Postal Rate Commission
Submitted 10/18/2006 3:46 pm
Filing ID: 54233
Accepted 10/18/2006

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

Postal Rate and Fee Changes, 2006 **Docket No. R2006-1**

RESPONSE OF PITNEY BOWES INC. WITNESS JOHN C. PANZAR TO VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. INTERROGATORIES (VP/PB –T1-12-15)

Pitney Bowes Inc. ("Pitney Bowes") herby submits the answers of Pitney Bowes witness John C. Panzar to Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. interrogatories VP/PB-T1-12 through 15. Each question is stated verbatim and then answered.

Respectfully submitted,

_________/s/____________________
James Pierce Myers
Attorney at Law
1211 Connecticut Avenue, NW
Suite 610
Washington, DC 20036
Telephone: (202) 331-8315
Facsimile: (202) 331-8318
E-Mail: jpm@piercemyers.com

Michael F. Scanlon
PRESTON GATES ELLIS &
ROUVELAS MEEDS LLP
1735 New York Avenue, NW
Washington, DC 20006
Telephone: (202) 628-1700
Facsimile: (202) 331-1024
E-Mail: mscanlon@prestongates.com

Counsel to PITNEY BOWES INC.

DATED: October 18, 2006

VP/PB-T1-12 Please refer to your testimony, PB-T-1, page 20, lines 6 to 14. According to your equation at line 8, the incumbent has:

Downstream costs = $F_D + c_D V$

Upstream costs = $F_U + c_U V$ and Fixed common costs = F_J.

a. Would you agree that the upstream costs, $F_U + c_U V$, constitute the incremental cost of the upstream activities?

b. If you do not agree, please define what you believe to be the incremental cost of the upstream activities and discuss how and why it differs from your upstream costs as defined above.

RESPONSE

a. Agreed. However, it is important to note that "upstream activities" are a *cost component*, not a service.

b. Not applicable.

VP/PB-T1-13 Please refer to your testimony PB-T-1, at page 20, lines 6-14 and page 22, lines 1-9, and for this interrogatory, assume that the incumbent has unbundled its pricing so that the upstream service component is priced separately from delivery; *i.e.*, the incumbent's rates consist of two components, one for delivery (p_D) and one for upstream activities (p_U). The stamp price, p, is equal to $p_D + p_U$, and $p - p_D = p_U = w$ the worksharing discount. Assume further that all service providers are charged the same price for access to and usage of the local delivery network, and the rate for delivery is designed to cover not only the downstream costs ($F_D + c_D V$), but also the fixed common costs (F_J). Also assume that the fixed upstream costs (F_U) are non-trivial; *e.g.*, equal to, say, 20 to 30 percent of the upstream volume variable costs.

a. Would you agree that if the rate for each individual upstream activity is priced at its variable cost, then:

(i) the difference between rates for two activities will equal the difference in their variable costs?

(ii) the rate differential between two activities, if measured and stated as the difference from the more costly activity to the less costly activity, reasonably might be stated as a "discount"?

(iii) the rate differential between two activities, if measured and stated as the difference from the less costly activity to the more costly activity, reasonably might be stated as a "surcharge"?

(iv) regardless of whether stated as a "discount" or "surcharge," the rate differential between two activities would be the same amount for the two activities in question so long as it represents the difference in the variable costs of the two activities, and the variable costs of the two activities are estimated on a consistent basis?

If you do not agree with any of the above, please explain the basis for your disagreement.

b. Would you agree that if all rate differences for upstream activities are exactly equal to differences in variable cost, and rates for each upstream activity reflect variable cost only, then the revenues from the upstream volume will just cover upstream variable cost; *i.e.*, upstream revenues will equal $c_U V_U$? If you do not agree, please explain.

c. Would you agree that if the rate for each upstream activity is set at its volume variable cost, then revenues from the rates for upstream activities will not be sufficient to cover the upstream fixed costs, F_U? If you do not agree, please explain.

d. If rates (including rate differentials) for upstream activities fail to cover the fixed upstream costs (F_U), then (i) should those upstream fixed costs also be recovered from the component of the rates charged for delivery, or (ii) should they be recovered via some kind of markup on upstream volume variable costs? Please explain.

e. Please refer to your response to preceding part d. If it is your position that all fixed costs ($F_J + F_U + F_D$) should be recovered from the rate component that is for delivery only, please explain the principles or logic which lead you to conclude that those mailers who completely bypass the upstream portion of the network, and have no need for the incumbent to maintain an integrated network, should pay rates for delivery that include the upstream fixed costs, F_U. Please indicate whether your position would be the same, even if such mailers have available alternate (*i.e.*, private) means of delivery.

f. Please refer to your response to preceding parts d and e. If it is your position that all fixed costs ($F_J + F_U + F_D$) should be recovered from the rate component that is for delivery only (p_D), and the rate component for upstream activities (p_U), should cover only variable costs — and fail to cover the upstream incremental costs — would you consider it reasonable to say that mailers who use the upstream activities then would be partially cross-subsidized by mailers who completely bypass the upstream portion of the network, and use only the delivery portion of the network? Please explain your answer, and in doing so explain whether forcing mailers who do not use the upstream portion of the network to pay a share of its incremental cost comports with:

(i) the criterion in section 3622(b)(1) that rates be fair and equitable, and

(ii) the spirit of section 3622(b)(3), which was intended to preclude rates that knowingly involved cross-subsidies.

g. As a hypothetical, please suppose that all mail within a subclass were workshared to the point where none of it used any upstream services. Should rates for this subclass cover (*i.e.*, cross-subsidize) a portion of the fixed costs of the upstream portion of the network? Please explain.

h. Please refer to your response to preceding part d. If it is your position that rates for upstream services should be sufficient to cover all upstream costs ($F_U + c_UV$), and some or all of the upstream fixed costs (F_U) should be recovered via some kind of markup on upstream volume variable costs, please state whether you would recommend (i) a markup that is a fixed amount per piece of mail, and which would maintain rate differentials for upstream services that are equal to differences in variable cost, or (ii) a markup that is a percentage of volume variable cost, which then would cause rate differentials to exceed differences in volume variable cost, or (iii) some combination of a fixed and percentage 6 markup, or some other markup. Please explain the basis for your recommendation.

RESPONSE

a. I cannot answer the question as stated. In the hypothetical and in the cited portion of my testimony there is only *one* upstream activity.

b. I cannot answer the question as stated. In the question and in the cited portion of my testimony there is only *one* upstream activity.

c. No. As noted in my response to VP/PB-T1-12, "upstream activities" are not a service. Thus, in the hypothetical, the firm is offering two services to mailers: end-to-end service at the stamp price p and delivery service at the workshared price p_D, so that one can define the work-sharing discount $w = p - p_D$. The notion of a price for "upstream activities" has no meaning in this context because it is not a service valued by any end users.

d. Again, "upstream activities" are not a service.

e. In terms of the hypothetical, it is my position that the worksharing discount be equal to c_u. Each unit of both *services* (end-to-end and delivery only) makes the same contribution to the total fixed costs of the firm. Neither service would be receiving a subsidy because both would be paying less than there stand alone average cost. In this example, a private delivery service could succeed only if it were able to provide delivery services at a lower per unit cost than the incumbent.

f. In this example, charging the ECPR based worksharing discount of c_u would result in the revenues collected from *each service* at least covering their incremental costs. Again, the notion of a price for "upstream activities" has no meaning in this context because it is not a service valued by any end users.

g. Rates for all subclasses, even those that did not include "upstream activities" make a contribution to the *total* institutional costs of the network. Whether the rates for such a hypothetical "no upstream activity" subclass involved a cross subsidy is a quite separable issue. One would compare the rate to the average stand alone cost of serving that subclass.

h. I cannot answer the question as stated. In the hypothetical and in the cited portions of my testimony there is only *one* upstream activity. Again, "upstream activities" are not a service.

VP/PB-T1-14 Please refer to your answer to VP/PB-T1-13. Also assume that the upstream portion of the network were separated from the downstream portion and privatized.

a. Would you agree that such a privatized operation would need to set rates for its upstream services that would cover all of its costs, $F_U + c_U V_U$? If not, please explain.

b. Would you agree that if the incumbent (now the downstream delivery operator) charged all service providers the same prices for access to and usage of the delivery network, and those prices were just sufficient to cover the costs $F_J + F_D + c_D V$, then those mailers who do not use any services of the upstream network would not pay any portion of the upstream fixed costs, F_U? If not, please explain.

c. Since a privatized, competitive upstream operator would have to cover not only its variable costs, but also its fixed costs, F_U, some of its (unbundled) prices could be expected to exceed those resulting from variable cost pricing under ECPR. Would you expect that such a privatized, competitive outcome would be less efficient and less desirable than having a vertically-integrated incumbent that sets all rates according to ECPR, as described in your testimony at pages 22-23? Please explain.

RESPONSE

a. Agreed, and its rates would also have to cover F_J as well.

b. Agreed.

c. The outcome proposed is *not* "competitive." Rather, it is a situation of bilateral monopoly. I would expect the outcome to be less efficient than the integrated outcome under ECPR, if for no other reason than the wasteful duplication of overhead network costs F_J.

VP/PB-T1-15 Please refer to your testimony, PB-T-1, starting at page 29, line 17 to page 30, line 9, and page 30, lines 19-22.

a. Please explain why you assume that all upstream costs of an incumbent postal operator can be classified into a dichotomy consisting of costs that are either (i) variable at the margin or, (ii) fixed over all possible levels of output. If you have any empirical evidence to support this assumption, please provide it, or indicate where it can be found.

b. You state (p. 29, ll. 20-21) that "[w]hen there are non constant returns to scale, there are two ways to measure 'per unit avoided cost:' marginal cost or average incremental cost." Please define the term "average incremental cost" as you use it here, and explain why the incumbent cannot avoid some incremental costs when volume declines.

c. Suppose the incumbent has some costs that cannot be avoided at the margin (in the calculus sense of a very small, almost infinitesimal decline in volume) but which can be avoided if and when contestable volumes are transferred to consolidators. Please explain why such costs should be excluded from the avoided cost calculation. As part of your response, please explain how excluding costs that are semi-fixed, or semi-variable, but which clearly are avoidable over the relevant range of output, results in (i) a more efficient outcome, and (ii) lowest combined cost.

RESPONSE:

a. Purely for analytical convenience.

b. As used in the cited portion of my testimony, the "average incremental cost" of a service component is, on a per unit basis, the costs that would be avoided if the firm no longer produced the component in question. The incremental costs of a component *do* typically decline with volume. Thus incumbent can "avoid some incremental costs when volume declines."

c. In my testimony, I stated that component specific *fixed* costs are not avoided as volume changes and, therefore, should not be included in the avoided cost calculation. The situation posited here is one in which *marginal* component costs are not constant. I did not discuss this case in my testimony, but it remains the case that productive efficiency requires that worksharing discounts be set equal to the *marginal* avoided component cost of the incumbent as long as (i) the incumbent continues to provide some of the component (ii) consolidators supply their services competitively.