

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.
FOLLOW-UP INTERROGATORIES AND REQUESTS FOR
PRODUCTION OF DOCUMENTS TO PITNEY BOWES INC.
WITNESS JOHN C. PANZAR (VP/PB-T1-16-29)
(October 18, 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 follow-up interrogatories and document production requests. If necessary, please
redirect any interrogatory and/or request to a more appropriate witness.

Respectfully submitted,

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VP/PB-T1-16.

Please refer to your response to VP/PB-T1-1 and the graph provided in the Attachment to the interrogatory, which dealt with mail with non-uniform (*i.e.*, heterogeneous) costs. The interrogatory quoted a section of your testimony (PB-T-1, p. 28, l. 21 to p. 29, l. 2) which says: “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.”

- a. Your response to part a states that “[m]ost of my testimony ... focused on the case in which the Postal Service’s unit avoided costs of the workshared activity were the same for all workshared mail. Only in Section VI.B.2 did I address issues relating to the heterogeneous avoided costs.” In terms of the discussion in your testimony to which you refer, Section VI.B.2, as well as your paper, “Clean Mail and Dirty Mail: Efficient Worksharing Discounts in the Presence of Mail Heterogeneity,” referred to in footnote 24 of that section of your testimony (a revised version of which is provided in response to USPS/PB-T1-8), in the face of heterogeneous cost conditions described in the question please state your understanding of
 - i. marginal cost;
 - ii. average marginal cost;
 - iii. average volume variable cost;
 - iv. volume variable cost; and

- v. attributable cost that the Postal Service's costing systems would generate.
- b. If you believe the Postal Service's costing systems, under the conditions assumed and described in the question, likely would provide costs that are different from those defined and explained in the question, please explain the meaning of the costs that you believe the Postal Service's costing systems would generate.
- c. Part a also asked whether the definitions in the question were consistent with "how you use [the] terms in your testimony." Please explain whether the cost terminology which you use in Section VI.B.2, *Cost Difference and Cost Avoidance*, of your testimony (as well as your above-cited paper) is consistent with the way the terms are defined and explained in the question. If any of the references to cost that you use in Section VI.B.2 are defined in a way which differs from the way the cost terms are defined in the question, please explain all differences.
- d. Please refer to your response to part a, and the two sentences quoted in the question, which are from the introductory paragraph of Section VI.B. in your testimony.
 - i. Do those sentences relate to your analysis in Section VI.B.2 dealing (in your words) with "heterogeneous avoided costs," or to sections you refer to as "[m]ost of my testimony" dealing with

costs of worksharing activity that are “the same for all workshared mail”?

- ii. If your response to the preceding question is that they relate not to Section VI.B.2, but to the other sections of your testimony, please explain their applicability to the Postal Service, which does not have “the same [costs] for all workshared mail.”
 - iii. If they relate to Section VI.B.2, please explain your answer further, which begins: “Most of my testimony, *including the portion cited above.*” (Emphasis added.) That is, how does the fact that most of your testimony deals with horizontal cost curves address whether your use of terms in Section VI.B.2 is consistent with the definition of the terms in the question?
- e. Please explain how the “costs avoided” which you discuss in Section VI.B.2 of your testimony relate to the Postal Service’s (i) marginal cost, (ii) average marginal cost, (iii) volume variable cost, and (iv) average volume variable cost.
- f. Please explain how the “costs avoided” which you discuss in Section VI.B.2 relate to the Postal Service’s attributable cost under the assumption that attributable costs include not only volume variable costs, but also some intrinsic fixed costs.

VP/PB-T1-17.

Please refer to your response to VP/PB-T1-1(b) and the graph in the question's Attachment. The interrogatory asked about guidance that could be provided in the situation described in the question. In your response to part b, you say: "Again, I did not focus on this situation in my testimony."

- a. Does this mean that no part of your testimony focuses on a situation where the Postal Service has different marginal costs (i) for different segments of the mailstream, and (ii) for mail within the various segments?
- b. Unless your answer to part a is an unqualified affirmative, please clarify which parts of your testimony would apply to such situations.

VP/PB-T1-18.

Please refer to your response to VP/PB-T1-3(b). The interrogatory asks about the applicability of the analogy of the classic "make or buy" decision to a situation where the Postal Service's marginal costs vary across the mailstream. Your response is that "[t]he position advocated in the cited portion of my testimony [relating to "make or buy" decisions] referred to the case in which the upstream costs of the postal administration are constant."

- a. Please explain whether your response means that the notion of a "make or buy" decision is useless in helping to think about postal worksharing situations in which marginal costs vary across the mailstream.

- b. If it is not useless, please explain why it cannot be applied to the situation described in the question to conclude that the postal administration is paying a competitor 3 cents to supply services that it could supply for 2.5 cents.
- c. The assumption of the question was that the discount is 3 cents and all of the volume in cells $k+1$ to n , and no more, is being handled by the competitor. The question also assumed that the competitor's cost curve coincided with the cost curve of the postal administration, for the same volume cells. Under the conditions stipulated in the question, please explain whether applicability of the notion of a "make-or-buy" decision changes if the competitor's costs for the volume in cells $k+1$ through n are lower than the postal administration's costs.

VP/PB-T1-19.

Please refer to your response to VP/PB-T1-3(g), which asked if, in your analysis, you made any assumptions about the actual shape of the postal administration's cost curve.

- a. Your response begins: "Again, most of my testimony, including the portion cited above, focused on the case in which the Postal Service's unit avoided costs of the workshared activity were the same for all workshared mail." In this answer, please explain which specific portion of your testimony is described as "the portion cited above."

- b. As you point out, most of your testimony assumes “that the straight line in question is horizontal.” If the cost curve of the Postal Service is not horizontal, and instead is downward sloping (or curved), please explain whether the portions of your testimony that assume it to be horizontal are applicable to ratesetting for the Postal Service. To the extent that some sections are not applicable, please list those sections and describe any limitations on applicability.
- c. You say: “Only in Section VI.B.2 did I address issues relating to the heterogeneous avoided costs.” Accordingly, in Section VI.B.2, did you make any assumptions about the shape of the Postal Service’s marginal cost curve (*e.g.*, as presented in VP/PB-T1-1 and its Attachment)? If so, please explain what those assumptions are.
- d. Do you agree that if the competitors’ cost curves for the same segments of the mailstream lie below the Postal Service’s cost curve, the ratesetting policies you advocate eventually will result in all of mail being handled by the competitors? If you do not agree, please explain:
- i. Which policies would not have this result and why; and
 - ii. How the dividing line should be determined between mail that the Postal Service handles and mail that the competitors handle.

VP/PB-T1-20.

Please refer to your response to VP/PB-T1-5(e). Within a specified situation where the current discount and every detail about the Postal Service's costs are known, but nothing is known about costs of competitors, the question asked whether a basis exists for recommending a revised discount. You respond that "[t]here is not enough information to make a recommendation."

- a. Please explain what additional information you would require in order to enable you to make a recommendation.
- b. If you knew that some volume had been taken by competitors at the given discount, and you had a revised Postal Service cost curve, similar to the one presented in VP/PB-T1-1 and its Attachment, then for the remaining volume would you have enough information to make a recommendation on a revised discount?
 - i. If so, please explain what that recommendation would be.
 - ii. If not, please explain what additional information would be needed.
- c. Except that the curves in question might not be straight lines and that detail relating to Postal Service costs might not be so extensive (*i.e.*, you might know little more than the marginal cost of 4 cents), please explain the difference between the situation being faced in the instant docket and the situation described in part b of this question.

VP/PB-T1-21.

Please refer to your response to VP/PB-T1-5(f). The introduction to the interrogatory referenced VP/PB-T1-1. Part f asked: “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.” Your response to part f stated that: “The hypothetical is too abstract to form such expectations.”

- a. Please explain what it is about the model presented in VP/PB-T1-1 that you consider to be “too abstract” to allow you to address the question in part f.
- b. Consider a hypothetical in which the Postal Service has a downward sloping cost (*i.e.*, heterogeneous) curve when the volume is ordered by cost, from highest to lowest. Please explain what is “too abstract” for you to address the question of why competitors might be able to process some volume at a lower cost than the Postal Service, but not other volume.
- c. Please consider a hypothetical in which the Postal Service has a cost curve, which need not be linear, but which slopes downward (*i.e.*, heterogeneous) when the volume is ordered by cost. Can you think of any reasons why competitors might be able to process some mail at a lower cost than the Postal Service, but not other mail? If you can, please provide those reasons. Would one possibility for different costs as between the Postal Service and competitors be that the Postal Service realizes

substantial scale economies on some portions of the volume, not on others?

VP/PB-T1-22.

Please refer to your response to VP/PB-T1-6(a and b), where you emphasize that Ramsey pricing requires “total costs” so that breakeven is defined, and consider a subclass that has a *revenue requirement* equal to its cost times its cost coverage and that is composed exclusively of two categories, one of letters and one of flats. Please explain any reasons you see for rejecting a breakeven requirement in a Ramsey pricing formula that constrains the revenue (the summation of price times quantity) to equal the *revenue requirement*.

VP/PB-T1-23.

Please refer to your response to VP/PB-T1-6(d)(ii). The interrogatory asked: “Absent information that the elasticities of any included categories [in a subclass], 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.” Your response is that you “advocate the use of ECPR for pricing work shared products,” and you refer to pages 47-49 of your testimony.

- a. Please confirm that in all cases you would view letters in a subclass as a workshare variant of flats in the same subclass. If you do not confirm,

please explain all cases in which the difference between them would not be viewed as due to worksharing.

- b. Please confirm that the reasons you give on pages 47-49, and extending through page 50, line 7, which explain your reasons for preferring ECPR over Ramsey for ratesetting within subclasses, represent the sum total of your reasons for not setting rates, as explained in the question, “as though the category elasticities were the same as the subclass elasticity.” If you do not confirm, please explain any other reasons that respond to the question.
- c. Under Ramsey, if you believe that setting rates in default as though the elasticities of the categories were the same as the elasticity of the subclass would likely give a wrong solution, please explain whether changing the elasticity of letters relative to flats would move the letter-flat rate difference (i) above and below the cost difference times the subclass cost coverage or (ii) above and below 100 percent of the cost difference. For purposes of this question, assume the cross elasticity between letters and flats is low.

VP/PB-T1-24.

Please refer to your response to VP/PB-T1-6(g)(iii). You explain that “if the unworkedshared [meaning not workshared] mail covers its incremental costs, the use of

ECPR will typically ensure that the other categories will also cover their incremental costs.”

- a. Would you also argue that if the workshared category “covers its incremental costs, the use of ECRP will typically ensure that the”unworkshared category will also cover its incremental costs?
- b. Please assume that letters are a lower-cost, workshare variant of flats, that the subclass has only the two categories (*i.e.*, letters and flats), and that the cost coverage of the subclass is 170 percent. If the workshared category (letters) covers its incremental costs and the nonworkshared category (flats) does *not*, would you agree that increasing the passthrough of the cost difference from its ECPR level of 100 percent up to a level of 170 percent would reduce the chances of the nonworkshared category not recovering its incremental costs? If you do not agree, please explain.

VP/PB-T1-25.

Please refer to your response to VP/PB-T1-6(f)(ii), where you say: “The discussion in my testimony regarding ‘letters and flats’ deals with the advantages of basing rate differences on cost differences within a subclass. The term ‘100 pass through’ does not apply.”

- a. Do you agree that under ECPR, the rate difference between two categories would normally be equal to 100 percent of the cost difference between the two categories? If you do not agree, please explain fully.

- b. By the phrase “100 pass through” do you mean 100 percent passthrough? If you do not, please explain what you mean.
- c. Please explain why the phrase “100 pass through” or 100 percent passthrough (whichever you specify as being your meaning in your response to part b of this question), does not apply to a situation of “basing rate differences on cost differences within a subclass.”

VP/PB-T1-26.

- a. Please refer to your response to VP/PB-T1-7(a). Referring to your words, the interrogatory asks how using ECPR within a subclass *facilitates* applying the non-cost factors between subclasses. The emphasis is on the term facilitates, as you argued on page 50, lines 2-3, that such facilitation takes place. Your answer refers to what is “generally” done and what “can be” done. Please explain whether you believe that using ECPR within a subclass, instead of Ramsey, as explained further in VP/PB-T1-18, makes it any easier, any more straightforward, or any more meaningful to apply the non-cost factors between subclasses.
- b. Please refer to your response to VP/PB-T1-7(b). Is it fair to interpret your response to this interrogatory to mean that you recommend that the Commission not apply the non-cost factors contained in Section 3622(b) below the subclass level? Unless your answer is an unqualified affirmative, please explain what you mean.

- c. Please refer to your responses to VP/PB-T1-7(a) and (c).
- i. Is it your understanding that the Commission does not apply non-cost criterion 3622(b)(4), the effect of rate increases on mailers, to rate categories within a subclass? If so, please state the basis for your understanding.
 - ii. Is it your understanding that the Commission does not apply non-cost criterion 3622(b)(6), the degree of preparation to rate categories within a subclass? If so, please state the basis for your understanding.
 - iii. Is it your understanding that the Commission does not apply non-cost criterion 3622(b)(7), simplicity, to rate categories within a subclass? If so, please state the basis for your understanding.

VP/PV-T1-27.

Please refer to your response to VP/PB-T1-8. The interrogatory pertains to a reason given in your testimony (p. 50, ll. 4-7) for preferring ECPR to Ramsey within subclasses. All three parts of the question relate to your reason. Your responses all state that you advocate ECPR, in one case (part b) mentioning productive efficiency.

Your statement on page 50 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.” (Emphasis added.)

Please explain whether your response, particularly your statement in response to part b that “[I]t is not a question of whether it is easier or harder to adjust depending on the passthrough,” means that the issue of it being “relatively straightforward” to make adjustments under ECPR and, presumably, not “relatively straightforward” to make adjustments under Ramsey *is not really a reason* for preferring ECPR to Ramsey. If it does not mean this, please explain the sense in which it is more straightforward under ECPR.

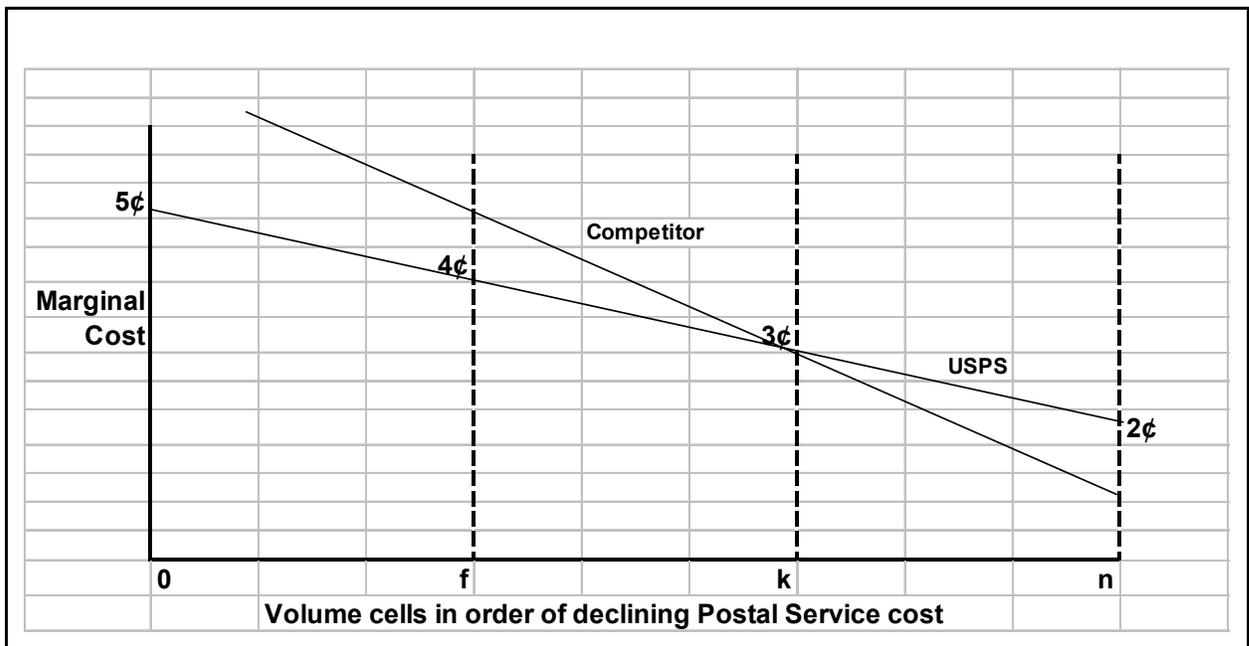
VP/PB-T1-28.

Please refer to your response to VP/PB-T1-3(e). Using words from page 29, lines 1-2, of your testimony, where you say that “the theoretically correct approach” is to base the discount on unit attributable costs as the Commission does, the interrogatory asked what “theoretically correct approach” you would recommend in the situation shown in the graph attached to VP/PB-T1-1 if the discount were currently at 3 cents, the competitors’ curves were the same as those of the Postal Service, and all of the volume in cells $k+1$ through n had left the postal administration and become handled by the competitor.

- a. Your response is that “it makes no difference what discount is selected under the posited circumstances.” In your response to VP/PB-T1-3(d), you agreed that the unit attributable cost for the remaining mail is 4 cents.

Please explain why your recommendation that the “theoretically correct approach” would be to base the discount on unit attributable cost would not be a basis for recommending, under the conditions of the question, that the discount be increased from its current level of 3 cents to a new level of 4 cents.

- b. If your recommendation on page 29 does not apply to the situation in the question, involving as it does a downward sloping cost curve for the Postal Service, please specify the nature of the situations to which it does apply.
- c. Suppose instead that the Postal Service cost curve and the competitor cost curve are shown in the following graph:



Here too, the discount is currently 3 cents, the volume in cells $k+1$ to n has left the Postal Service and gone to the competitor, and the unit attributable cost of the mail remaining in the Postal Service is 4 cents.

Please explain whether your recommendation on the “theoretically correct approach” would be to increase the discount to 4 cents.

- d. If your recommendation in the situation in part c is that, given the unusually detailed information available in this question, the correct discount is 3 cents, please explain how in normal Postal Service cost estimation and ratesetting one would know that 3 cents is the correct discount.
- e. If all information about the competitor’s cost curve is removed and the particulars are that the current discount is 3 cents, the Postal Service has a downward sloping cost curve of some kind, some of the mail has left and gone to a competitor, and the average marginal cost of the mail that remains is 4 cents. Do you agree that, in this general situation, the only information from the Postal Service’s data systems would be 4 cents and that no system gives 3 cents? If you do not agree, please explain how the 3-cent figure would be developed.

VP/PB-T1-29.

Please refer to your response to VP/PB-T1-8.

- a. Do you agree that the practical effect of your response to part a is that the Commission should not mark up any of the costs caused by additional weight of mail?
 - i. Unless your answer to the preceding question is an unqualified affirmative, please explain the reasons for your disagreement.
 - ii. If your answer to the question above is affirmative, please explain all reasons why you believe that the cost of weight should not be marked up, and that all overhead costs should be assessed strictly on a per-piece basis.
 - iii. Please explain how not marking up the cost of weight always enhances economic efficiency.

- b. Would you agree that the practical effect of your response to part b is that the Commission should not mark up any of the costs caused by additional weight of mail, or any of the costs caused by transportation of mail?
 - i. Unless your answer to the preceding question is an unqualified affirmative, please explain the reasons for your disagreement.
 - ii. If your answer to the question above is affirmative, please explain all reasons why you believe that the cost of transportation should not be marked up, and all overhead costs should be assessed strictly on a per-piece basis. If you feel that the cost of

transportation should be marked up in some subclasses (*e.g.*, Priority Mail), but not others, please explain what distinction(s) you would use to justify marking up transportation costs in some subclasses, but not others.

- iii. Please explain how not marking up the cost of transportation always enhances economic efficiency.