/NECR costs.

Response:

In checking into your question, I found that the original D Report, contained in USPS-LR-L-96, was supplemented by an addendum D Report, contained in USPS-LR-L-169, on August 15, 2006, in response to a Commission “request to witness Waterbury for corrected library references ... that ‘include the corrections to the APC cost reduction and the corrections to the periodical air transportation’ figures.” Notice Concerning LR-L-169, et al., August 15, 2006. The D Report in the addendum shows a cost of \$3,189,175,000, which, except for what might be a reversal of two digits, appears to be the number referenced in your question. I found that putting the “addendum” figure into my worksheet does not change any of the rates.

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**ADVO/VP-T1-5.**

On page 118, you state that: ". . .the difference between them [letters and flats within the same subclass] is not a matter of worksharing. The default recognition for a cost difference under these conditions is the subclass cost coverage, but certainly at least 100 percent." On pages 183-184 (lines 20 ff), you assert that the ECR letter-flat rate differential should be based on a passthrough of the full letter-flat cost differential (adjusted to reflect origin entry) multiplied by the subclass cost coverage. On Page 178 (lines 13-14), you state: "This [100% passthrough of the Basic letter-flat origin cost difference] is far less than a passthrough equal to the subclass cost coverage, which, in theory, I see no reason should not be the default prescription for letters and flats, which are for all practical purposes separate products."

- (a) Please confirm that your concept is that 100% of the total origin cost difference between different "products" (within the same subclass) multiplied by subclass cost coverage should be the basis for the rate difference between the two "products." If this is incorrect, please provide the correct explanation.
- (b) Please explain why the product markup is based on total origin cost when the subclass markup is based on total actual cost, and origin cost is a non-existent cost for a majority of the pieces in each of the "products?"
- (c) Under your theoretical design of rates for separate "products" within a subclass, is there a cost coverage objective for each product individually, relative to the cost coverage for the entire subclass? Please explain fully.
- (d) Please provide all economic documentation you have that supports your above-cited concept ("theory") of the appropriate way to develop rate differences between two "products" within the same subclass.

Response:

- (a) Confirmed, with comment. I have referred to this as the *default* passthrough. This means that reasons may be found for deviating from it. These reasons should be stated.
- (b) I have focused on the *origin* passthrough because it abstracts from questions relating to the dropship discounts, which should be considered a separate subject.

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- (c) No. As long as two categories that are essentially separate products are in the same subclass, I tend to look at the subclass markup as applicable to each of them, at least as a default position. The way I have applied this is to operate at the basic level, origin entered. This allows separate questions to be asked about presort discounts and dropship discounts, as noted in part (b) above.
- (d) Perspectives on postal rates have evolved before the Commission, with inputs from the courts and a number of intervenors, the latter providing testimony and analysis from a considerable range of experts. I draw heavily on this evolution and feel like my understanding has evolved along with it. Application of a coverage factor has been standard fare in many situations, including rates differentiated by weight and zone in Parcel Post and Priority Mail. In Standard mail, a conclusion has been that costs relating to weight should receive a markup, in the same way. The question of letters and flats in Standard was a new issue in Docket No. R90-1, and has taken several turns since. Particularly in sections beginning on pages 114, 156, and 178 of my testimony, this issue is discussed at some length.

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**ADVO/VP-T1-6.**

On page 118 (lines 5-8), you state that: "Letters and flats tend to be separate products with separate processing streams . . . the difference between them is not a matter of worksharing." On page 178 (lines 13-16), you state that ECR letters and flats "... are for all practical purposes separate products."

- (a) Please explain what you mean by "product" and clearly differentiate that term from the traditional postal terms of "subclass" and "rate category."
- (b) Please provide your understanding of how much difference there must be between two "products" in order to call them "separate" and apply separate cost coverages to their origin costs while keeping them within the same subclass.
- (c) Please provide your understanding of how much difference there must be between two "products" in order to separate them into two separate subclasses.
- (d) Please identify all the separate "products" in the Standard Regular subclass.

Response:

- (a) Please see my discussion of deaveraging beginning on page 10 of my testimony. Also, accept the term *category* as a generic one, useful for referring to some kind of grouping, which may receive separate rate recognition, may be a product, and/or may be a subclass. Usually, the terms "rate cell" and "rate element" are used to refer to something finer than a category, but I know of no rule that this must be the case.

As if there were such a thing as a concept of a product that should be applied everywhere, the question of what is a product has received attention from time to time. My view of the matter is that if two categories tend to look like separate products, to be processed in

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separate mailstreams, to have different costs, to be purchased in markets that are arguably different, and to have relatively low cross elasticities, they tend to be separate products. *When* separate products or categories should be identified as separate subclasses is, of course, a subject that has been the source of a great deal of contention in rate proceedings. My view of how categories tending to be products should be handled in setting rates makes the subclass question a small additional step, instead of a large one. This in and of itself makes sense; major discontinuities in relationships between alternatives are not generally good things.

- (b-c) I find it difficult to describe degrees of differences of the kind of you seek, and to set up decision rules that identify critical levels that say: once you reach this hurdle, all relevant things change. If we had several hundred potential products to consider, guidelines might become more important. As it is, we have only a few. The best way to deal with them is to rely on testimony and deliberation before the Commission. The principal goal should be the development of paths that help lead us to fair and equitable rates.
- (d) Roughly, I would think that letters, flats, and parcels look like separate products.

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**ADVO/VP-T1-7.**

Are all ECR letters one "product" as you define the term?

- (a) If so, is it your belief that the only difference between basic ECR letters (with as few as 10 pieces per carrier route) and saturation letters is the degree of worksharing? Explain the basis for your answer.
- (b) If so, is it your belief that basic ECR letters (with as few as 10 pieces per carrier route) serve the same market and have the same price sensitivity as saturation letters? Explain the basis for your answer.
- (c) If not, please identify the number of separate letter "products" in ECR.

Response:

Basically, yes.

- (a) I do not know if any analysis has ever been done to determine whether 10 pieces per route is the optimum cutoff, or the most appropriate. When saturation rates were first proposed in Docket No. R90-1, saturation mail had a walk-sequence requirement, which amounted to *optional* preparation, while basic pieces did not. Now, all of the pieces have a line-of-travel or walk-sequence requirement, essentially removing anything optional. Still, if cased, saturation letters would be cased faster than basic letters, suggesting work that does not need to be done. On the other hand, automation compatibility was not an issue at that time, particularly for carrier route mail, but both high-density and saturation must now be automation compatible, though not basic. The section beginning on page 123 of my testimony discusses this issue. Therefore,

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there *are* worksharing differences, but I do not contend that there are not other differences as well, as discussed in part (b) of your question.

- (b) I have no evidence that could support an answer. My presumption would be, depending in part on how the term *market* is defined, that the markets differ and that the elasticity of saturation letters is higher than the elasticity of basic letters.
- (c) My testimony, of course, treats all ECR letters as one product, and adopts notions of ECP to recognize cost differences. Beyond this, I have not taken a position on whether there are, so to speak, sub-products of letters. However, a case could be made for giving separate recognition in rates to saturation letters, in part for competitive reasons.

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**ADVO/VP-T1-8.**

Are all ECR flats one "product" as you define the term?

- (a) If so, is it your belief that the only difference between basic ECR flats (with as few as 10 pieces per carrier route) and saturation flats is the degree of worksharing? Explain the basis for your answer.
- (b) If so, is it your belief that basic ECR flats (with as few as 10 pieces per carrier route) serve the same market and have the same price sensitivity as saturation flats? Explain the basis for your answer.
- (c) If not, please identify the number of separate flat "products" in ECR.

Response:

Basically, yes.

- (a) I do not know if any analysis has ever been done to determine whether 10 pieces per route is the optimum cutoff, or the most appropriate. When saturation rates were first proposed in Docket No. R90-1, saturation mail had a walk-sequence requirement, which amounted to *optional* preparation, while basic pieces did not. Now, all of the pieces have a line-of-travel or walk-sequence requirement, essentially removing anything optional. Still, if cased, saturation flats would be cased faster than basic flats, suggesting work that does not need to be done. Therefore, there *are* worksharing differences, but I do not contend that there are not other differences as well, as discussed in part (b) of your question.
- (b) I have no evidence that could support an answer. My presumption would be, depending in part on how the term *market* is defined, that the

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markets differ and that the elasticity of saturation flats is higher than the elasticity of basic flats.

- (c) My testimony, of course, treats all ECR flats as one product, and adopts notions of ECP to recognize cost differences. Beyond this, I have not taken a position on whether there are, so to speak, sub-products of flats. However, a case could be made for giving separate rate recognition to saturation flats, in part for competitive reasons.

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**ADVO/VP-T1-9.**

Please identify all the rate categories within ECR whose cost differences represent worksharing differences.

Response:

Please see the discussion of this issue contained in my responses to ADVO/VP-T1-7, 8, and 10.

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**ADVO/VP-T1-10.**

On page 5, lines 4-6, you state that: "The design of rates within subclasses should also be guided by principles, including notions of worksharing, efficient component pricing, cost-based rates, the efficiency of signals sent to mailers, and fairness." Please refer to the Direct Testimony of John C. Panzar (PB-T-1) where he states that the principles supporting efficient component pricing also apply to basing rate differences – other than worksharing discounts – on cost differences. On page 45, lines 9 ff, he states:

More so than in most markets, mailers have the opportunity to "design their own service." That is, they can choose many of the intrinsic properties of their mailing: its size (one ounce or several); its shape (letter or flat), the time of day at which it enters the mail stream, the location at which it enters the Postal Service network – and many other of their mail's characteristics. Two aspects of this flexibility are important for rate-making purposes. First, and most importantly, differences in these characteristics may have important impacts on the costs that the mail imposes on the Postal Service. Second, while mailers may have preferences over these characteristics (e.g., a flat may better serve their purposes than a letter), the relative value of shifting from one alternative to another may be dramatically different than the difference in Postal Service costs. Just as with traditional worksharing, an effective way to induce changes in mailer behaviour is through rate differences that reflect cost differences.

The basic economic argument in support of cost-based rate differentials is the same as that for avoided cost worksharing discounts. Mailers can act to minimize end-to-end costs only if the difference in rates for mail with differing characteristics reflects differences in the costs incurred by the Postal Service . . .

- (a) Do you agree with Dr. Panzar? If not, please explain fully why not.
- (a) Please identify the ECR rate categories/elements for which you would develop rates on the basis of efficient component pricing.

**Response:**

- (a) I agree that we should all be working together to improve our understanding of these issues and our ability to apply that understanding;

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but at this point, I disagree respectfully with Dr. Panzar. A range of considerations is involved in these matters, which probably explains why it is easy for opinions to differ on implementation. My position is that there should be limits to the strict adherence to ECP (sometimes ECPR [R=Rule]) principles and that one of the limits should involve identifiable and separate categories within subclasses, particularly categories that can easily be viewed as separate products.

In a broad sense, an interest in the efficiency of resource allocation in the economy suggests that the distance of rates from marginal costs, measured in percentage terms, is critically important. As rates are moved further and further from costs, or as some rates are moved further from costs than other rates are from costs, the efficiency tends to decline, unless there are elasticity reasons for the disparities. On this basis alone, then, any approach to ratesetting that neglects elasticities and places some rates closer to costs than other rates are to costs is suspect, and this is precisely what ECP does.

The Standard mail subclasses include a range of categories that differ significantly in terms of cost. Under these conditions, an approach that focuses on per-piece markups, as ECP does, is a prescription that turns attention away from the percentage relationships known to be relevant, and that leads invariably to some rates being relatively far from

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costs and to other rates being relatively near costs. Therefore, in this setting, ECP raises questions that need to be addressed. Specifically, if per-piece contributions are to receive attention, there needs to be a justification for doing so.

The justification for emphasis on per-piece contributions can be looked at in two ways. The first is to look at reasons why attention to the elasticity relationships, as commonly particularized in the Ramsey formulas, presents difficulties. Dr. Panzar has a section discussing this issue. The second is to focus positively on the merits of the ECP approach, which Dr. Panzar also addresses. I will discuss both of these ways.

In explaining why giving weight to the elasticities, and therefore to the Ramsey formulas, presents difficulties, Dr. Panzar presents four considerations. The first consideration is:

First, Ramsey Pricing requires precise information about production costs and consumer demands. ECPR requires only information about cost differences at the margin. Thus a system of prices that provide incentives for efficient worksharing can be put in place using only the costing systems of the Postal Service. Estimates of demand elasticities are not required. [PB-T-1, p. 49, beginning on l. 6.]

As a practical matter, I do not see that these issues present difficulties, for several reasons. (1) I do not see that the cost information required

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for Ramsey pricing need be any more “precise” or accurate than the cost information required for ECPR. (2) I do not see the cost information required for ECPR as being less demanding than the costs required for Ramsey. For the most part, the cost differences required for ECPR have been found by taking the difference between two category costs, so the costs needed for Ramsey are known. (3) In cases where ECPR focuses on costs of a benchmark that is different from the costs available for the categories involved, I see ECPR costs as more demanding than Ramsey, not less. (4) The question of whether a special “margin” is needed for ECPR is an open one, but is not considered a relevant issue in Standard mail. One can argue that a margin associated with the cost of the next piece that would move to a workshare category, under a slight increase in the discount, should be used, and estimates of such a cost have been used in some cases, but this again makes *greater* demands on the costing, not less. Also, Dr. Panzar argues that the “theoretically correct approach” to estimating costs avoided is to use attributable costs, which is not a cost at a margin relating to the propensity to move to the workshare category (p. 29, ll. 1-2). (5) It is true that the use of Ramsey requires information on the elasticities involved, although I see no reason why this information has to be particularly “precise.” However, elasticities are available at the subclass level and, absent evidence

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suggesting otherwise, I see no reason why the subclass elasticity should not be assumed and used for major components in the subclass. I believe we understand that cross elasticities are relatively unimportant if they are small; if they are large, I believe we understand that they move the Ramsey solution toward the ECPR solution, but not all the way. In short, none of the reasons discussed in this first consideration support adopting a direct application of ECPR and neglecting notions of economic efficiency. Some judgment may be required in dealing with these matters, but judgment is always required in ratesetting exercises.

Dr. Panzar's second reason for preferring ECPR to Ramsey is:

Second, Ramsey Pricing does not automatically ensure that prices are free of cross-subsidization. That is, it must be verified that the prices of each product are at least as large as the associated average incremental costs. This is much less likely to be a problem for worksharing discounts set in accordance with ECPR. Intuitively, as long as the base, non work-shared price covers its average incremental cost, application of ECPR will ensure that all of the associated discounted prices are also free of cross subsidy. [PB-T-1, p. 49, beginning on l. 11, footnotes omitted.]

I do not see that there is any meaningful likelihood of Ramsey pricing causing a cross subsidy. Unless there are significant differences in elasticity, which is not known to be the case among the categories in either Regular or ECR mail, a Ramsey solution goes in the direction of equal percentage markups over costs, which assures that each price is

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well above costs. On the other hand, ECPR produces different percentage markups, and is thus more likely than Ramsey to get into cross-subsidization territory. And, in Standard mail in particular, the markups are reasonably high, making it unlikely that even ECPR would lead to a cost-subsidy test being failed. Therefore, to the extent that concern over the matter of cross-subsidization exists, it cuts in favor of Ramsey, not ECPR.

Dr. Panzar's third reason for preferring ECPR to Ramsey is:

Third, Ramsey Pricing weighs surplus dollars equally. While appealing to economists, this neutrality does not allow for the Commission to exercise independent judgment with respect to the non cost factors specified by the Postal Reorganization Act. It is true that Ramsey Pricing principles could be applied using unequal welfare weights. However, ECPR facilitates the application of non cost factors on a subclass by subclass basis while maintaining incentives for efficient worksharing within a subclass. [PB-T-1, p. 49, beginning on l. 18.]

Equating the recognition of social policy to the application of "welfare weights," I agree that consideration is sometimes given to social policy in setting rates. However, this is most often done as a matter between subclasses. With the exception of First-Class, the extent to which social policy is a factor within subclasses is more limited, and I do not see much role for it within Standard, a bulk subclass serving the business needs of firms and other organizations. For example, I do not see any

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social policy reasons to favor flats with a relatively low markup, compared to letters. In any event, I do not see any way in which the freedom or the latitude to consider social policy *among* subclasses is “facilitate[d]” by emphasis *within* subclasses on ECPR instead of economic efficiency. Similarly, I do not see any way in which the freedom or latitude to consider social policy within subclasses is constrained by a default position that emphasizes economic efficiency instead of ECPR. Both Ramsey and ECPR point to default positions but neither precludes recognition of other factors.

Dr. Panzar’s fourth reason for preferring ECPR to Ramsey is:

Finally, and most importantly, 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. [PB-T-1, p. 50, beginning on l. 4.]

Changes in the “postal industry” fall neatly into two camps. The first involves changes in markets, which could change the elasticities faced. The second involves changes in technology and factor prices, which could change Postal Service costs. The relation of ECPR to these differs.

In the first camp, changes in postal markets do occur, even though it is sometimes difficult to get a handle on them. When postal

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markets and associated elasticities change, the Ramsey model advises on how rates should be adjusted; ECPR does not. To say that ECPR is preferred as a guideline because it does not require information on elasticities is a *non sequitur*; it justifies honoring an inferior guideline by pointing to the very reason it is inferior — that it cannot advise on how elasticities should be recognized or on how to adjust to changes in them. It is true, of course, that information on elasticities is hard to come by, and might be qualitative at best, but that is no reason to recommend sitting in the wrong place.

The second camp involves changes in Postal Service costs. The “particular” Dr. Panzar provides is that “worksharing technology” might change and that this might call for a corresponding adjustment in the rates. I do not see that “the use of ECPR” instead of Ramsey makes it any easier to make any needed adjustments. The facts are that changes in costs can be recognized under either approach. If new information on demand elasticities is not available, the elasticity effect underlying the current rates can be continued. If qualitative perspectives on elasticities seem reliable, they too can be considered. As noted above, some judgment may be required, but that is to be expected.

Combining all four of these considerations does not, in my opinion, add up to a conclusion that notions relating to economic

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efficiency should be viewed as either inapplicable or unduly difficult to apply within subclasses, and that ECPR should therefore be preferred.

This leaves the question of whether the positive attributes of ECPR argue for its broad or exclusive application within subclasses.

Dr. Panzar's "inclusive definition" of worksharing is that it "refers to any private sector *activity* which *reduces* the *costs* of the Postal Service" (p. 7, ll. 4-6, emphasis in original). This may be somewhat broad, as it includes the activity of not mailing at all and it makes everything hinge on how the word *activity* is defined. My preference is the slightly less inclusive definition that worksharing relates to mail preparation alternatives faced by mailers that allow mail to be entered further downstream, thereby allowing reduced Postal Service costs. This comports clearly with non-cost factor number 6 in the Act (39 U.S.C. § 3622(b)), which requires consideration of "the degree of preparation of mail."

Now, let's begin from a base position in which no worksharing is being done. From such a position, allowing worksharing discounts has several noteworthy characteristics. (1) So long as the discount is not larger than the unit incremental cost avoided, the discount can be offered without increasing the rates of any other mailers, so that the movement to the provision of a discount is a Pareto improvement, at least from the

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point of view of mailers. Such improvements are generally viewed favorably. (2) Under this same proviso, offering the discount does not make the Postal Service any worse off financially. Unless the Postal Service prefers a large payroll to a small one, which should not be a goal, the Postal Service should be indifferent to such a change. (3) If the cost to the mailer of the added preparation is less than the cost to the Postal Service of doing the work avoided, there is a net increase in efficiency, a reduction in combined cost, a lower net rate for the mailer, and the possibility that the mailer might enter more mail than before, due to elasticity. The potential gain here is very large. For example, having mailers presort 50 billion addresses on a computer for 1 cent per piece, so that the Postal Service can avoid sorts costing 4 cents each, would be a net savings to the nation of \$1.5 billion — not small on any scale. (4) Mailers moving from a non-workshared position to a workshared position would maintain their per-piece contribution to fixed costs (and therefore, by extension, to the costs of providing universal service). There may or may not be a policy preference for requiring that mailers beginning to workshare maintain their contribution. (5) If the cross elasticities between the workshare levels are reasonably high, as in mailers deciding to workshare on the basis of the discount, the discount under ECPR becomes close to one that would exist if the focus had been

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purely on economic efficiency instead. (6) Allowing a discount equal to the cost savings puts the Postal Service into the position of being able to say to the mailer that is unable to change the preparation of his mail: “We are only charging you the *extra* cost of your mail, relative to the cost of workshared mail.” Charging only the extra cost is a rather high form of consideration. As a matter of social policy, this could be an attractive feature. (7) Worksharing tends to recognize a very important aspect of reality, that mailers, through the use of technology, planning, controlling, scheduling, and other decisions they make regularly are often well-positioned to prepare mail in ways that reduce overall combined costs, but they have no incentive to do this (in fact, it would cost them extra) without the discounts.

I do not see that any of these considerations, involving social policy or other matters, argues in any persuasive way that ECPR should be applied to the difference between categories like letters and flats. In fact, I think that the Postal Service is at its most basic level a carrier of letters and that nothing should be done to limit the extent to which mailers are permitted to avail themselves of the Postal Service’s letter-delivery facility. Also, the cross elasticity between letters and flats is generally considered to be low, meaning that the Ramsey solution might not be close to the ECP solution and that the gains from Ramsey might

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be reasonably large. In this regard, it is interesting that Dr. Panzar suggests in his discussion of letters and flats that the value of using flats instead of letters might “be dramatically different than the difference in Postal Service costs” (p. 45, ll. 18-19). This suggests, to me, that the cross elasticity may be low.

No reason is thus found to lean toward ECP considerations for the rate difference between letters and flats. The guideline of choice should be emphasis on concepts of economic efficiency, even though honoring such concepts does not represent an unmixed assignment in terms of simplicity and achieving agreement among all parties involved.

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**ADVO/VP-T1-11.**

On page 116 (lines 5-6), you state that you know of no evidence that the sensitivity of volume to price is much greater for ECR flats than for ECR letters.

- (a) Please provide all evidence you have that the price sensitivities of all the flat and letter "products" in Standard Regular are similar.
- (b) Please provide all evidence you have that the price sensitivities of all the flat and letter "products" in ECR are similar.
- (c) Are there any cross-price sensitivities among the "products" in Standard Regular? If so, please provide any information you may have.
- (d) Are there any cross-price sensitivities among the "products" in ECR? If so, please provide any information you may have.

Response:

- (a-b) I know of no evidence of comparative price sensitivity. In order to act, some evidence is usually required. If no evidence is available, the usual response is not to act as though it were.
- (c-d) So far as I know, the conventional wisdom on this question is that the cross elasticities in question are reasonably low. In this regard, it is interesting that Postal Service witness Thress did not put a rate difference into his letter-flat share equations. *See USPS-T-7*, pp. 365-397. Many flats could not in any reasonable way be converted into a letter. Others are part of a business model that would not be served by a letter instead of a flat. Decisions to change format are often accompanied by other changes as well, such as a different quality or thickness of paper or the inclusion of art or photographs.

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**ADVO/VP-T1-12.**

On lines 11-13 of page 118, you state: "No theory of which I am aware suggests that two products, even though related, should have the same per-piece markups . . . "

- (a) Please explain what you mean by this statement.
- (b) Please explain what you mean by "related" and specify whether it involves to any extent cross-price sensitivities between the two "relations."
- (c) Please explain fully your criteria for determining how "related" products must be before they must (or must not) have the same per-piece markups.

Response:

- (a) The lines cited are part of a section that discusses the letter-flat rate differential. They mean that two products (like letters and flats) would be expected to have percentage markups, that the two percentage markups might or might not be the same, that having the same per-piece markups would be a special case of different percentage markups, and that I know of no theory of efficient resource allocation suggesting that this special case has any special properties to commend it.
- (b) For purposes of my response to this question, I am assuming that related products can be viewed as *relations*, in the same sense that a person might say "my relations are coming for dinner." The subject here, as noted in part (a) above, is letters and flats. Even if not suggested by the fact that they are in the same subclass, my reference to them being related is based on little more than that they are bulk categories used

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primarily for advertising purposes. Part of their relatedness is historical in that Congress created a bulk category that would pay pound rates, and did not distinguish between letters and flats. I did not mean to suggest high cross elasticities. If the cross elasticities were meaningfully high, the extent to which they are separate products would be reduced and the economically efficient rate differences would move downward toward the cost differences.

- (c) Assuming emphasis is placed on developing economically efficient prices, the cross elasticities would have to be reasonably high for the per-piece markups to be the same. I do not know a way to specify what the critical levels might be.

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**ADVO/VP-T1-13.**

Please refer to your discussion on pages 20 ff on the guidelines for de-averaging existing subclasses into two or more separate subclasses and refer again to your statement on page 118 (lines 5-8) that letters and flats have separate processing streams.

- (a) Do you agree with the Commission that products within subclasses should be homogenous with respect to both cost and market factors? Please explain.
- (b) Is it your opinion that Standard letters and flats no longer have common cost characteristics and that the cost characteristics within Standard are no longer homogenous? Please explain.
- (c) Is it your opinion that ECR letters and flats no longer have common cost characteristics and that the cost characteristics within ECR are no longer homogenous? Please explain.
- (d) Is it your opinion that ECR letters and flats have intrinsic cost differences because of their mail characteristics? Please explain.

Response:

- (a) Basically, yes, but some comment is needed. If subclasses were constructed to accord with strict homogeneity, “with respect to both cost and market factors,” there would be a really large number of subclasses, and no discounts, no rate categories, and no rate cells would be needed. Short of that, the application of the principle you cite has been to select subclasses based on market factors, broad product lines, and costs generally, and then to go further in the direction of recognizing costs by establishing such rate features as rate categories, worksharing discounts, surcharges, zones, and weight cells.
- (b) See my response to part (a) above. My proposal is to recognize the cost differences between letters and flats, without dividing them in to separate

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subclasses. I do not know whether the degree of homogeneity, however that might be measured, has changed. I do not accept the “no longer” assumption in your question.

- (c) See my response to parts (a) and (b) of this question.
- (d) The subject of *intrinsic* cost differences has been a difficult one. Usually it means that cost differences are innate or inherent, and are difficult to attribute to particular separable characteristics such as the degree of presortation or dropshipping. Cost differences due to the bulk nature of the product, which would be greatest for saturation mail, would be an example of an intrinsic cost difference. The cost differences between letters and flats are due primarily to specific operations for flats costing more than corresponding operations for letters. Thus, there are differences in the costs of letters and flats, and the differences occur “because of their mail characteristics.” I do not see anything critical that depends on the extent to which they are considered intrinsic.

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**ADVO/VP-T1-14.**

On page 176, you state that: "With the exception discussed above for high-density flats, setting rates in this way honors all of the costs in the tree."

- (a) Please explain fully what you mean by "honors."
- (b) Please explain fully how "honoring costs in the tree" comports with your concept of product pricing and economic efficiency.

Response:

- (a) The section you cite discusses setting the saturation discount relative to high-density, for flats. Since a limitation was placed on the high-density discount (relative to basic, as discussed in the section beginning on page 173), the section explains that the saturation discount was set in such a way that saturation mail was not disadvantaged by that limitation. My thinking in using the word *honor* was to say that the saturation costs were recognized in full, in this case as though the discount were given from the basic level instead of the high-density level.
- (b) Recognizing costs in this way is consistent with notions of efficient component pricing, as they have been applied in developing discounts for saturation flats. I have not proposed any changes in this approach. If it were decided to place greater emphasis on economic efficiency, attention would have to be given to the various elasticities and cross elasticities involved, of which no estimates are available. If it is true, as I suspect, that the cross elasticities are small and that the own-price elasticity of

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saturation mail is relatively high, the passthrough would turn out to be over 100 percent.