OFFICIAL TRANSCRIPT OF PROCEEDINGS
BEFORE THE
POSTAL RATE COMMISSION

In the Matter of:)
) Docket No.: R2006-1
POSTAL RATE AND FEE CHANGES)

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POSTAL RATE COMMISSION

In the Matter of:)
) Docket No.: R2006-1
POSTAL RATE AND FEE CHANGES)

Suite 200
Postal Rate Commission
901 New York Avenue, N.W.
Washington, D.C.

Volume 26
Wednesday, November 1, 2006

The above-entitled matter came on for hearing pursuant to notice, at 9:32 a.m.

BEFORE:

HON. GEORGP A. **OMAS**, CHAIRMAN
HON. DAWN A. TISDALE, VICE-CHAIRMAN
HON. RUTH Y. GOLDWAY, COMMISSIONER
HON. TONY HAMMOND, COMMISSIONER
HON. MARK ACTON, COMMISSIONER

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WITNESSES APPEARING:

JOHN C. PANZAR
R. RICHARD GEDDES
J. GREGORY SIDAK

C O N T E N T S

E X H I B I T S

EXHIBITS AND/OR TESTIMONY	IDENTIFIED	RECEIVED
Corrected direct testimony of R. Richard Geddes on behalf of United Parcel Service, UPS-T-3	9110	9110
Corrected designated written cross-examination of R. Richard Geddes, UPS-T-3	9111	9111
Corrected direct testimony of J. Gregory Sidak on behalf of Newspaper Association of America, NAA-T-1	9124	9124
Corrected designated written cross-examination of J. Gregory Sidak, NAA-T-1	9124	9124
Corrected direct testimony of John C. Panzar on behalf of Pitney Bowes, PB-T-1	9142	9142
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Valpak/Pitney Bowes Exhibit, VP/PB-T1-16	9212	9212
Workshare Hypothetical for Witness Panzar, XE-OCA/PB-T1	9252	9252

P R O C E E D I N G S

(9:32 a.m.)

CHAIRMAN OMAS: Good morning. Today, we continue hearings to receive the direct case of participants other than the Postal Service in Docket No. R2006-1 concerning the Postal Service's request for rate and fee changes.

Does anyone have a procedural matter that they would like to discuss at this point?

(No response.)

CHAIRMAN OMAS: There being none, three witnesses are scheduled to appear today. They are Witnesses Geddes, Panzar, and Sidak. There will be no cross-examination for either Geddes or Sidak. For the convenience of the witnesses and counsel, we will enter their testimony into evidence first. Mr. McKeever.

MR. McKEEVER: Thank you, Mr. Chairman. John McKeever for United Parcel Service. I have with me two copies of a document designated "Direct Testimony of R. Richard Geddes on behalf of the United Parcel Service" and identified as UPS-T-3, which has been previously, of course, filed in this proceeding. There have been no revisions to that testimony, and I move that they be admitted into evidence.

CHAIRMAN OMAS: Is there any objection?

(No response.)

CHAIRMAN OMAS: Hearing none, Mr. McKeever, would you please provide the reporter with two copies of the corrected direct testimony of Richard Geddes. That testimony is received into evidence. However, as is our practice, it will not be transcribed.

(The document referred to was previously marked for identification as Exhibit Nos. UPS-T-3 and was received in evidence.)

CHAIRMAN OMAS: Mr. McKeever, have the answers to the designated written cross-examination been reviewed and corrected?

MR. McKEEVER: Yes, they have, Mr. Chairman. Dr. Geddes did file a revised response to UPS-T-4. That is in the packet of designated cross, and so that material is ready to be admitted into evidence.

Dr. Geddes, by the way, will be filing a certificate of authenticity within a day or so with respect to his direct testimony. I apologize for not mentioning that before. But the written cross-examination is in proper shape.

CHAIRMAN OMAS: Thank you. With that, would you please provide two copies of the corrected designated written cross-examination of Witness Geddes to the reporter. That material is received into evidence and is to be transcribed into the record.

(The document referred to was previously marked for identification as Exhibit Nos. UPS-T-3 and was received in evidence.)

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF UNITED PARCEL SERVICE
WITNESS R. RICHARD GEDDES
(UPS-T-3)

Party	Interrogatories
United States Postal Service	USPS/UPS-T3-1-6

Respectfully submitted,

Steven W. Williams
Secretary

INTERROGATORY RESPONSES OF
UNITED PARCEL SERVICE
WITNESS R. RICHARD GEDDES (T-3)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
USPS/UPS-T3-1	USPS
USPS/UPS-T3-2	USPS
USPS/UPS-T3-3	USPS
USPSIUPS-T3-4	USPS
USPSIUPS-T3-5	USPS
USPSIUPS-T3-6	USPS

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

USPS/UPS-T3-1. Please refer to page 9 of your testimony, lines 12 - 17, as well as footnote 7.

a. Please provide a citation for the quote from Docket No. R94-1 in footnote 7.

b. Please provide specific examples in the past where the Postal Rate Commission has, invoking 39 U.S.C. §3622(b)(5), reduced a markup in order to help the Postal Service "maintain" market share.

c. Please provide specific examples in the past where the Postal Rate Commission has, invoking 39 U.S.C. §3622(b)(5), reduced a markup in order to help the Postal Service "capture" market share.

RESPONSE:

a. Docket No. R94-1, Opinion and Recommended Decision, ¶ 5116.

b.-c. Referring to 39 U.S.C § 3622(b)(4), in Docket No. R94-1, ¶ 5116, the Commission stated, "At present, the Postal Service handles in excess of 70 percent of the volume in the second-day delivery market and is the source of approximately 45 percent of the revenue generated in that market. Tr. 7A/3100. Yet, witness Foster notes that there are signs the Postal Service has had difficulty maintaining its share of volume and revenue. USPS-T-11-94; Tr. 7A/3150. Its share by volume of the second-day package market has declined from 76 percent in 1990 to 72 percent in 1993. Tr. 7A/3100. This decline is a sign of potential market deterioration and supports a below systemwide average rate increase." Additionally, in ¶ 5317 of its Docket No. R2000-1 decision, the Commission stated, "It is also the Commission's opinion that restraining coverage ... is appropriate under § 3622(b)(5) to avoid the harm that higher rate levels may cause to the Postal Service's position as a competitor in the market in which Priority Mail competes." These statements indicate that the Commission has invoked

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

39 U.S.C §3622(b)(5) to lower markups to maintain the Postal Service's volume and market share.

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

USPS/UPS-T3-2. Please refer to footnote 9 on page 11 of your testimony, where you assert several reasons why it can be difficult for private sector operators to compete against the Postal Service. Please confirm that there may be countervailing reasons why it can be difficult for the Postal Service to compete against private sector operators. If not confirmed, please explain.

RESPONSE:

Confirmed. Like any firm, the Postal Service may find it difficult to face competition for a variety of reasons, including inefficient operations or lack of use of cutting-edge technology, or many other business decisions. Regarding only legislated reasons for the Postal Service's difficulty in facing competition (such as the universal service requirement), then confirmed with the proviso that those costs to the Postal Service are a very small part of its annual budget. See 'Testimony before the President's Commission on the Postal Service," Robert H. Cohen, Director, Office of Rates, Analysis and Planning, Postal Rate Commission, February 20, 2003, pp. 1-2.

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

USPS/UPS-T3-3. Please refer to Figure 1 in your testimony.

a. Please confirm that one reason for the upward trend in First-class Mail's markup index since Docket No. R84-1 has been an increase in worksharing, which, ceteris paribus, causes the cost coverage to increase. If not confirmed, please explain.

b. If confirmed, do you think it would be appropriate to first control for the increase in worksharing since Docket No. R84-1 before comparing the trend in First-class Mail's markup index with that of nonworkshared Priority Mail? If not confirmed, please explain.

RESPONSE:

a Confirmed that, as discussed by Postal Service witness O'Hara in his response to DFS & MSI-T31-1 (Tr. 17/5073-75), increased worksharing in a subclass will tend to lead to cost coverage increases if contribution per piece for the subclass is held constant.

b. Such an analysis is worthwhile. Although I agree with the Commission that its markup index "remains the most useful tool available for measuring relative burdens over time" (Docket No R2001-1, ¶ 2058), Dr. O'Hara views contribution per piece as a way to normalize cost coverage comparisons as worksharing increases. Response of Dr. O'Hara to DFS & MSI-T31-1 (Tr. 17/5073-75). A review of contribution per piece for First Class Letters and Priority Mail from Docket Nos. R84-1 to R2005-1, shown below, indicates that the contribution per piece for First Class Letters increased from 8.79¢ to almost 21¢ per piece -- approximately 138% -- from R84-1 to R2005-1, while the contribution per piece for Priority Mail has actually decreased. Thus, even on a contribution per piece basis, Pricrity Mail's contribution has declined, while the contribution for First Class Letters has increased substantially. The settlement in Docket No R2005-1 alone resulted in a 20% decline in Priority Mail's contribution per

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

piece – a 10% decline compared to Docket No R2000-1, the last litigated case – while that for First Class Letters increased **by** 33% since Docket No R20001.

			[A] Contribution to Institutional Cost Per Piece	[B] Ratio to Total Mail 8 Services	[C] Percent Increase From Prior Case	Sources: Col. B	Col. C
[1]	R2005-1	First Class Letter	20.91	1.41	13.4%	A1/A3	A1/A4-1
[2]		Priority Mail	157.25	10.61	-19.9%	A2/A3	A2/A5-1
[3]		Total Mail & Svcs	14.82	1.00	7.4%	A3/A3	A3/A6-1
[4]	R2001-1	First Class Letter	18.44	1.34	17.2%	A4/A6	A4/A7-1
[5]		Priority Mail	196.28	14.23	12.4%	A5/A6	A5/A8-1
[6]		Total Mail & Svcs	13.80	1.00	12.8%	A6/A6	A6/A9-1
[7]	R2000-1	First Class Letter	15.74	1.29	7.3%	A7/A9	A7/A 10-1
[8]		Priority Mail	174.62	14.28	15.5%	A8/A9	A8/A11-1
[9]		Total Mail & Svw	12.23	1.00	10.1%	A9/A9	A9/A 12-1
[10]	R97-1	First Class Lener	14.67	1.32	-0.5%	A10/A12	A10/A13-1
[11]		Priority Mail	151.14	13.62	-15.2%	A11/A12	A11/A14-1
[12]		Total Mail & Svcs	11.10	1.00	0.5%	A12/A12	A12/A15-1
[13]	R94-1	First Class Lener	14.75	1.34	0.1%	A13/A15	A13/A16-1
[14]	Further	Priority Mail	178.32	16.15	-0.2%	A14/A15	A14/A17-1
[15]		Total Mail & Svcs	11.04	1.00	0.1%	A15/A15	A15/A18-1
[16]	R94-1	First Class Letter	14.74	1.34	19.1%	A16/A18	A16/A19-1
[17]		Priority Mail	178.68	16.20	8.1%	A17/A18	A 7/A20-1
[18]		Total Mail 8 Svcs	11.03	1.00	15.0%	A18/A18	A18/A21-1
[19]	R90-1	First Class Lener	12.37	1.29	2.0%	A19/A21	A19/A22-1
[20]	Remand	Priority Mail	165.22	17.23	0.0%	A20/A21	A20/A23-1
[21]		Total Mail & Svcs	9.59	1.00	3.0%	A21/A21	A21/A24-1
[22]	R90-1	First Class Letter	12.12	1.30	20.4%	A22/A24	A22/A25-1
[23]		Priority Mail	165.24	17.75	20.1%	A23/A24	A23/A26-1
[24]		Total Mail 8 Svw	9.31	1.00	21.4%	A24/A24	A24/A27-1
[25]	R87-1	First Class Letter	10.07	1.31	14.6%	A25/A27	A25/A28-1
[26]		Priority Mail	137.61	17.94	-15.3%	A26/A27	A26/A29-1
[27]		Total Mail & Svcs	7.67	1.00		A27/A27	
[28]	R84-1	First Class Letter	8.79				
[29]		Priority Mail	162.39				
[30]		Total Mail & Svw	NA				

Source Col. A: ***Commission's Opinion*** *and* Recommended *Decision. Appendix* G, Schedule *1*

Revised October 24,2006

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

USPS/UPS-T3-4. Please refer to Table 1 in your testimony.

a. Please confirm that Priority Mail volume declined by 30.5 percent from FY 2000 to FY 2004.

b. Please confirm that in addition to increasing by approximately 5 percent in FY 2005, Priority Mail volume is on track to increase by about the same amount in FY 2006.

c. Do you believe that two consecutive years of approximately 5 percent volume growth — during a time when real GDP has boen growing by 3 to 4 percent — constitutes "recovery" from the 30.5 percent volume decline, from 2000 to 2004? In answering, please refer to your assertion at page 17, lines 8 - 10 that "[t]hese recent volume improvements indicate that whatever Priority Mail's perceived service performance may be, it has a sufficiently high value that its volume can recover from a series of unfavorable events and rate increases." When you say "can recover," do you mean that Priority Mail volume has the potential to recover (which has not yet been manifested)?

d. While Priority Mail volume was declining by 30.5 percent, by how much did UPS volume in the total (ground and air, combined) 2- and 3-day package and document delivery market change from 2000 to 2004? Please provide your response both in absolute and percentage terms.

RESPONSE:

a. Confirmed. I note that the period chosen starts with the year immediately prior to September 11 and the anthrax attacks.

b. Confirmed. If one takes the average of the growth rates for the first three quarters of FY 2006, the result is 5 percent

c. This question has two parts. The first part asks if I believe that 5 percent volume growth constitutes a recovery from a 30.5 percent decline. Whether or not 5 percent constitutes recovery from a volume decline does not depend on the magnitude of the decline over the previous five years (an arbitrarily chosen period), but instead on the overall historical average growth rate. The average of the annual growth rates in

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RESPONSES OF UNITED PARCEL SERVICE WITNESS GEODES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

Priority Mail volume from 1971 (the year postal reorganization was implemented) through 2000 was about 6.7 percent. USPS-LR-L-74, Priority Mail Volume History, p. 3 of 9. A 5 percent annual growth rate is thus three quarters of the way to the historical average annual growth rate. If one includes the years 2001 through 2005 (since those are valid observations on volume history), the historical average annual growth rate falls to about 4.8 percent. Therefore, a 5 percent increase is greater than the historical annual growth rate, which I believe constitutes recovery. Regarding the second part of the question, I mean that Priority Mail volumes have recovered from the unfavorable events, which also indicates that they can do so in the future.

d. I have not been asked to examine UPS's volume data, and therefore I do not have it.

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

USPS/UPS-T3-5. Please refer to your testimony at page 17, lines 8 - 10, specifically the reference to volume recovering from "a series of unfavorable events and rate increases." Do you believe that Priority Mail's volume decline since 2000 is only due to unfavorable events and rate increases, and not possibly also to some more permanent and systemic factors that have potentially reduced the product's long-term competitiveness? Please explain fully.

RESPONSE:

Please see my response to USPS/UPS-T3-4. Because Priority Mail volume growth rates are approaching the historical growth rate after seven quarters, I do not believe that permanent or systemic factors have reduced the long-term competitiveness of Priority Mail.

RESPONSES OF UNITED PARCEL SERVICE WITNESS GEDDES
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE

USPS/UPS-T3-6. Please refer to page 21 of your testimony, line **4.** Why do you recommend the very same markup for Priority Mail, 63 percent, as proposed by the Postal Service in USPS-T-31, considering that you use a different cost basis for that markup (based on the Postal Rate Commission's cost attribution methodology) than the Postal Service? Please explain fully.

RESPONSE:

In my view, the best recommended cost coverage is not dependent upon the cost basis utilized, as this question implies. Instead, cost coverages should be determined based on the eight non-cost-based ratemaking factors as discussed on pages **4** through 7 of my testimony. The reasons for my recommended cost coverage of 163 percent for Priority Mail are discussed on pages 12 through 21 of my testimony. Note that my recommendation of a cost coverage equal to that proposed by the Postal Service is only a first step toward a coverage above the systemwide average.

CHAIRMAN OMAS: Is there any additional written cross-examination for Witness Geddes?

(No response.)

CHAIRMAN OMAS: That brings us to Mr. Baker. Would you please assist us as well to receive a corrected version of Mr. Sidak's testimony into evidence?

MR. BAKER: Thank you, Mr. Chairman. William Baker cn behalf of the Newspaper Association of America. I have with me two copies of a document labeled the "Direct Testimony of J. Gregory Sidak on behalf of the Newspaper Association of America," designated NAA-T-1, as filed on September 6, 2006. There have been no changes to that testimony since then, and Mr. Sidak has filed a declaration with the Commission to the accuracy of the testimony, as well as, by the way, as to the designated written cross-examination.

So, with that, Mr. Chairman, I move the admission of this testimony into evidence.

CHAIRMAN OMAS: Is there any objection?

(No response.)

CHAIRMAN OMAS: Hearing none, Mr. Baker, would you please provide the reporter with two copies of the corrected direct testimony of Gregory Sidak?

That testimony is received into evidence. However, as is our practice, it will not be transcribed.

(The document referred to was previously marked for identification as Exhibit Nos. NAA-T-1 and was received in evidence.)

CHAIRMAN OMAS: Mr. Baker, have the answers to the designated written cross-examination been reviewed and corrected?

MR. BAKER: Yes, Mr. Chairman. They have been reviewed, and no corrections were needed.

CHAIRMAN OMAS: On that, would you please provide two copies of the corrected designated written cross-examination of Witness Sidak to the reporter? That material is received into evidence and is to be transcribed into the record.

(The document referred to was previously marked for identification as Exhibit Nos. NAA-T-1 and was received in evidence.)

Is there any additional written cross-examination for Witness Sidak?

(No response.)

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

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

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS **J.** GREGORY SIDAK
(NAA-T-1)

Party	Interroaatories
Advo. Inc	**ADVO/NAA-T1-1-7**
Greeting Card Association	**GCA/NAA-T1-1**
Postal Rate **Commission**	ADVOINAA-TI-1-7 GCAJNAA-T1-1

Respectfully submitted,

Steven W. Williams

Steven W. Williams
Secretary

INTERROGATORY RESPONSES OF
NEWSPAPER ASSOCIATION OF AMERICA
WITNESS J. GREGORY SIDAK (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
ADVOINM-TI-1	Advo. PRC
ADVOINAA-T1-2	Advo. PRC
ADVO/NAA-T1-3	Advo. PRC
ADVO/NAA-T1-4	Advo, PRC
ADVO/NAA-T1-5	Advo, PRC
ADVOINAA-T1-6	Advo, PRC
ADVOINAA-T1-7	Advo, PRC
GCA/NAA-T1-1	GCA, PRC

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS **J.** GREGORY **SIDAK**
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

ADVO/NAA-T1-1. On pages **9-10** (lines **14 ff**) you state:

> My understanding of postal ratemaking practice as it has evolved over the years is that the Cornrnissicn has recognized that economic efficiency is served. by accurate pricing signals for each identified worksharing activity (for example, presortation and dropshipping). This recognition enables the work *to* be done by the lowest-cost provider, whether that is the Postal service, the mailer, or a third-party service vendor *to* the mailer. To promote such efficiency, the Commission has applied ECP in setting discounts for worksharing such as presortation and destination entry at, ideally, 100 percent of the estimated avoided cost of the activity whose performance the Postal Service avoids. This correct application of ECP advances economic efficiency by providing accurate pricing signals *to* mailers and the Postal Service. (footnote omitted)

Dropship discounts have been offered in Standard Mail since R90-1 and the cost avoidances supporting those discounts have not been challenged in over ten years. Given this information and your cited comments, do you believe dropshipping discounts should reflect 100 percent of the costs avoided by the Postal Service? Please explain your response.

Answer:

Were one to base dropshipping discounts on efficient component pricing. then yes, those discounts should be set tc passthrough 100 percent of accurately measured costs avoided

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS J. GREGORY SIDAK
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

ADVO/NAA-T1-2. On page 10 (lines 3-6), you state: "Under ECP, accurately measured costs avoided would be passed through at a rate of 100 percent to each particular category of mail responsible for those costs avoided. In this manner, each category of mail would be charged only its incremental costs, and the USPS would achieve break-even pricing."

(a) Please provide your definition of incremental costs of a particular category of mail.

(b) Please provide your definition of "category of mail." In that definition, please explain how the term "category" relates to postal subclasses.

(c) Please provide your understanding of how "break-even" pricing applies to development of rates within a particular subclass.

Answer:

(a) A review of this concept. the definition for average incremental cost. and the evaluation of incremental cost relative to marginal cost can be found in my article with Professor William J. Baumol.[1] Specifically, average incremental cost for the entire service x is defined as follows:[2]

$$AIC_x = [TC(x,y,z,\ldots) - TC(0,y,z,\ldots)]/x$$

In words, this equation states that the average incremental cost to the multiproduct firm for service x is the total cost to the multiproduct firm including the production of x less the total cost to the multiproduct firm without the production of x.

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[1] William J. Baumol & J. Gregory Sidak. *The Pricing of Inputs Sold to Competitors,* 11 YALE J. ON REG. 171, 176-77 (1994).

[2] *Id.* at 177.

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS J. GREGORY SIDAK
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

This term is then divided by x tc transform total incremental cost into average incremental cost.

(b) In the particular passage cited, I was using "category of mail" to refer to a type of mail within a subclass, such as ECR saturation flats mail. I should note, however, that the particular definiticn of "category of mail" does not change the basic economic point made in that pasrage — namely. that accurately measured worksharing discounts passed through at 100 percent are consistent with ECP.

(c) Break-even pricing is a concept that applies to the production of the firm (in this case the Postal Service) across all products that it produces. For that reason, break-even pricing does not directly affect the development of any specific postal rate. Rather. break-even pricing serves as a global constraint that jointly affects the regulated firm. Put differently, firms earn profit, whereas products do not.

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS J. GREGORY SIDAK
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVOINAA-T1-1-7)

ADVOINAA-TI-3. On page 10 (line 12-13), you use the terms "opportunity cost," "access charge," and "delivery charge." Please explain how these terms apply to the development of rates for a particular mail category within a postal subclass.

Answer:

Please see pages 8 and 9 of my testimony for a discussion of opportunity cost and its application to postal ratemaking:

> "The Private Express Statutes give the Postal Service a legal monopoly over the delivery of the great majority of items in the postal system. In ECP terms. the Postal Service is the sole supplier of the input of "delivery" of a piece of mail. However, the Postal Service faces competition in the processing (presortation, barcoding) and transportation (destination entry) parts of the process. So when the Postal Service "allows" access to its delivery network for such workshared mail, the price of that access (the postage paid) should recover the costs of the delivery network as well as the opportunity cost ot the Postal Service's not providing the workshared activity. In postal ratemaking, this opportunity cost is what the Postal Service would have earned towards the recovery of overhead had it provided the workshared service (and thus the full retail service) instead of the mailer."

The access charge is the price paid by competitors to access an asset held by the vertically integrated monopolist. Therefore, the access charge is the result of the application of a pricing rule to that monopolist

As it applies to worksharing. the delivery charge would equal the postal rate for a mail subclass that allowed the Postal Service to recover 100 percent of its attributable costs The delivery charge plus a portion of the Postal Service's overhead recovered under a particular rate for a particular subclass of mail would equal the access charge. Put differently, an access charge can be decomposed into two separate pieces, the component that allow the postal service to recover 100 percent of costs attributed and the component that is applied toward the collection of overhead charges

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WITNESS J. GREGORY SIDAK
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

ADVOINAA-T1-4. On pages 11-12 (lines 9ff), you explain why you believe Efficient Component Pricing is generally not applicable to shape-based rates. You state (lines 22ff): "Although the choice of the shape of mail piece might be considered "optional" in some sense, it is not a choice between the mailer or the Postal Service performing a particular function in the type of scenario to which ECP is intended to apply."

(a) Please explain what you mean when you say "the choice of the shape of mail piece might *be* ccnsidered 'optional' in some sense.

(b) For a postal subclass serving a specific mail demand/market, please explain how you would develop subclass rates to signal *to* that market the postal costs of mailing a letter shape vs. a flat shape vs. a parcel shape.

(c) Please explain how your approach in *(b)* above would ensure that mailers would be able to minimize the total (postal and mailer) mailing cost consistent with their own demand requirements.

(d) Please explain how your approach in (b) above would ensure that regardless of the market's selected mix of shapes, the contribution to USPS institutional cost from that market would not substantively change.

Answer

(a) Mailers may have a choice of the shape of the mail they ultimately decide to send For example, for each particular type of advertisement sent there may not be one and only one shape of mail under which it would be profitable to mail that advertisement

(b) Unless shape were considered a form of worksharing, which I am not aware to be the case, ECP does not apply to shape-based rates. The ratemaker would therefore have to apply other economic and regulatory criteria it is required to apply. ***As*** an economist. I would presume that cost differences due to differences in shape would

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ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

affect differences in rates, as marginal cost is a key factor in determining the price of a good produced by the firm.

(c) By basing price differences on both cost differences and, potentially, on differences in value between the shapes, the price differences would reasonably allow mailers to select the cost minimizing alternative among the set of shape-based substitutes that offer similar value. Put differently, holding the value of the mail shape constant, price difference would bo detarmined largely by the cost difference. Alternatively, holding the shape-based cost differential the same, price differences would be based largely on the difference in value of the mail.

(d) This would be accomplished by setting rates so that the rates of the subclass at least met the desired revenue for that subclass.

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ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

ADVO/NAA-T1-5. Please refer to the Direct Testimony of John C. Panzar (PB-T-1). On page **45,** lines 9 ff:

> 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 behavior 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

(b) The current basis for rate differences among ECR Basic, High-Density and Saturation mail (by shape) are their dropship-neutralized mail processing and delivery cost differences. Please explain fully whether you believe these differences are strictly worksharing-related and therefore ECP applies to them.

(c) If you do not believe the mail categories in (b) above to be strictly worksharing-related, please explain how you believe the rate differentials among basic, high-density, and saturation mail should be developed in order to ensure economic efficiency by providing accurate pricing signals to mailers and the Postal Service.

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ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

Answer:

(a) I agree with the first paragraph in the quoted statement so long as one is considering products with roughly the same economic value to consumers. That is, the main factor that differentiates the products is the cost of producing the product by the firm. In general, however, I stress that ECP was developed to price accurately the access to an input of the vertically integrated monopolist. a concept that seems to me unrelated to differences in mail shape.

(b) Yes. My understanding is that destination entry and presortation are worksharing activities that may be performed not only by the vertically-integrated monopolist (the Postal Service) but also by private firms (mailers).

(c) Not applicable

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ANSWERS TO INTERROGATORIES OF
ADVO. INC. (ADVO/NAA-T1-1-7)

ADVO/NAA-T1-6. On pages 12 and beyond, you discuss several ways to consider and quantify the proposed DAL surcharge. On page 17 (lines 11-13, you state that DALs offer benefits to the mailer not available to high-density mailers that are ineligible to use DALs. In response to VP/USPS-2, the *USPS* states that for the four-month period of March-June 2006, the following were accompanied by DALs: 7.7% of ECR high-density non-letter DDU pieces, 2.2% of ECR high-density non-letter DSCF pieces, and *2.6%* of ECR high density non-letter pieces. This means roughly 4.85% of all ECR high-density non-letters are accompanied by DALs.

(a) Given that ECR high-density flats also use DALs, do you believe there should be also be a DAL surcharge for high-density flat DALs? Please explain.

(b) If reliable DAL cost information were available, would you quantify the DAL surcharge on the basis of cost alone? If so and there is a difference in cost between a saturation flat DAL and a high-density flat DAL, should that cost difference be recognized in the two DAL surcharges? Please explain.

Answer

(a) My understanding is that postal regulations do not permit high-density flats to use DALs However, to the extent that postal regulations might allow them and the considerations that led the Postal Service to propose a surcharge for saturation DALs would apply as well, then yes

(b) Please see pages 15-18 of my testimony Regarding cost differences translating into rate differences, please see my responses to ADVO/NAA-T1-5(a) and ADVO/NAA-T1-4(b) Specifically. to the extent that high-density DALs were allowable, and to the extent that the Postal Service can accurately estimate the separate costs for those DALs and for DALs on ECR saturation flats, then as an economist I would recommend that accurately measured cost differences between those DALs should affect the price differences between them.

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ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T1-1-7)

ADVO/NAA-T1-7. On pages 15-16 (lines 15ff), you discuss the possibility of using value-based pricing. On page 17 (lines 14-15) you state that: " . . . another way to view the proposed DAL surcharge is to characterize it as a recapture of revenue displacement." NAA witness Ingraham. page 2, lines 14-17), notes that ECR high-density and ECR saturation flat rate categories are competitive with each other. In other words, to achieve Totai Market Coverage (TMC). one may distribute one's entire TMC product via the USPS saturation category or one may distribute some of one's TMC product via the USPS high-density category and the remainder via newspaper private delivery. USPS rates for these two categories can have a large impact on the choice.

(c) With that in mind, do you believe the USPS should price any of the (substitutable) services offered in the TMC market on the basis of "revenue displacement?"

(d) With that in mind. *do* you believe that the USPS should price a portion of one (substitutable) TMC service on the basis of "revenue displacement" but not price the other (substitutable) TMC service in the same way?

(e) Please confirm that if rates for the various (substitutable) TMC services within the ECR subclass were based on Ramsey pricing or developed to maximize institutional cost contribution, then both value of service and revenue displacement would be implicitly reflected in the results.

Answer:

(a) I believe the Postal Service should and does price the services offered in the total market coverage area in a manner consistent with the concept of the avoidance of "revenue displacement" as it was used in my testimony. For example, were the Postal Service to, hypothetically, eliminate ECR high density as a mail offering. then current ECR high density mailers would have only the ability to use ECR basic or ECR saturation mail. Because certain mailers choose ECR high density at its current rate and because not all mailers would substitute to another form of mail were ECR high density riot available, the Postal Service would, presumably, be forgoing the recovery of a certain amount of institutional costs by the non-existence of ECR high density

(b) This section of my testimony discussed the pricing of an optional feature that has value to the mailer, but which the Postal Service no longer finds consistent with long-term efficiency. To the extent that optional feature has any revenue displacement associated with it, another way to characterize value pricing for that feature would be the recapture of revenues displaced—that is, a recouping of revenues that would be gained were this currently unpriced and optional feature eliminated.

(c) To answer this question I assume that "value of service and revenue displacement" is meant to refer to value of service maximization and the minimization of revenue displacement. That said, this assertion is likely incorrect for two reasons. First, "revenue displacement" between two types of mail would be determined by the cross-price elasticity of substitution. The value of the service for a particular type of mail would be determined by several demand factors that are unrelated to the cross-price elasticity of demand (one of those factors would be the own-price elasticity of demand). Second, Ramsey pricing and value of service maximization are generally at odds. The maximization of the value of service is achieved by perfectly competitive pricing, which maximizes consumer surplus.

ANSWER OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS J. GREGORY SIDAK
TO INTERROGATORY OF
THE GREETING CARD ASSOCIATION (GCA/NAA-T1-1)

GCA/NAA-T1-1

Please consider the following two propositions, which might be asserted of some particular mailer activity:

(1) The activity is the lowest-cost option for the mailer.

(2) The activity is not one which could be performed by the Postal Service.

Please refer to page 8, line 1, through page 11, line 8, orf your prefiled testimony. Under the view of efficient component pricing set out in those pages, would you include as 'worksharing' activities, potentially subject to a worksharing discount which would comport with efficient component pricing -

(a) An activity of which (1) is !rue?

(b) An activity of which (2) is true?

(c) An activity of which both (1) and (2) are true?

Please explain fully the reasons for your answers.

Answer:

To answer these questions I begin by noting that ECP was developed as a method to determine an efficient price for an input owned by the vertically-integrated monopolist. ECP is, therefore, not applicable for determining price differences that fall outside of this realm. That said, if a cost-saving action can be undertaken by both the Postal Service and by the mailer, then that action can be characterized as the mailer competing with the Postal Service for the provision of that cost-saving service. I therefore answer the sub-parts of this question as follows:

(a) Presuming that this option can be characterized as competition with the Postal Service for the provision of the activity in question, then yes

ANSWER OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS J. GREGORY SIDAK
TO INTERROGATORY OF
THE GREETING CARD ASSOCIATION (GCA/NAA-T1-1)

(b) No. If the vertically-integrated monopolist cannot provide the service in question, it cannot charge a different rate to itself than what it could, hypothetically, charge to the competing mailer. Hence, ECP would not apply to this activity.

(c) No. See the explanation to part (b).

CHAIRMAN OMAS: There being none, that brings us to Mr. Scanlon with Pitney Bowes. Would you please call your witness? I see he is already in the chair.

Mr. Panzar, would you please stand up?

Whereupon,

JOHN C. PANZAR, Ph.D.

having been duly sworn, was called as a witness and was examined and testified as follows:

CHAIRMAN OMAS: Would you please be seated?

Mr. Scanlon, you may proceed.

DIRECT EXAMINATION

BY MR. SCANLON:

Q Dr. Panzar, you have before you two copies of a document entitled "Direct Testimony of Dr. John C. Panzar on behalf of Pitney Bowes, Inc.," designated as Revised PBT-1, dated October 31, 2006.

A Yes.

Q Was this testimony prepared by you or under your direction?

A Yes.

Q And if you were to give your testimony orally today, would it be the same?

A Yes, it would.

Q Are there any library references associated with your testimony?

A No.

MR. SCANLON: Mr. Chairman, at this time, I will provide two copies of the testimony to the reporter and ask that they be admitted into evidence as the testimony of Dr. John C. Panzar.

CHAIRMAN OMAS: Is there any objection?

(No response.)

CHAIRMAN OMAS: Hearing none, Counsel, would you please provide the reporter with two copies of the corrected direct testimony of John C. Panzar? That testimony is received into evidence. However, as is our practice, it will not be transcribed.

(The document referred to was previously marked for identification as Exhibit Nos. PB-T-1 and was received in evidence.)

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CHAIRMAN OMAS: Dr. Panzar, have you had an opportunity to examine the packet of designated written cross-examination that was made available to you in the hearing room this morning?

THE WITNESS: Yes, I have.

CHAIRMAN OMAS: If those questions were posed to you today orally, would your answers be the same as those you previously provided to us?

THE WITNESS: Yes, they would.

CHAIRMAN OMAS: Are there any additions or corrections that you would like to make to those answers?

THE WITNESS: No.

CHAIRMAN OMAS: Counsel, would you please provide two copies of the corrected designated written cross-examination of Witness Panzar to the reporter? That material is received into evidence and is to be transcribed into the record.

(The document referred to was previously marked for identification as Exhibit Nos. PB-T-1 and was received in evidence.)

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

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

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF PITNEY BOWES INC.
WITNESS JOHN C. PANZAR
(PB-T-1)

Party	Interroaatories
Advo, Inc.	USPSIPB-TI-1-18 VPIPB-TI-1-15
American Bankers Association and National Association of Presort Mailers	ABA-NAPMIPB-TI -1-2
Greeting Card Association	GCA/PB-T1-1-4
Parcel Shippers Association	USPSIPB-TI-9, 11 VPIPB-TI-10
Postal Rate Commission	ABA-NAPMIPB-TI -1-2 GCA/PB-T1-1-4 USPSIPB-TI-1-18 VPIPB-TI-1-15
United Parcel Service	USPSIPB-TI-5, 9-11
United States Postal Service	USPSIPB-TI-1-18

Party	Interrogatories
Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association Inc.	ABA-NAPMIPB-TI -1-2
	USPSIPB-TI-1-18 VP/PB-T1-1-15

Respectfully submitted,

Steven W. Williams
Secretary

INTERROGATORY RESPONSES OF
PITNEY BOWES INC.
WITNESS JOHN C. PANZAR (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Desianatina Parties
ABA-NAPMIPB-TI-1	ABA-IJAPM. PRC, Valpak
ABA-NAPMIPB-TI-2	ABA-NAPM. PRC, Valpak
GCAIPB-TI-1	GCA, PRC
GCAIPB-TI-2	GCA, PRC
GCAJPB-TI-3	GCA, PRC
GCAIPB-TI-4	GCA, PRC
USPSIPB-TI-1	Advo, PRC, USPS, Valpak
USPSIPB-TI-2	Advo, PRC, USPS. Valpak
USPS/PB-T1-3	Advo, PRC, USPS, Valpak
USPSIPB-TI-4	Advo, PRC. USPS, Valpak
USPSIPB-TI-5	Advo, PRC, UPS, USPS, Valpak
USPSIPB-TI-6	Advo, PRC, USPS. Valpak
USPSIPB-TI-7	Advo, PRC, USPS, Valpak
USPSIPB-TI-8	Advo, PRC, USPS. Valpak
USPSIPB-TI-9	Advo, PRC, PSA, UPS, USPS, Valpak
USPSIPB-TI-IO	Advo, PRC, UPS, USPS, Valpak
USPSIPB-TI-I1	Advo, PRC. PSA, UPS, USPS, Valpak
USPSIPB-TI-12	Advo, PRC, USPS. Valpak
USPSIPB-TI-13	Advo. PRC, USPS, Valpak
USPSIPB-TI-14	Advo, PRC, USPS. Valpak
USPSIPB-TI-15	Advo, PRC, USPS. Valpak
USPSIPB-TI-I6	Advo, PRC. USPS. Valpak
USPSIPB-TI-17	Advo, PRC, USPS. Valpak
USPSIPB-TI-18	Advo, PRC, USPS, Valpak
VPIPB-TI-1	Advo, PRC, Valpak
VPIPB-TI-2	Advo, PRC, Valpak
VPIPB-TI-3	Advo, PRC, Valpak
VP/PB-T1-4	Advo, PRC, Valpak
VPIPB-TI-5	Advo, PRC, Valpak
VPIPB-TI -6	Advo, PRC, Valpak

Interrogatory	Designating Parties
VPIPB-TI-7	Advo, PRC, Valpak
VP/PB-T1-8	Advo, PRC, Valpak
VP/PB-T1-9	Advo. PRC, Valpak
VPIPB-TI-10	Advo, PRC, PSA, Valpak
VPIPB-TI-11	Advo. PRC, Valpak
VPIPB-TI-12	Advo, PRC, Valpak
VPIPB-TI-13	Advo, PRC, Valpak
VPIPB-TI-14	Advo. PRC, Valpak
VPIPB-TI-15	Advo, PRC, Valpak

ABA-NAPM/PB-T1-1 In your testimony (PB-T-I), you include a discussion of the application **of** Efficient Component Pricing Rule (ECPR) to postal ratemaking. At page 18, you affirm the familiar efficiency properties of the ECPR:

> Fortunately, the efficient "make or buy" negotiations described above can be decentralized using ECPR-based worksharing discounts set equal to the per unit avoided costs of the Postal Service.

Under the ECPR, is the correct measure ***of*** avoided costs the full cost difference (due to both worksharing and non-worksharing factors) rather than the cost avoidance due exclusively due to worksharing factors? Please explain.

RESPONSE

As I explain in my testimony on pages 45-47, the principles supporting ECPR apply not only **to** cost avoidances but to cost difference? as well. **As** I show, if there are cost differences that are not reflected in rate differences, a "rate rebalancing" that aligns Postal service rates with Postal Service volume variable costs can induce eflicient changes in mailer bebaviour. These changes both benefic the mailer and increase the institutional cost coverage of the Postal Service.

ABA-NAPM/PB-T1-2 At pages 35-39 of your testimony (PB-T-I), you describe some issues related to the calculation **of** cost avoidance due to the heterogeneity of workshared mail. At the end of this section, you state that:

> From this perspective, the current Postal Service proposal to de-link single piece and workshared First-class letters should be viewed as a means of decreasing the heterogeneity discussed above.

Please explain further how the de-linking proposal would decrease the heterogeneity of First-Class Mail, and what effect that would have on efficient pricing.

RESPONSE

Workshared mail appears to be more homogeneous than Single-Piece First-Class Mail. Workshared mail must be barcoded. is largely machinable and is entered trayed and faced with printed addresses. Single-Piece First-class Mail is far more vaned with respect to these characteristics. Thus, workshared mail **is** more homogeneous than the mixture of Single-Piece and all workshared mail. I understand that over the years there have been numerous discussions concerning **the** proper benchmark for workshared mail. With delinking, this argument no longer is necessary and the discussions pertaining to cost differences, cost avoidances, and benchmarks would have less consequence for Single-Piece Mail. This would certainly facilitate more efficient pricing in workshared mail.

GCA/PB-T1-1 Please consider the following two propositions, which might be asserted of some particular mailer activity

1. The activity is the lowest-cost option for the mailer.

2. The activity is not one which could be performed by the Postal Service.

Please refer to page 7, lines 506 of your pre-filed testimony. Would the definition proposed there include as "worksharing" –

a. An activity of which (1) was true?

b. An activity of which (2) was true?

c. An activity of which both (1) and (2) are true?

Please explain fully the reasons for your answers.

RESPONSE

a. As stated on page 7 of my testimony, I set out a broad definition of worksharing as follows, "worksharing refers to any private sector *activity* which ***reduces*** *the costs* **of** the Postal Service." Under this definition, the focus is on whether the activity reduces the costs of the Postal Service regardless of whether the activity is the lowest-cost option for the mailer or whether the activity is one which could be performed by the Postal Service.

b. Please see (a) above.

c. Please see (a) above.

GCA/PB-T1-2 Please refer to page 11, lines 13-15 and 17-19, **of** your pre-filed testimony. Please supply all documents in your possession presenting, disputing, or otherwise reflecting the Postal Service arguments reported in the two cited passages of your testimony.

RESPONSE

I do not have any specific documents presenting, disputing, or otherwise reflecting the Postal Service arguments characterized in my testimony, nor did 1 rely on any such documents in developing my testimony. These passages reflect my understanding of the Postal Service's position on these issues.

GCA/PB-T1-3 Please refer **to** pages 12-13 of your pre-filed testimony.

Please provide any data or estimates in your possession concerning the number of households in the United States which possess a postage meter.

RESPONSE

I do not have any data **or** estimates concerning the number **of** households in the United States which possess a postage meter, **nor** did I rely on any such data or estimates **in** developing my testimony.

GCA/PB-T1-4 Please refer to page 12, lines 12-16, of your pre-filed testimony. Is it your opinion that the long lines at retail windows referred to in this passage of your testimony reflect only the purchase of stamps? Please provide the reasons for your answer.

RESPONSE

No. Obviously, the Postal Service provides additional services at retail windows.

USPSIPB-TI-I On page 15 of your rebuttal testimony (USPS-RT-13) on behalf of the Postal Service in Docket No. R97-1, you testified (Tr. 34/18457) as follows:

> There may be good reasons to depart from this Efficient Discount Policy when setting rates. For example, as Witness Bernstein points out, Ramsey optimal prices may involve different discounts (footnote).
>
> Footnote: In other words, efficient "discounts" do not necessarily yield efficient "rates." Logically, this is not surprising, as the scope of the inquiry involved in exploring efficient discounts does not address the broader issue of the efficiency of the base rate to which the discount is applied.

Do you still agree with this portion of your previous testimony? If not, why not?

RESPONSE

Yes

USPS/PB-T1-2 During oral cross examination on your rebuttal testimony in Docket No. R97-1 (Tr. 34/18465-66), you defined "efficient discount policy" as "the situation where the discount between a full-service sub-class of mail and one for which work sharing provided is equal to the per unit postal cost saved," and when asked if you support and recommend utilization of that policy, you replied:

> A As I explained in the testimony, it's the starting point for ensuring cost efficiency -- that is, ensuring that mailers engage in **work** sharing only when they are at least as efficient as the Postal Service at the margin in providing that work.
>
> *So,* in that sense, I recommend it, but there may be demand side reasons or reasons in accordance with the Postal Statute for deviating from that efficient discount policy.
>
> To further elaborate, I guess, if I could – you might want to rename it the cost-efficient discount policy, because that's what the term "efficiency" should refer to.

Do you still agree with this portion of your previous testimony? If not, why not?

RESPONSE

Yes.

USPS/PB-T1-3 During oral cross examination on your rebuttal testimony in Docket No. R97-1 (Tr. 34/18481), you were asked if there is a tension between the "efficient discount policy rate" and the "efficient rate." You responded that:

> **A.** There's a pricing tension between demand-side considerations, value of service, elasticity of demand, and cost efficiency considerations. There's certainly a tension there, anytime the rate is not consistent with the efficient discount policy.

The following exchange then occurred (Tr. 34/18482-84):

> **Q** And in terms of pricing and determining prices, would you agree that it is necessary to examine both tlie efficient rate as well as the efficient discount policy rate before making a final judgment?
> **A** I would say that it would be desirable to examine both in the following sense.
> The "efficient" rate -- I would like to put the term in verbal quotes -- in order to do that, let me use the term Ramsey rate that comes from maximizing some well-understood total surplus function.
> That rate takes into account this trade-off between the supply side and the demand side that I have been discussing, so if I were charged with the task of maximizing total surplus, I would want to know the Ramsey rate and that rate would reflect -- in some cases it will depart from the efficient discount rate, but that rate will reflect **the right** trade-off between the cost considerations and demand considerations.
> But that is only -- now for the Commission's purposes **1** would think that would be useful information, but their statutory responsibility isn't as simple as maximizing total surplus.
> They may be willing to trade off demand side considerations against cost side efficiencies as well, and I would think they would want to know both numbers.
> If they were just interested in Ramsey-like total surplus calculations they wouldn't have to pay any great attention to the efficient discount policy because the Ramsey calculation has made that trade-off automatically.
> ***So*** I guess that's saying yes, I would like -- if I were in the position of setting the rates I would like to see both numbers.
> **Q** And you wouldn't simply by rote choose the efficient discount policy rate over the efficient or Ramsey rate?
> **A** No.

Do you still agree with these portions of your previous testimony? If not, why not?

RESPONSE

Yes

USPS/PB-T1-4 Would you agree that application of ECPR will lead to no improvement in cost efficiency if, relative to the status quo, it leads to no change in mailer behavior? If **not,** please identify the change in cost efficiency in the following scenario. Assume that a particular activity can be performed by the Postal Service at a unit cost of 10 cents, and further assume that there are two sets of mailers for whom it is feasible to conduct this activity themselves. The first set constitutes 60 percent of mailers, and for those mailers it costs 6 cents to conduct the activity. The second set constitutes 40 percent of mailers, and for them it costs 12 cents to conduct the activity. The current status **quo** discount is **7** cents, and therefore 60 percent of the mailers engage in the worksharing activity. Application of ECPR would increase the discount to 10 cents. Please confirm that increasing the discount from 7 cents to 10 cents under this scenario would not lead to any change in mailer behavior, or in the cost efficiency of the postal system. Please explain **your** answer fully.

RESPONSE

Yes, but I believe it unlikely that application of ECPR will not change behavior given how discounts have changed behavior in the postal arena to date. The Cohen ***et al.*** paper **1** cite in my testimony shows that in 2004, almost 150 billion pieces of mail **of** the total **206** billion pieces of mail availed themselves of worksharing discounts.

USPS/PB-T1-5 Please consider the following scenario. Assume at a partici r activity can be performed by the Postal Service at a unit cost of 10 cents, and further assume that there are three sets of mailers for whom it is feasible to conduct this activity themselves. The first set constitutes 60 percent of mailers, and for those mailers it costs **6** cents to conduct the activity. The second set constitutes 5 percent of the mailers, and for them it costs **9** cents to perform the activity. The third set constitutes 35 percent of mailers, and for them it costs 12 cents to conduct the activity. The current status quo discount is 7 cents, and therefore **60** percent of the mailers engage in the worksharing activity. Application of ECPR would increase the discount to 10 cents. Please confirm that increasing the discount from 7 cents to 10 cents under this scenario would lead to the mailers in the seccnd set **(5** percent of the total) to start worksharing, and that this change in mailer behavior would improve the cost efficiency of the postal system. Please also confirm. however, that the mailers in the first set ***(60*** percent **of** the total) will receive a rate reduction **of 3** cents without any effect on their behavior, that this lost revenue (assuming sub-unitary elasticity) will need to be made **up** by higher rates for some other mailers, and that the higher rates charged elsewhere could lead to an overall loss in efficiency notwithstanding the increase in cost efficiency relating to the 5 percent of the mailers in the second set. Please explain your answer fully.

RESPONSE

Confinned that mailers in the second set would change behavior and begin worksharing. **Also** confinned that mailers in the first set will receive a rate reduction with no change in behavior. Also confirmed that lost revenue will need to be made **up** from elsewhere. Since my testimony is focused on the application **of** the ECPR discount regime at the subclass level, the lost revenue would presumably come from mailers within the subclass. If higher rates are also required elsewhere this could (but doesn't necessarily have to) lead to a decrease in overall welfare. **Also,** my testimony sets forth the arguments in favor of instituting a system of cost-based discounts at the subclass level. It does not specifically address the issue **of** how one makes changes from an existing system of discounts that are less than avoided cost. Note that in the above example, and under ECPR more generally, the issues of "lost revenues" does not arise when one considers introducing an avoided cost discount of 10 cents **for** the first time.

USPSIPB-TI-6 On page **26** of your testimony, you note that Cohen, et al. (2006) "argue that the end result of this process is an increase in volume far greater than what would be predicted on the basis of price elasticities alone." Do you agree with their argument? Why, or why not?

RESPONSE

I do not know the precise basis **for** their argument, so I can neither agree nor disagree. My interpretation of their statement is that the introduction **of** worksharing discounts set **off** a dynamic process of learning on the pan of mailers and consolidators that has accelerated the growth **of** worksharing.

USPS/PB-T1-7

a. Would you agree that, with respect to ECPR, the issue is how much worksharing activity changes when discounts change, and that if a higher discount results in little additional worksharing activity, then its primary effect is to give away money to mailers who are already worksharing, while raising the rates for other mailers (nonworksharing mailers, or mailers of another subclass)? If not, why not?

b. Would you agree that rhe magnitude of the response by mailers to a change in a worksharing discoun! is a function of the price elasticity in some form or another, and it is therefore not advisable generally to attempt to ignore demand factors when setting worksharing discounts as part of an omnibus postal rate proceeding? If not, why not?

RESPONSE

a. I believe that the issue with ECPR is that it encourages productive efficiency. As to whether or not it gives money away, please *see* my response to USPS/PB-T1-4 above.

b. The magnitude of the response is a function of the distribution of the mailers costs to perform the activity. The price elasticities of workshared products, are themselves, in large part determined by this distribution. In general, productive efficiency is important. If I knew I would get no response to a discount, I might carefully consider whether to implement it but usually discounts have elicited responses and I would not take as the starting position that the discount will not induce a response. Again, the arguments in my testimony refer to the desirability of a system of cost based discount, not on the practical details **of** moving toward them **from** some other system ofdiscounts. (See my answer **to** USPS/PB-T1-5).

USPSIPB-TI-8 Is the 2006 Bern conference paper cited in footnote **24** on page 36 of your testimony the same as the paper ""Clean" Mail and "Dirty" Mail: Efficient Work-Sharing Discounts with Mail Heterogeneity," previously circulated in draft form? If so, please provide a copy of a version of that paper that can be cited and quoted.

RESPONSE

The paper cited in my testimony is a revised version **of the** Bern conference paper. **1** have attached a copy to my response.

USPS/PB-T1-9 Your section heading on page 45 indicates your intent to present the case for basing ***infra-subclass*** rate differences on Postal Service cost differences. Why does not the same case apply to basing ***infer-subclass*** rate differences on Postal Service cost differences? Please explain fully.

RESPONSE

The arguments in favor of cost based rate differences apply any time mailers can make use of price differences to efficiently alter their behavior. However, as earlier citations to my past testimony have revealed, there is generally a tension between cost efficiency considerations and Ramsey-style, demand side factors. If price elasticities within a subclass are assumed to be approximately equal, than the issue of different elasticity based markups does not apply as strongly within the subclass as it might across subclasses. Thus, the issue of demand is less important within a **subclass** than across subclasses and the case for ECPR does not need to consider the tensions described earlier.

USPS/PB-T1-10 On page 49, you state that Ramsey Pricing weighs surplus dollars equally, and that this neutrality would not allow postal ratemakers to exercise independent judgment with respect to the non cost factors specified in the Act.

a. Is your concern only applicable to mechanistic application of Ramsey Pricing (i.e., rates are automatically and invariably set at the levels calculated by the Ramsey model), or would it also apply to a procedure where the price levels suggested by the Ramsey model are considered as useful information for ratemakers, but do not. preclude subsequent adjustment based on consideration of other factors of the Act? Please explain fully.

b. Would you agree that if one has reservations about weighing surplus dollars equally, one might have the same type **of** reservations about imposing an equal unit contribution requirement (what you refer to on page 48 as the "same nominal markup") on different mailers? **If** not, please explain fully.

c. Would you agree that if one has reservations about weighing surplus dollars equally, one might have the same type **of** reservations about imposing a strict obligation on each type of mailer **to** cover the costs they impose on the Postal Service, regardless of their unique financial circumstances.? If not, please explain fully.

d. Would you agree that if one starts down the road **of** thinking about dollars from different mailers differently, such ***an*** approach can call into question some of the most basic types of economic analysis that are routinely applied in ratemaking proceedings? If not, please explain fully.

RESPONSE

a. My concern is the former.

b. No. The equal markup condition is a required to provide incentives for cost efficiency, not as an end in itself.

c. No. The restrictions on cross-subsidy also have a role in ensuring productive efficiency by not creating incentives for inefficient entry.

d. No. **As** suggested in part (a), such an approach may be required so as to "not preclude subsequent adjustment based on consideration of other factors **of** the Act."

USPS/PB-T1-11 On page **49,** you note that Ramsey pricing requires demand elasticity estimates, and ECPR pricing does not. Is your point that, for instances in which separate demand elasticities arc not routinely estimated (e.g., the 3-digit mail and 5-digit mail in your example on page 48), a substantial hurdle is presented to any attempt to use Ramsey Pricing at that level, or is your point that, even in situations in which the demand elasticity estimates are available, it is better to ignore them and focus exclusively on cost differences at the margin? Please explain fully.

RESPONSE

As a practical issue, I believe there is a substantial hurdle to estimating the demand elasticities for each class, subclass, rate category, and rate element of mail. Given the uncertainties that would be inherent is these estimates, 1 would prefer to establish prices that one can be reasonably confident will maximize productive efficiency rather than merely attempt to maximize total surplus based upon much less reliable estimates. Also, remember that my testimony focuses on the desirability of applying ECPR at the subclass level, where elasticity differences (and any theoretical gain from applying them to rates) are presumably quite small.

USPS/PB-T1-12 On the top of page **50,** you discuss the constantly changing and evolving postal industry, changing worksharing technology, and changing demand elasticities

a. Would **you** agree that changing technologies may cause shifts in demand curves, without necessarily causing material changes in the price elasticities? If not, please explain fully.

b. If evolving technology is causing changes in demand elasticities, are those not likely to be circumstances in which it is most critical to know the magnitude of the effect that setting discounts at a particular level is going to have on mailers' choices to workshare or not (which **is** precisely the type of information encompassed in the price elasticities), rather than relying on a procedure which ignores that information? Please explain your answer fully.

RESPONSE

a. I agree that this is possible, but it is far from certain.

b. I disagree with the conclusion that applying ECPR to discounts within a subclass need in any sense ignore information about changing demand elasticities. Recall that ECPR relates to differences between rates. Elasticity considerations would still be required to determine the overall rate level of a subclass. And, again, the arguments in my testimony refer to the desirability of a system of cost based discount, not on the practical details of moving toward them from some other system **of** discounts. (See **my** answer to USPS/PB-T1-5)

USPS/PB-T1-13 Please refer to page 49 of your testimony. There you indicate that Ramsey Pricing does not automatically ensure that prices are free of cross-subsidization. On behalf of Valpak, witness Mitchell in his testimony in this case makes the same point, but also states that the "argument that cross subsidies are bad and should be avoided is a fairness argument, not an economic one," and that "[n]othing in notions relating to the efficiency of resource allocation argue that cross subsidies are bad or explain how to avoid them." VP-T-3 at 10-11. Do you agree with these statements? Are they consistent with your previous testimony on this subject, USPS-T-11 at 8-12 (Docket No. R97-1)? Please explain fully.

RESPONSE

I do not agree with the last quoted statement of Witness Mitchell. As noted above, there is an important economic efficiency reason to avoid cross-subsidization. Cross-subsidization creates incentives for inefficient entry. I do not believe the statement is consistent with my cited prior testimony.

USPS/PB-T1-14 Please refer to page **36** of your testimony, where you state:

> The basic theoretical result [of your recent Clean Mail/Dirty Mail paper] was that an efficient allocation of mail processing activity between the Postal Service and mailers requires a worksharing discount equal to the average Postal Service processing cost of the type of mail just at the margin of being profitable for mailers to workshare.

a. Would you agree that the profitability of worksharing for a specific type of mail is a function of the specific level of the workshare discount, and, therefore, in order to be able to identify the type of mail just at the margin of being profitable for mailers to workshare, it is necessary to have a particular discount in mind already? If not, why not?

b. Please explain how the theoretical result described above can be practically applied to aid in the determination of the most appropriate worksharing discount.

RESPONSE

a. Yes.

b. The theoretical analysis described above establishes the conditions that must be satisfied for a discount to minimize postal sector costs. Given sufficient information about the worksharing cost curves of mailers and the Postal Service, it would be possible to calculate the cost efficient discount. Even with less information, it might be possible to design an iterative procedure that would converge to the desired result. Perhaps the most "practical" application of the analysis lies in understanding why using a "benchmark" mail type such as BMM would not lead to the cost efficient discount.

USPS/PB-T1-15 Please refer to **your** testimony at page 8, lines **I8 - *20.*** Where, and by whom, is a "policy objective" of a "universal workshare discount" stated? How would you define the term "universal workshare discount"?

RESPONSE

The phrase "universal workshare discount" as I use it in the context of my testimony, is intended to mean expanded workshare opportunities, based on rates that comport with ECPR, for a larger group of mail users who may not currently take advantage of workshare discounts. I state in my testimony that the promotion **of** postal sector productive efficiency, the reduction of the Postal Service's end-to-end costs, and lower postal rates for mail users **is a** policy objective worth pursuing.

USPS/PB-T1-16 Please refer to your testimony at page 10, lines 1 - 3. Your statement about the average haul of First-class Mail relative to the average haul of all other classes of mail is stated as an expectation. Do you have any empirical information to confirm that expectation? If empirical information were to contradict that expectation, **would** not that necessarily imply that the magnitude of potential benefits of distance related rates for First-class Mail is likely to be smaller than your testimony suggests? Please explain fully.

RESPONSE

No. According to the response of the Postal Service to PB/USPS-T32-49, the Postal Service does not have any empirical information to contradict my expectation. My testimony does not attempt to quantify the "magnitude of potential benefits" of distance-related rates for First-class Mail. Rather, my testimony simply states that in FY 20005, transportation costs for First-class Presort Letters totaled $432 million or about .9 cents per piece, and points out that some fraction of the $2.372 billion mail processing costs and their associated piggybacks in **FY** 2005 could be avoided by entering mail deeper into the system. I performed no specific calculations based on average haul. Moreover, regardless of the average haul of First-Class Mail, a distance-related discount would save some of these costs.

USPS/PB-T1-17 Please refer to your testimony at page **15,** lines **17 -** 19. How would you propose to implement **a** discount **for** properly addressed mail pieces (e.g., considering that when pieces are mailed, whether or not they are properly addressed is not known)?

RESPONSE

My testimony discusses the concept of expanding worksharing to include address quality rather than the implementation of that concept. It bears noting that in Standard Mail, the Postal Service charges a forwarding fee for Standard Mail letters and flats that require forwarding as requested by the mailer, notwithstanding the facr that the quality of the address is unknown when the pieces are mailed. Thus, in that case, an indirect "worksharing discount" is accomplished through unbundling the forwarding component of end to end service. Presumably, something similar could be applied to First-Class Mail.

USPS/PB-T1-18 Please refer to your testimony at page 18, lines 10 - 11. Please explain how "the costs of the Postal Service would fall by more than the revenues **lost** through the discount" if (a) "the Postal Service saves $0.10 for each piece" (pg. 16, lines 23 - 24), and (b) the discount is $0.10 (pg. 18, line 8).

RESPONSE

This is a typographical error. The phrase should read "the costs of the Postal Service would fall by the amount of the revenues lost through the discount." My testimony **will** be changed to reflect this.

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 ofpieces, 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 ail 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.

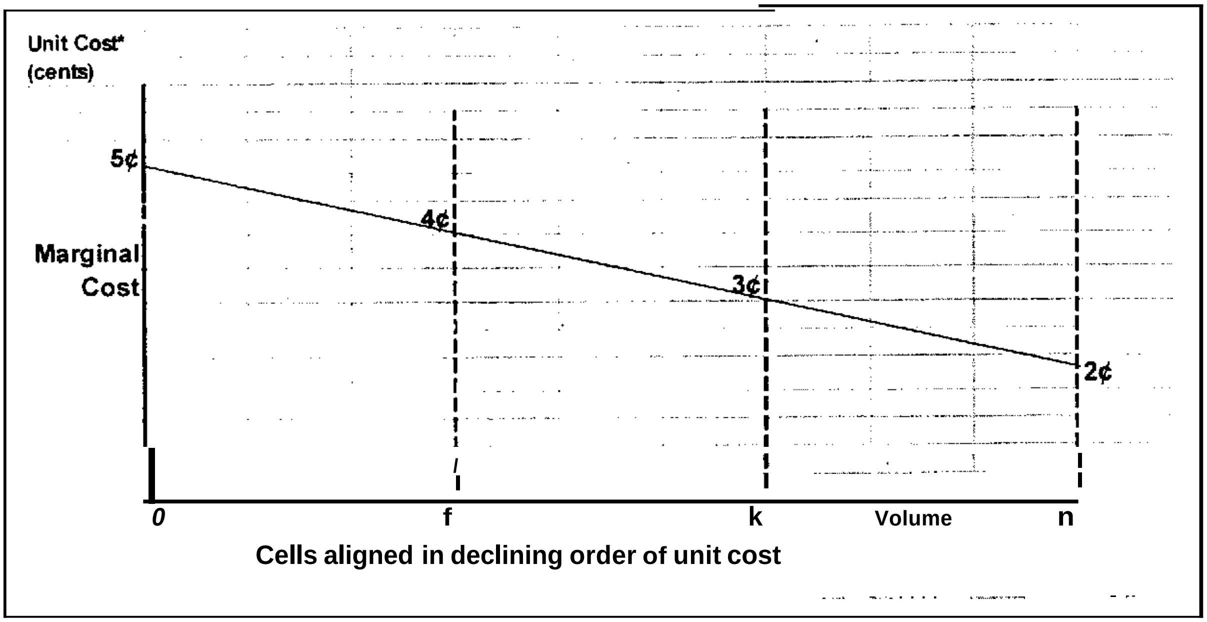
a. Within the framework of this example and the assumptions made, is this description of marginal cost, average marginal cost, average volume variable cost, volume variable cost, and attributable cost consistent with your understanding of the postal administration's costs and with how you use these terms 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 I: Upstream Costs of Postal Service Product A

Attachment to VP/PB-T1-1

Figure 1: Upstream Costs of Postal Service Product A



*Average variable cost = unit atrributable cost = marginal cost

RESPONSE

a. 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. Only in Section VI.B.2 did I address issues relating to the heterogeneous avoided costs.

b. Again, I did not focus on this situation in my testimony. Nevertheless, it is clear that the question cannot be answered without further information regarding the upstream cost curves of *competitors*.

VPIPB-TI-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 isalso 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.

RESPONSE

I am not sure what is meant by the "propensity of volume in the cells to be of interest to potential competitors." Nevertheless, if potential competitors are no more efficient or less efficient than the postal administration for *any* type of mail it makes no difference what discount is set. The particular level of discount will have no impact on total postal sector costs.

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.

h. 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#? lfyou 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 arc.

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.

RESPONSE

a. Agreed.

b. The position advocated in the cited portion of my testimony referred to the case in which the upstream costs of the postal administration are constant.

c. Agreed.

d. In the context of this hypothetical, I would agree.

e. **As** indicated above, it makes no difference what discount is selected under the posited circumstances.

f. In the context of this hypothetical, I would agree.

g. 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. Only in Section VI.B.2 did I address issues relating to the heterogeneous avoided costs. Thus most of my testimony assumed that the straight line in question is horizontal.

h. No, I made no explicit assumptions about competitors ***cost*** curves. My testimony often assumed that the aggregate ***market*** *supply* curves of **all** competitors is upward sloping: **i.e.**, competitors as **a** group would supply more upstream services the greater the discount offered them.

VPIPB-TI-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 ofthe postal administration and, at the same time, with the propensity ofthe 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 wiih any **of** the above, please explain.

b. **In** this situation, please explain what you would recommend as the theoretically correct discount level.

RESPONSE

a. (i) Agreed. (ii) Agreed. (iii) Agreed.

b. In this situation, it would be eflicient for competitors to capture *all* of the upstream activity. Any discount greater than or equal to **5** cents would accomplish this.

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 **39.**

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 **39** or less to handle mail that would cost the postal administration between **3¢** and **49** to handle? If you do not agree, please explain.

d. Do you agree that if all volume in cells **k+l** 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.

RESPONSE

a. Agreed

b. Agreed.

c. Agreed.

d. Agreed.

e. There **is** not enough information to make a recommendation.

f. The hypothetical is too abstract **to** form such expectations.

VP/PB-T1-6. Please refer to your testimony, PB-T-I, 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 oifference, 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-I, p. 49, l. 7), (ii) whether one is at a margin and the other **is** not (PB-T-I. p. 49, l. R), 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-I, 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 nonworkshared 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-I, 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 nor agree, please explain.

RESPONSE

a. (i and ii) **As** I explain in my testimony, ECPR requires only information about cost differences at the margin while Ramsey pricing requires information about marginal costs ***and*** total costs, as well as own price and cross price elasticities **for** all services.

(iii) The margin for Ramsey pricing **is** the marginal cost. The cost differences for ECPR are differences in marginal cost.

b. By the two approaches I presume you refer to ECPR and Ramsey pricing. My understanding is that USPS cost systems would provide the required ***marginal*** cost information for both approaches. Again, the total **cost** information required for the determination of the Ramsey pricing break-even constraint is not required **for** ECPR analysis.

c. In principle, the USPS cost systems produce costs that could be used in Ramsey pricing. They do not produce own price and cross price demand elasticities.

d. (i) In rate cases, it is my understanding that the Service produces own price and cross price elasticities at the sub-class level, but not at the rate category or rate element level.

(ii) As I explain in my testimony on pages 47 to 49, I advocate the use of ECPR for pricing work shared products. In ECPR pricing, markups are at the subclass level (or implicitly at the rate category level) and elasticity enters into only one of the factors used in selecting the markup.

e. I agree given your note.

f. (i) I do not deal with the details of Ramsey pricing formulae in my testimony. This question calls for a detailed analysis of a particular case (i.e., equal own-price elasticities with non zero cross elasticity) that I have not analyzed. Nor do I know of a paper in the literature where this case is explicitly discussed.

(ii) The discussion inny 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.

g. (i) Yes.

(ii) Without more information, I have no way of knowing whether the "risk" is "significant" or not. As I explained in my testimony, the first step in a cross-subsidy analysis under ECPR would be to check that the rate of the unworkshared category covers its incremental costs.

(iii) I am not sure what is meant by "minimized" in this context. Again, as I explained in my testimony, if the unworkedshared mail covers its incremental costs, the use of ECPR will typically ensure that the other categories will also cover their incremental costs.

VP/PB-T1-7. Please refer to your statement, PB-T-I, p. 50, ll. **2-3,** that "ECPR facilitates the application of non-cost 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 non-cost 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.

RESPONSE

a. It is my understanding that the non-cost factors **of** the Act are generally applied at the class and subclass levels to determine the cost coverage of **a** class or subclass. Once the cost coverage is determined, ECPR can be used within the subclass for discounts.

b. No, my testimony does not suggest that non-cost factors should be applied below the class and sub-class level.

c. It is my understanding that the non-cost factors **of** the Act are generally applied at the class and sub-class level.

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.

RESPONSE

a. I advocate the use of ECPR for pricing workshared products.

b. It is not a question **of** whether it is easier or harder to adjust depending on the passthrough, The issue **is** that a 100 percent passthrough promotes productive efficiency and Rsmsey pricing does not.

c. I would set the original rate at a passthrough **of** 100 percent. If **costs** changed, whether **or** not elasticities changed, I would advocate new rates with a passthrough **of** 100 percent. Please see a and b above.

VPIPB-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."

RESPONSE

a. The preference for percentage markups stem for the fact that Ramsey markups are most easily expressed as percentage markups over marginal cost. If absolute markups were used, they would depend on the marginal cost of the service. Thus, Ramsey absolute markups for products with the same elasticity but with different marginal costs would be different, **but** the percentage markups for these products would be the same.

b. From an economist's perspective, elasticity of demand **is** a measure of the value of the service.

VP/PB-T1-10. Please refer to your testimony PB-T-I 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 I-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 I-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.

RESPONSE

a. Yes.

b. Yes.

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 (FU) or volume variable (cU). 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.

RESPONSE

a. The correct answer could be 5.0 cents, 7.0 cents, or any number in between, depending on the details of the example.

b. Marginal costs are evaluated at a particular level of output, thus "jumps" or "kinks" in the cost curve at other output levels are irrelevant to their determination. The calculation of incremental costs would typically reflect such "'jumps" or "kinks."

c. **As** explained in my testimony, productive efficiency requires that the marginal costs of an activity be equated between active providers. With a competitive upstream sector, this is accomplished by setting worksharing discounts equal to the marginal avoided cost of the Postal Service at the forecasted activity level.

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

Downstream costs = $F_D + c_D V$

Upstream costs = $F_U + c_U V$ and Fixed common costs = F_I

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-I, 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,)*** 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_I). Also assume tha! 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, ifmeasured 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 ($F_I + F_u + F_D$) 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 ($F_I + F_u + F_D$) 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,** $+ c_U V$), 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" arc 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, + $F_D + c_D V$, then those mailers who do not use any services **of** the upstream network would not pay any portion of the upstream fixed costs, F,? 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-intcgrated incumbent that sets all rates according to ECPR, as described in your testimony at pager 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 coniponcnt cost of the incumbent as long as (i) the incumbent continues **to** provide some of the component (ii) consolidators supply their services competitively

MR. OLSON: Mr. Chairman?

CHAIRMAN OMAS: Yes.

MR. OLSON: Bill Olson for Val-Pak. I wanted to just confirm that, as the responses to interrogatories were filed, there was a figure that was not appended to Val-Pak Interrogatory No. 1, which we have advised counsel for Pitney Bowes about and placed in the file. It is actually referenced in the interrogatory, and it was in the original interrogatory, and we would like to have that figure reproduced in the record so that the record is clear, and I believe there is no problem with that.

CHAIRMAN OMAS: Without objection, so ordered.

MR. SCANLON: Just to clarify the record, Mr. Chairman, the figure with respect to Val-Pak/ Pitney Bowes T-1-28 is also a revised figure.

CHAIRMAN OMAS: Thank you, Mr. Scanlon.

MR. OLSON: Mr. Chairman, may I also -- we have some additional designations that came in yesterday.

CHAIRMAN OMAS: I think I'm going to get to that right now, if you give me a minute.

MR. OLSON: Yes, sir.

CHAIRMAN OMAS: Last night, Dr. Panzar

provided responses to Val-Pak Interrogatories 16 through 29. I would like to have these answers into evidence.

Mr. Scanlon, were all of those answers included in the packet of written cross-examination?

MR. SCANLON: Mr. Chairman, here are two additional sets.

CHAIRMAN OMAS: Okay. So what you're telling me, they were included in the packet of written cross-examination that we presented earlier.

MR. SCANLON: No, Mr. Chairman. They are now.

CHAIRMAN OMAS: Okay. Thank you. So Mr. Scanlon, for the record, has given the reporter two copies of the responses to Interrogatories 16 through 29 from Val-Pak.

Dr. Panzar, would your answer to those questions be the same as those you provided to us last night?

THE WITNESS: Yes, they would.

CHAIRMAN OMAS: Thank you.

The discovery responses are received into evidence and are to be transcribed.

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(The document referred to was previously marked for identification as Exhibit Nos. VP/PB-T1-16 and was received in evidence.)

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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-I, 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 1 address issues relating to the heterogeneous avoided costs." In terms of the discussion in your testimony to which you refer. Scction 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 arc "tlic same for all workshared mail"?

ii. If your response to tlic preceding question is that they relate not to Section VI.B.2. but to tlic 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.

RESPONSE

a. This question really refers to a paper cited in my testimony rather than my testimony itself. Tlic discussion in my paper made use of the following definitions:

i. *Two* values of "upstream," marginal cost were defined for each type of mail: the unit cost. *t*, that would be incurred by the Postal Service *if* it performed the upstream function; *and* the unit cost, *s*, that the mailer would incur if it performed the upstream function itself

ii. **As** used in my paper, the term ***average marginal cost*** referred to the ***average,*** for a ***given*** value of mailer unit cost *s*, of the unit costs the Postal Service would incur *if* it performed the upstream function for all mail with mailer unit costs.

iii. I do not believe 1 defined the term ***average volume variable* costs.**

iv. **As** used in my paper. the term ***volume variable*** [sorting] *costs* would refer to ***all*** of the sorting costs incurred by the Postal Service.

v. In the context of my theoretical model, the volume variable and attributable snrting costs would he the same.

b. I would not like to speculate as to what the Postal Service's costing systems would produce in an entirely hypothetical situation. However, I intended the upstream variable costs in my example to correspond to the volume variable costs that the Postal Service costing system would calculate for such a hypothetical scnicc component.

c. Scction VI.B.2 docs not explicitly define cost concepts. However, I believe the terminology is consistent with that used in the question.

d.

i. Those sentences refer to the issue of whether the marginal costs (unit volume variable costs) or average incremental costs of a component should be used in calculating cost avoidances.

ii. They are applicahlc to the above issue regardless of whether or not the Postal Service has heterogeneous or homogeneous costs. See Section

VI.B.1 of my testimony, which focuses on the homogeneous cost case for ease of exposition.

iii. Not applicable.

e. In Section VI.B.2 I used the term costs avoided to describe workshared component costs in general terms. Depending on the details of the situation they could correspond to any of the terms mentioned.

f. I am not familiar with the term "intrinsic fixed costs." In Section **VLB.2,** the term "cows avoided' would not include any fixed costs as long as the Postal Service continued to providr some of the upstream component.

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 mail stream, and (ii) for mail within the various segments?

b. Unless your answer to part a is an unqualified affirmative, please clarify which pans of your testimony would apply to such situations.

RESPONSE

a. No

b As I stated in my original response to VP/PB-T1-1(b), only Section IV.B directly discussed the case of heterogeneous upstream Postal Service costs of the type posited in tlic Valpak hypothetical.

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 mail stream. 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 mail stream.

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.

RESPONSE

a. The "make or buy" logic remains useful when Postal Service processing costs are heterogeneous.

b. The problem arises, not because of the "make or buy" logic, but because it is not practicable to set different worksharing discounts for mail that imposes different upstream costs on the Postal Service

c. Again, the "make-or-buy" logic applies, and would yield a cost efficient outcome if it were feasible to set different worksharing discounts for mail that imposes different upstream costs on the Postal Service.

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 rate setting 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 Scction VI.B.2 did I address issues relating to the hctcrogencous 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 prcscnted 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 rate setting 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.

RESPONSE

a. I was refemng to the portions cited in VP-PB-T-I.

b. *All* portions of my testimony remain applicable. However, as I have pointed out, the analysis becomes more complicated when Postal Service upstream costs vary across pieces of mail in the same discount category. As in all aspects of rate-setting, there is a trade off involved in the number of rates and/or discounts that are established. The rate schedule would become hopelessly complex if one specified enough different rate categories so that all items within a category were completely homogeneous. But that would eliminate the problem under discussion.

c. No, I did not make any specific assumptions.

d. I did not make any recommendations for the situation described in the hypothetical. When the competitors' costs are lower than those of the Postal Service for all types of mail, I suspect that the repeated application of *any* discount equal to the *average* of heterogeneous Postal Service costs would lead to competitors processing all the mail. But, that would be cost efficient in the context of this example.

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 infomiation 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 pan b of this question.

RESPONSE

a. 1 would need information about the cost curves **of** potential competitors and how they are correlated with those **of** the Postal Service for the various "cells" of mail

b.

i. The hypothetical does not provide enough information. In particular, based on the information given, one cannot determine whether the mail taken would have cost the Postal Service more or less to process than it cost the competitors that took it.

ii. **As** explained in part (a), above, I would need information about the cost curves of potential competitors and how they are correlated with those of the Postal Service. The difficulty with the present hypothetical is that it tries to collapse two mail characteristics, i.e., Postal Service processing costs and mailer processing costs. into a single dimension.

c. The problems posed by cost heterogeneity are difficult. My earlier cited paper attempts to develop a theoretical framework for dealing with them. In the absence of complete information, one docs the best one can by basing decisions on plausible assumptions and. eventually. subjecting those assumptions to empirical tests. Also. as stated in my response to VP/PB-T1-19(b). there is a trade off between makig the complexity of the rate schedule and establishing more numerous and more homogeneous rate categories. Finally, the Postal Service proposal to "delink" Single Piece and workshared mail should reduce cost heterogeneity.

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 thatyou 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 yon 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 he able to process some mail at a lower cost that 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 economics on some portions of the volume, not on others'.)

RESPONSE

a. If provides no detail or even general discussion about the actual operations of any specific group of consolidators or competitors.

b. Please *see* VP/PB-T1-21(a), above.

c. At the level of generality of the hypothetical, all one can say is that it is because their cost functions are different. Scale economies might play a role **in** the real world, but all the hypothetical examples proposed have assumed constant **returns** to scale for both parties.

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.***

RESPONSE

I am not familiar with the notion of imposing a "revenue requirement" at the subclass level in Postal Rate making. I have only seen those words applied to the sum of all mail classes and services. It would seem. however. that even if **one** knew all the information necessary to apply Ramsey pricing. doing so at the subclass level with a breakeven constraint violates the spirit of Ramsey pricing because it does not consider the relationships of demand and consumer **surplus** across classes. Applying Ramsey pricing to subclasses within a class once coverage were set for the class would also seem to erode any benefits derived from Ramsey pricing

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 Oats 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 rate setting 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 wouldikely give a wrong solution. please explain whether changing the elasticity of letters relative to flats would move the letter-flat rate differcnce (i) above and below the cost differcnce 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.

RESPONSE

a. Not confirmed. I do not view letters in a subclass as a workshare variant of flats in the same subclass in all cases. Because mailers can often chose whether to mail a flat or a letter, the same arguments can be applied to pricing shape-related cost differences as are applied to worksharing-related cost differences.

b. Confirmed.

c. The question is unclear. If the question is asking whether different elasticities for subclasses would result in different rate differences, assuming Ramsey pricing for subclasses within a class once the coverage for the class had been set, the answer is yes

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* I70 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.

RESPONSE

a **Yes.**

h. **As** stated in my response to VP PB-T1-23(a), I do not consider letters to be a workshare variant of flats. Having said that, if letters covered its incremental cost and **flats** did not with rates set at cost differences, increasing the rate differential could not decrease the chnncc of flats covering its incremental costs. Whether or not it increased the chance would depend on **the** incremental cost.

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."

RESPONSE

a. The principles supporting ECPR also support the notion that rate differences should reflect 100 percent of the cost differences.

b. Yes.

c. The phrase "pass through" is generally understood to refer to workshare-related avoided costs

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 VPIPB-TI- 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 noncost 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 docs not apply noncost 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 noncost criterion 3622(b)(7), simplicity, to rate categories within a subclass? If so, please state the basis for your understanding.

RESPONSE

a. My answer to VP/PB-T1-7(a) states, in pertinent part, that "[i]t is my understanding that the non-cost factors of the Act **are** generally applied at the class and subclass levels to determine the cost coverage of a class or subclass." I do not understand what it means to "more meaningful[ly] . . . apply the non-cost factors between subclasses."

h. No. My answer to VP/PB-T1-7(b) stares, in pertinent part, "my testimony does not suggest that noli-cost factors should be applied below the class and sub-class level."

c (i.-iii.) It is my understanding that the noli-cost factors of the Act arc generally applied at the class and subclass levels to determine the cost coverage of a class or subclass.

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 pan 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 ECPK tu Ramsey. If it does not mean this, please explain the sense in which it is more straightforward under ECPR.

RESPONSE

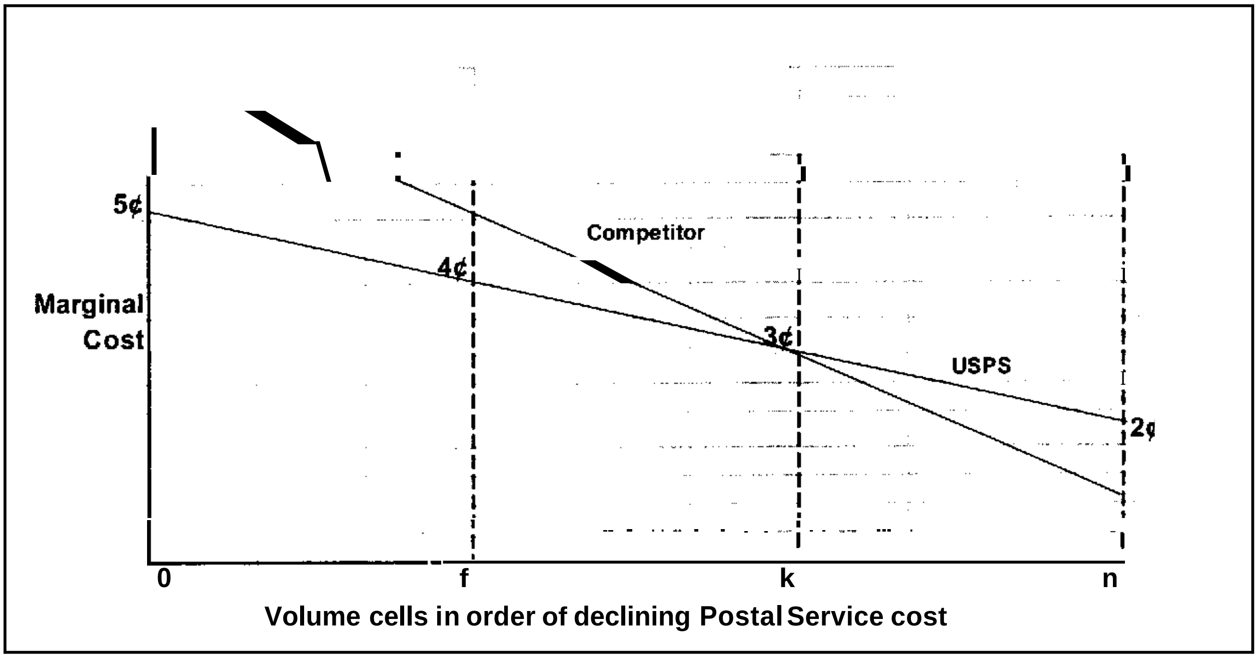
Obviously, it is no harder to adjust a "170% pass through" to reflect cost changes than it is to adjust a "100% pass through" to reflect those changes. The reason ECPK is more suited to deal with cost changes, is because the required percentage pass through to implement it does not change as costs change. This is not generally true under Kamsey pricing.

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+l 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 circumstancts." 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 he increased from its current level of 3 cents to a new level of 4 cents.

b It 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 tlic 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 Portal 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. It 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.

RESPONSE

(a.-b.) The quote taken from my testimony on page 29 refers to the use of marginal component cost versus average incremental component cost in the discount determination. See my response to VP/PB-T1-16(d)(i), above.

c. Again, the quoted portion of my testimony does not refer to this situation. However. for the reasons stated in my Response to VP/PB-T1-20, above, the hypothetical does not provide enough information to answer the question. At a discount of 3 cents. the Postal Service would. as assumed, lose all the mail that cost *competitors* 3 cents or less to process. However, the example does not make clear how much that mail *would have cost* tlie Postal Service to process. Thus, one cannot be sure that the attributable cost of the remaining mail would be 4 cents. as assumed in the hypothetical. Therefore. there is no way of recommending what the discount should be without making further assumptions. This is where the "correlations" referred to in my earlier response come into play.

d Not applicahlc.

e. In terms of the assumptions made in tlie hypothetical, I agree that the average marginal costs figure would be 4 cents.

VPIPB-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.

h. Would you agree that the practical effect of your response to part b is that the Commission should no! 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. hut not others.

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

RESPONSE

a. The questions do not appear to follow from my answer to VPIPB-TI-8. Assuming that the correct reference is to VP/PB-T1-10, as I explain in my testimony on pages 45 to 47, the principles supporting ECPR apply to all the cost differences for mail within a subclass. Thus, from a pure theoretical perspective, the price difference should be equal to the cost difference. When this is so, each piece makes an equal contribution to overhead.

b. The questions do not appear to follow from my answer to VP/PB-T1-8. Assuming that the correct reference is to VP/PB-T1-10, please see my response to VP PB-T1-29(a) above.

CHAIRMAN OMAS: Is there any additional written cross-examination to Dr. Panzar?

(No response.)

CHAIRMAN OMAS: There being none, this brings us to oral cross-examination. Four participants have requested oral cross-examination: the Office of the Consumer Advocate, Parcel Shippers Association, U.S. Postal Service, Val-Pak Direct Marketing Systems, Inc., and Val-Pak Dealers Association.

Mr. Costich, would you begin, please?

MR. COSTICH: Thank you, Mr. Chairman.

DIRECT EXAMINATION

BY MR. COSTICH:

Q Good morning, Professor Panzar.

A Good morning.

CHAIRMAN OMAS: Dr. Panzar, is your mike on?

THE WITNESS: I believe so.

CHAIRMAN OMAS: Okay. Good. Would you pull it a little bit closer to you, please? Thank you, sir.

BY MR. COSTICH:

Q Last night, the OCA served a cross-examination exhibit and provided it to your counsel. Have you had a chance to look at that?

A Yes, I have, and I appreciate the opportunity to view it in advance.

MR. COSTICH: Mr. Chairman, do commissioners have a copy of that cross-examination exhibit?

(Pause.)

CHAIRMAN OMAS: I don't think so.

BY MR. COSTICH:

Q Professor Panzar, this exhibit concerns your response to Val-Pak Interrogatory No. 8(c), and in my cross-examination exhibit, I posed a hypothetical in which there are two categories of mail within a subclass: One is workshare, and one is nonworkshare. When the workshare category was created, the cost difference for that category was five cents, and the discount was set at five cents, and now the cost difference is 10 cents.

I believe your response to Val-Pak 8(c) said that you would recommend that the discount be increased to 10 cents. Is that correct?

A Yes.

Q Then I added some more assumptions to my hypothetical concerning the elasticity of workshare volume with respect to the discount, and that elasticity is assumed to be 0.1, so that doubling the discount from five to 10 cents, which is a 100-percent increase in the discount, would cause 10 pieces to convert from nonworkshare to workshare. Do you follow that?

A Yes, as assumed.

Q Now, the 10 pieces that shift save the Postal Service 10 cents and essentially cost of the Postal Service 10 cents in additional discounts, so that's essentially a financial wash. Correct?

A Correct.

Q But each of the original 100 workshare pieces now receives and additional five-cent discount, which costs the Postal Service five dollars. Does that seem right to you?

A Well, at this point, we need to go back and inquire as to why the cost difference changed from five cents to 10 cents. Presumably, either the cost of the nonworkshared mail increased five cents, or the cost of the workshared mail decreased five cents.

If the cost of the workshared mail decreased five cents, then this five dollars that you are talking about here in terms of the additional five cents in discount is just the pass-through of the cost savings of that decrease. So that involves a no-net change for the Postal Service as well.

Q Well, if the Postal Service has been

collecting in rates that five cent savings up to the point of the rate change, the increase in the discount, it will still be five dollars worse off, will it not?

A Basically, you're saying it was collecting too much between the time that the cost went down and the time the rate changed. So relative to that situation, it would need another five dollars, but relative to the initial situation, you combine the cost change and the rate change, and the Postal Service is exactly where it was before.

Q If we're talking about a cost reduction for the workshare category, and the Postal Service has been collecting that cost reduction as revenue up until the point where the discount is reduced, then the Postal Service will presumably have to recover that five dollars from the other nonworkshare category. Is that correct?

A I don't see there is five dollars to recover. If it took that five dollars of cost savings, as the hypothetical assumes, we're leaving all of the money within this category that five dollars is a cost savings that's accrued to this subclass. So if they weren't collecting that savings, they have been running a surplus on that subclass until the discount change was made. So there is no shortfall, with respect to that subclass, to recover.

Now, if you say they took that five dollars and sent it to some other subclass, and then, when the discount was adjusted, they would have to recover that cost, that might be true, but that doesn't affect the logic of the financial impact of 100 percent ECR-based adjustment of discounts, as I discussed in my response to the interrogatory you cited.

Q Let's assume that the Postal Service used the cost savings to fund institutional costs, and thus was able to postpone seeking any rate changes until it was about to lose money again. In that situation, they have got to get that five dollars back from the nonworkshare category. Correct?

A Well, if they have taken it out of that subclass and used it for something else, then they can recover that five dollars from that subclass, but it's just a wash in terms of the net position of the Postal Service. You can't say that, as a result of the discount policy, you could levy an additional five dollars on the nonworkshared portion of the subclass

They saved that money right away. If they tossed it away or sent it somewhere else, then, yes, they would have to get it back, but if they kept it within the subclass, as the focus of the hypothetical suggests, then there is no need to raise any additional money from the nonworkshared portion.

Q In my hypothetical, the Postal Service does have to raise someone's rates to get that five dollars back, and the result of that effort, at least initially, raising the single-piece rate by the five cents in order to get it back, is unsuccessful in the sense that there are only 90 pieces of first-class mail upon which to impose that extra five cents, which only gives them $4.50.

The end result is that if the Postal Service succeeds in getting back the full five dollars from the nonworkshare category, the Postal Service loses volume, the nonworkshare rate is now more than five cents higher than the original rate, and the workshare rate is now higher than it was originally because the nonworkshare rate has been raised more than five cents, the total discount is now 10 cents, but that results in a rate that's actually higher in the discount category than it was originally. Did you follow that part of the hypothetical?

CHAIRMAN OMAS: Excuse me. If I could interrupt, Mr. Panzar, could you please pull the mike closer? We're not getting a good transmission from you. Thank you. And if you could speak just a little louder, it would be most appreciated. Mr. Costich, you as well, please. Thank you.

THE WITNESS: Yes. I followed that conclusion from your hypothetical, but that conclusion results from the fact that you want to raise an additional five dollars from the subclass, not as a result of applying the 100-percent-discount, pass-through principle.

If ysu want to raise additional money from a subclass, and there is inelastic demand but some elasticity, you're generally going to have to raise rates to do it.. It doesn't come about because of the application of ECPR or the 100-percent pass-through of the cost difference because you haven't accounted for the savings that led to the cost difference growing from five to 10 cents.

BY MR. COSTICH:

Q In my hypothetical, there appear to be no beneficiaries. Is that correct?

A In your hypothetical, the Postal Service has raised an additional five dollars from the subclass in question. Presumably, it's using that for some useful purpose. There are no beneficiaries amongst customers of mail in the subclass because both of their rates have gone up, but the five dollars is an extra five dollars available to the Postal Service.

Q Would a profit-seeking monopolist price according to ECPR?

A It depends on the situation. Sometimes it would; sometimes it wouldn't. In general, as a way of implementing efficient production decisions, that is, the make-or-buy aspect, it would follow ECPR logic. Sometimes it would forego exact application of the ECPR rule in order to extract some additional monopoly profits or monopsony profits, depending on which side of the market it was on.

Q Are profit-seeking monopolists considered to be productively efficient?

A Usually, but sometimes they are willing to forego the productive efficiency of the entire vertical chain of production in order to extract more monopoly or monopsony profits.

By deviating from ECPR, they sacrifice some overall productive efficiency, but a profit-seeking monopolist is, by definition, concerned only with his own profit; he is not concerned with the productive efficiency of the entire sector, so he is happy to make that trade-off when it's necessary.

Q In your testimony, you refer to the cost efficiency of the entire postal sector. Is that correct?

A Several times, yes.

Q And you suggest that the use of ECPR by the Postal Service would encourage productive efficiency throughout the entire postal sector. Is that correct?

A Throughout those portions where worksharing' is involved, it would induce mailers to provide worksharing services when they can provide them more cheaply than the Postal Service, yes.

Q If the Postal Service were a profit-seeking enterprise without a statutory monopoly, would that lead to productive efficiency in the postal sector?

A It depends upon how much monopoly power the Postal Service might have, even without a statutory monopoly. As I indicated in my answer to your earlier question, a profit-seeking monopolist or monopsonist facing a downward-sloping demand curve or an upward-sloping supply curve may choose to forego some productive efficiencies in order to extract some monopoly or monopsony rents.

So we can't know for sure whether the postal sector without a statutory monopoly for the Postal Service would end up being productively efficient or not. It depends on the circumstances.

Q Would a profit-seeking Postal Service without the benefit of the monopoly, the statutory monopoly, tend to move in the direction of productive efficiency for the entire sector, even if it didn't get all of the way there?

A Move relative to --

Q -- the current situation.

A -- the current situation? Well, that's counterfactual, I didn't address in my testimony. It would try to increase its profits. It might have a greater incentive to engage in cost-reducing efforts with respect to its own costs if it had shareholders and residual claimants, but in terms of the structure of the worksharing discounts it offered, as I've said before, it may choose to forego some of the productive efficiencies that could be achieved through worksharing in order to exploit its residual monopoly or monopsony power.

Q Does it appear to you that the Postal Service is doing that right now, deviating from ECPR in order to increase its ability to recover its institutional costs?

A No. That's not my understanding of the way the discount policies are set. The institutional costs are recovered through markups set at the various subclass levels, and the discounts tend to be cost based. So the coverage, the contribution, that a piece from a particular subclass makes, is determined by considerations of recovering institutional costs, but a cost-based, discount structure can be, and it's my understanding is, developed separately from that cost coverage calculation.

Q Are you aware that there is any dispute in this proceeding as to how to set the benchmark rate from which discounts would be subtracted?

A I'm aware that that's been an issue in past cases and this case. I don't know the details of the dispute that you refer to.

Q Are you aware that the implicit cost coverage for workshare mail in the first-class subclass is greater than 300 percent, while the implicit cost coverage for nonworkshare mail is approximately 170 percent?

A I was not aware of those specific numbers.

Q Do those numbers suggest that the Postal Service is extracting excess revenue from workshare mail in order to cover its institutional costs with lower rates for the nonworkshare mail?

A To the extent that -- let me back up a second.

When you gave those two numbers, were they in terms of the percentage cost coverage or the cost contribution per piece?

Q They are just total revenue divided by total cost within the categories.

A Because the basic principles of ECPR would make the value of the difference between price and marginal or unit-attributable costs be the same for workshared and nonworkshared pieces, but the percentage coverage would, of necessity, be higher for the workshared pieces because the costs are lower.

So the fact that we say the percentage of revenues over calculated costs is greater for workshared pieces doesn't necessarily conflict with the ECPR principle. I would have to go more deeply into the numbers to come up with an answer to your question.

MR. COSTICH: Thank you, Professor Panzar. Thank you, Mr. Chairman. I have no more questions.

CHAIRMAN OMAS: Thank you, Mr. Costich.

Mr. May?

MR. COSTICH: Excuse me, Mr. Chairman.

CHAIRMAN OMAS: Yes.

MR. COSTICH: I would like to move the admission of the cross-examination exhibit, which I have marked as XE-OCA/PB-T-1.

CHAIRMAN OMAS: Without objection

MR. OLSON: Mr. Chairman, I would like to clarify if counsel is asking it be transcribed or moved into evidence because --

CHAIRMAN OMAS: I think he said "moved into evidence."

MR. OLSON: In that case, I would object because the witness has expressed his differences with the assumptiors in the hypothetical, so I would say transcription, it makes all of the sense in the world to clarify cross-examination, but I'm not sure what this is evidence of.

MR. COSTICH: That's fine, Mr. Chairman, if we can just get it transcribed.

CHAIRMAN OMAS: Transcribed. Thank you.

(The document referred to was previously marked for identification as Exhibit Nos. XE-OCAP/PB-T1 and was received in evidence.)

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XE-OCA/PB-T9253

WORKSHARE HYPOTHETICAL
FOR WITNESS PANZAR

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

1. A mail subclass has 2 categories — workshare and non-workshare — each with 100 pieces of total volume.

2. When the workshare category was created, the cost difference was 5 cents and the discount was set at 5 cents.

3. Now the cost difference is 10 cents.

Does your response to VP 8(c) mean that you would recommend a new discount of 10 cents?

4. The elasticity of workshare volume with respect to the discount is 0.1.

5. A doubling of the discount (from 5 to 10 cents, or a 100-percent increase) would thus cause 10 pieces to convert to the workshare category.

6. Each of these 10 new pieces saves 10 cents and receives a IO-cent discount, a break-even transaction for the Post.

7. Each of the 100 old workshare pieces receives an additional 5 cents, or $5.00 in total

8. This $5.00 must be recovered from the non-workshare category.

Does your response to VP 8(c) mean that you would recommend a new discount of 10 cents?

9. The own-price elasticity for non-workshare volume is -0.2.

10. The own-price elasticity for workshare volume is -0.1.

11. The current price of non-workshare is 40 cents.

12. Raising the price of non-workshare by 5 cents will not recover $5.00

    a. Only 90 pieces of non-workshare remain — at most $4.50 can be recovered.

b. Raising the price of non-workshare by 12.5 percent (5/40) will cause 2.25 pieces of non-workshare to leave the Post.

13. The price of workshare will be ***higher*** (45+ cents less 10-cent discount = 35+ cents).

14. The price of non-workshare will be higher (45+ cents vs 40 cents).

15. The Post will be financially indifferent.

Does your response to VP 8(c) mean that you would recommend a new discount **of** 10 cents?

CHAIRMAN OMAS: Mr. May?

CROSS-EXAMINATION

BY MR. MAY:

Q Professor, I would like to first talk to you about your response to the Postal Service Question 9, if you have that handy. There, you state, "If price elasticities within a subclass are assumed to be approximately equal, then the issue of different price-elasticity-based markups does not apply as strongly within the subclass as it might across subclasses. Thus, the issue of demand is less important within a subclass than across subclasses, and the case for ECPR does not need to consider the tensions described earlier.

So is it the case that your discussion of intraclass rate differences in your testimony depends, at least, to some extent, on the assumption that the elasticities within a subclass are relatively similar, or, at least, that they are not known so one wouldn't be able to take them into account?

A I wouldn't say the analysis depends on that. It's just the case for cost-based, worksharing discounts is strongest in those situations. You can make the same arguments based on productive efficiency.

Q Is it the case that, in most instances you're familiar with, within the subclass, the elasticity differences are small or simply not known?

A That's my understanding of the general way in which subclasses are determined.

MR. MAY: Well, I would like to talk to you just about the case of parcel post where the elasticities below the subclass have been estimated by the Postal Service and are known to vary quite substantially within the subclass.

So, with that in mind, I would like you to examine two pages of Postal Service Witness's Thress's testimony, which I will provide you.

(Pause.)

BY MR. MAY:

Q Now, I've provided you with page 178 and page 185 of Witness Thress's testimony. Would you agree, if you've had time to examine it, that Witness Thress estimates that the own price elasticity of nondestination-entry parcel post is negative .374? And that would be basically what they call "retail parcel post." Correct?

A Yes.

Q And then, on page 85, Witness Thress there estimates the own price elasticity of destination

parcel post as negative 1.399.
A That's what the table says, yes.
Q And that would be workshared parcel post because it's a destination entry.
A Correct.
Q So the own price elasticity of workshared parcel post is almost four times as much as the own price elasticity of retail parcel post. Is that correct?
A According to these tables, yes.
Q Would you agree, from your review of those two tables, that Witness Thress does not even include cross-price terms between retail and workshared parcel post in his econometric demand equations?
A I don't see them printed out in these tables. I don't know what was in his equations when he estimated them.
Q Well, would you accept, subject to check, that perhaps it did not include cross-price terms because there is no significant cross-price elasticity between these two types of mail?
A Subject to check.
Q And that would be a good reason to leave them out, would it not, if that were the case?
A Yes.

Q Now, I would like to refer you to your response to Val-Pak Question 10(b). Now, I'm going to paraphrase your response, but I believe that you responded basically that the unit contribution of a retail parcel should be the same as a workshared parcel. Is that correct?

A Yes.

Q Now, when you answered that, were you aware of the significant differences in price elasticities between retail parcel post and workshared parcel post and the apparent lack of cross-price elasticity between the two products?

A No. I wasn't referring to any particular pair of workshared/nonworkshared products.

Q Or the elasticity.

A Or what the elasticity difference might be.

Q And, of course, there is no reason for you to do it because there was no mention in the question of that.

A Correct.

Q Given the significantly different elasticities between these two different products and the lack of cross-price elasticity, do you believe that the factors to consider in setting rate differences between these two products should be more similar to the factors that should be taken into account when determining rate differences across subclasses than to the factors for setting intraclass rate differences?

A Could you repeat that, please?

Q Given the significantly different elasticities between these two products, do you believe that the factors to consider in setting the rate differences between these two different products should be more similar to the factors that you would use in determining what the rate difference would be across a subclass rather than within the subclass?

A I just wanted to be sure you were referring to factors in general as opposed to specifically to noncost factors.

Looking at this example, my reaction would be, why are these two services in the same subclass? But taking that as a given, the difference in elasticities that you pointed out suggest that, in weighing the advantages of productive efficiency, as reflected through ECPR-based discount policy versus the Ramsey-type elasticity-based price differences, that the argument in this particular example shifts more to the use of price-elasticity-based differences in setting the market.

Q So, in other words, in these kinds of circumstances, Ramsey pricing should play a more important part in setting the rate differences than efficient component pricing, at least, when those kind of circumstances are known and exist.

A The case in favor of using the inverse elasticity rule to establish different per-piece markups is stronger in these kinds of situations than in the basic, homogeneous elasticity characterization of subclass demand that was the focus of my testimony.

Q Well, I suppose you inverted the question you had immediately -- why are these two products in the same subclass when they have such widely varying elasticities? You're implying, I think, that you believe they should not be in the same subclass if their demand characteristics are so different.

A I have not made any study of how to group products and services into classes and subclasses. I've just said that this would raise a red flag in my mind as to whether to include them in the same subclass.

Q Would Ramsey pricing indicate that the percentage marxup on workshared parcel post should be less than the percentage markup on retail parcel post or more?

A Based on these elasticities with no cross-elasticities, the inverse elasticity rule would apply fairly directly, and we would say that the markup on the workshared product would be less.

MR. MAY: Thank you, Dr. Panzar. That's all I have, Mr. Chairman.

CHAIRMAN OMAS: Thank you, Mr. May.

Mr. Koettinq?

MR. KOETTING: Thank you, Mr. Chairman.

CROSS-EXAMINATION

BY MR. KOETTING:

Q I just have one question, Professor Panzar, which, as chance would have it, also focuses on your response to Val-Pak Interrogatory 10(b) that Mr. May just discussed with you. I don't know whether your discussion with Mr. May might change your response to my question, but I'll ask it as posed anyhow.

Do I understand your testimony correctly, specifically, your response to Part B of Val-Pak Interrogatory 10, to mean that you believe that the unit contribution should be the same for all parcel post pieces, regardless of the weight or the zone or the level of workshare?

A This would be the result of direct application of the ECPR-based cost differences. If the differences for weight reflected the added costs of weight, then the contribution would be the same.

As I indicated in the answer to Mr. May's question, there is always a tension or trade-off between following the ECPR methodology, with its aim to promote productive efficiency, versus exploiting differences in demand elasticities. So, absent any direct information that demand elasticities are significantly different, my testimony recommends following the ECPR logic within a subclass.

MR. KOETTING: Thank you, Professor Panzar. That.'; all I have, Mr. Chairman.

CHAIRMAN OMAS: Thank you, Mr. Koetting.

Mr. Olson?

CROSS-EXAMINATION

BY MR. OLSON:

Q Dr. Panzar, William Olson from Val-Pak. First, I would like to thank you and Mr. Scanlon and Mr. Myers for getting us the responses to the third set of interrogatories yesterday, a day before they were due. It was helpful, and the good news is that that allowed me to strike some questions, but the bad news is that I added a couple.

Let me start with your testimony on page 20, specifically, lines 2 through 5, where you describe what you call "a hypothetical postal network with two vertical components: a downstream delivery component and an upstream composite component consisting of various collection, transportation, and sortation functions." Do you see that?

A Yes.

Q Okay. Many of my questions today will refer to this hypothetical. So unless I specify otherwise, if I say "downstream," I'm talking about delivery; if I'm talking about "upstream," I'm talking about processing and transportation and collection, I guess you would say. Is that okay?

A Okay.

Q And I want to start with clarifying some of the terms you use in your testimony on the next page, page 21. Let me just identify all of the terms so that you see them, and then I can see if I can synthesize them.

In line 7, you have the term "outside vendor." Do you see that?

A Yes.

Q And then, on lines 9, 10, 11, and 22, **you** use the word "a consolidator." Do you see that?

A Yes.

Q And then, on page 22, lines 5 and 6, you've got "providers of competitive services."

A I'm sorry. Which page was that?

Q That's the next page, 22.

A Yes.

Q And then, further down that page, you've got "a mailer or consolidator that performed the upstream functions." Do you see that phrase, lines 15 through 16?

A Yes.

Q Let me just take the phrase that is at the top of page 22, "providers of competitive services," and ask you if that is inclusive of what you call outside vendors. That's my first question. Is that inclusive of outside vendors?

A Yes.

Q And inclusive of consolidators?

A Yes.

Q And inclusive of mailers that perform upstream functions?

A Yes.

Q And so all of those can be considered providers of services that compete with the Postal Service's upstream activities.

A Yes.

Q Okay. To your knowledge, does Pitney Bowes engage in presorting mail prepared by others, which is to say mailers other than Pitney Bowes?

A That's my understanding, yes.

Q To your knowledge, does the subsidiary of Pitney Bowes that does the presort bureau work compete with other presort bureaus for business?

A I would assume so. I don't have any direct knowledge of who they compete with.

Q Do you have any knowledge of the competitive nature of the presort bureau industry? Do you know it to be a competitive industry or not?

A I know there are many providers of services in this industry. I'm not aware of any industrial economic studies that attempt to quantify the extent of competition in the usual academic sense, but, speaking loosely, I would characterize it as a competitive business, but I don't know, for example, the four-firm concentration ratio or Herfendahl index or any technical attributes of a market such as those.

Q Yes. That's way past what I was asking. I was just talking about the members of Joel Thomas's National Association of Presort Mailers, for example, that there are other companies beside Pitney that do presort work and compete with each other for business for mailers, in general terms.

A Certainly.

Q And, in fact, wouldn't those firms, Pitney and the other presort bureaus, also compete with this hypothetical postal network that's in your testimony as to the upstream activities?

A Yes. If they are given an opportunity through the establishment of worksharing discounts, they compete to that function. Since there is a statutory delivery monopoly, and, by presumption, the upstream function has no value to final consumers in and of itself, that is, without delivery, their competition with the Postal Service is basically, if allowed to, -- the structure of worksharing rates. If there were no worksharing discounts, this industry would disappear.

Q Rignt. But things being what they are, with worksharing discounts, we do see competition between presort bureaus or among presort bureaus, first of all -- yes? --

A Yes.

Q -- and we see compensation between presort bureaus and the Postal Service for this upstream work. Correct?

A Correct.

Q Okay. In your testimony, at several places, you refer to the paper by Cohen, et al., and you reproduce a table on page 4 or 5, I think, of your testimony which comes out of his paper. Isn't that correct?

A Yes, I do.

Q Page 6. I'm sorry. And Cohen, in that paper, has an estimate of 150 million pieces of mail that were workshared to some degree out of a total Of 206 billion pieces. I hope I said "billion" in both cases. I'm sorry. I meant to.

I take it, you must have had some confidence in that number, at least in general terms, as you reproduced this chart. Correct?

A To the extent that it was used for illustrative purposes to indicate how pervasive worksharing was. I made no independent study, quantitative study, of the extent of worksharing.

Q I wasn't headed in that direction. But when Cohen adds up workshared volume, he is talking about mail that receives worksharing discount. Is that correct?

A That's my understanding.

Q So a portion of the workshared mail that Cohen presents of 150 billion pieces; some of that receives some transportation and presortation within the Postal Service. Isn't that correct?

A I would assume so. There are several of his co-authors in the room. You would probably be better off to ask them.

Q I've got you on the stand, though.

But the concept is that, for example, if you entered mail at a DBMC, the Postal Service is going to do some transportation, for example, of that mail that it might not do if it was DDU entered. Correct?

A Yes.

Q Okay. But, on the other hand, particularly with DDU-entered mail, there is some of that workshared mail that bypasses virtually all Postal Service sortation and transportation. Is that not correct?

A I would assume so.

Q And I think you probably already said this, but with 150 billion pieces workshared mail out there, that indicates, in and of itself, does it not, that there is some extensive amount of competition for the upstream component of the network currently, under current rates with the Postal Service? Is that not correct?

A Yes.

Q Let me ask you to look at your Interrogatory

4, please, Val-Pak Interrogatory No. 4. Do you have that? I'll walk you through what the relevant parts are. Let me know when you --

A Yes. I've got the number four.

Q Part A of that interrogatory hypothesized a situation where there were competitors to the Postal Service's upstream activities, and they could provide the same services the Postal Service could but at a lower cost. Is that about right?

A I'm just trying to check whether the assumption of lower costs was introduced --

Q It's the last line right above A. It says: "One sample of the cost curve of the postal administration...."

A Okay. Yes.

Q So you agree that's basically what A says.

A Correct

Q Okay. And then, in B, let me read you your response. It says: "In this situation, it would be efficient for competitors to capture all of the upstream activity." Correct?

A That was my response to Part B, yes.

Q The result of that, of course, if it's most efficient for competitors to capture all of the upstream activity, I take it, is that the Postal

Service would probably close down its upstream activities and allow the competitors to do all of the upstream work. Would that not be correct?

A Under the assumptions specified in this hypothetical, that seems to be correct, yes.

Q That's all I'm asking, is under those assumptions, and, admittedly, this is all a hypothetical. But let me ask you, would you have any, and we're assuming the hypothetical to be true, under this scenario, would you have any qualms or reservations about recommending discounts and a pricing structure that would allow the more efficient outside competitors to capture all of the upstream activities and take that away from the incumbent postal administration?

A No, not under these circumstances.

Q So you have no reservation about following efficiency through to its logical conclusion, then

A Again, not under --

Q -- under these circumstances, yes. Okay.

And if you could look at your response to our Interrogatory 14, this question asks you to assume that the Postal Service's upstream component was separated from the downstream component and privatized. Correct?

A Correct.

Q Okay. Now, following privatization in this hypothetical, would you be willing to assume that the upstream component, in its now new, privatized status, would continue to collect and sort and transport mail? This is what used to be the Postal Service, now broken off, privatized. Would you assume that the upstream component would continue to collect, sort, and transport mail?

A If its cost structure allowed it to successfully compete in the marketplace, yes. I should point cut that you changed the cost structure between this hypothetical and the previous one. You've adopted my fixed-cost-plus-constant-marginal-cost simplification for the upstream costs of the Postal Service in Interrogatory 14, whereas back in number four, we had that ordered, downward-sloping collection of curves. So we've shifted situations a bit.

Q My question is actually going to be very practical and not theoretical, but **I** appreciate your pointing that out for the record.

If there were to be this type of hypothetical privatization, is there any reason that Pitney and other presort bureaus and other consolidators and vendors and other firms that provide upstream activities, is there any reason to believe they would not continue to be competitors of the Postal Service, if, of course, the Postal Service were able to operate efficiency enough to stay in business, as you said?

A I would assume that they would, yes.

Q Let me ask you to, then, take a look at how you responded to 14(c) because I'm not sure I understood this.

In 14(c), you say, "The outcome proposed is not competitive; rather, it is a situation of bilateral monopoly." Correct? And then you go on, but let me just stop there for a second. Okay?

Wouldn't a bilateral monopoly mean that the downstream delivery component has a monopoly, and the upstream component also has a monopoly? Is that what you mean by "bilateral monopoly"?

A Yes.

Q Then aren't you assuming that all of the existing competitors to the Postal Service, like Pitney Bowes, would cease to exist so that the Postal Service would have a monopoly over that upstream work?

A Well, that's why I brought up the issue about the cost structure. Under the cost structure assumed in the question taken from my paper, you have the case where the hypothetical, privatized, divested, upstream Postal Service has globally decreasing average costs of providing that upstream function. Essentially, it's a natural monopoly under all ranges of output.

So either its cost curves are too high for it to be a market player, in which case it would be priced out of the market, and you would have a competitive situation, or if it's active in the market, it will be either a monopolist or dominant firm. It's not a situation were it will be one of many competitors all taking prices given.

The assumption of price-taking behavior on the part of the hypothetical divested postal enterprise is not consistent with the cost structure assumed in the question. So that's what I meant in my answer to Part C. Under these circumstances, you're going to have either a monopolist or dominant upstream Postal Service firm dealing with a statutory monopoly downstream.

Q Well, let's assume the cost curve of the Postal Service is not such that it has a natural monopoly to have such low costs as to drive out all competitors, like Pitney Bowes. Under that scenario, there is no reason to believe that that would happen, is there, in the real-world illustration, if you were to take the Postal Service and privatize it this way?

A That is a very interesting, empirical question. I don't have any direct knowledge as to what would happen, but let's suppose that the cost structure of this hypothetical, divested, postal upstream entity were such that it was just one of many competitors, if you could. That's not what's specified in the hypothetical in Question 14, but let's go from there.

Q Okay. So, basically, your response, that our hypothetical describes a bilateral monopoly, is premised on the fact that we were assuming that the Postal Service was facing a very low cost curve in the upstream area. Is that what you're saying?

A Well, that specified that the average cost is everywhere downward sloping, so there is nothing that limits the size of the Postal Service in a competitive market. That's all that I was pointing out.

So if you want to posit a situation in which this divested postal entity is one of many upstream competitors, you have to have a different cost structure to go with that, one that eventually decreasing returns to scale set in, and the Postal Service wouldn't capture all of the market, or be eliminated entirely from the market.

Q Okay. Thank you. Let me ask you to look at your testimony at page 20. We started with this before the section above about your hypothetical postal network, but on lines 10 and 11, you talk about fixed costs that relate only to upstream activities, and those, I believe, you identify as F_u. Correct?

A Correct.

Q If the upstream activities of the Postal Service were unbundled and privatized, as we're positing, and all mailers who now use the Postal Service for some or, in some class, all of their upstream activities continue to use the Postal Service's new, privatized, upstream entity, wouldn't that privatized, upstream entity have to recover these upstream fixed costs, F_u, from the mailers who would be using that entity?

A Yes, if were to break even and remain in the market.

Q Page 24, please, of your testimony. You have a section there that you call "Preservation of Contribution." Let me just ask you, is it your testimony that all fixed costs should always be recovered from markups on the delivery function? **Is** that what the conclusion is of this section?

A In terms of the example presented here, with two components and a delivery monopoly, that's correct. The markup over marginal costs can be attributed to -- that's basically viewed as falling on the delivery function.

Q So we see all, 100 percent, of fixed costs being treated as institutional, and all of those institutional costs being recovered from the delivery function.

A Well, they are recovered from the services. The contribution of each piece is the same. So a piece that uses the upstream function makes the same contribution to the institutional cost as a piece that doesn't use the upstream function.

Q Which is another way of saying that the markup is only on the delivery function and that there is no markup on the sortation and transportation. Correct?

A You could interpret it that way. Each piece has a markup --

Q No. I understand the pieces --

A -- over its marginal cost.

Q No. I understand every piece has a markup, and if it has the same unit markup on all pieces, and all pieces use delivery, but not all pieces use sortation or transportation, then isn't it fair to say that you're recovering all of the institutional costs from a markup on delivery?

A Yes. I mean, it's part of the structure of the analysis. You could characterize it that way, but, again, each piece makes a contribution.

Q Yes. Are you aware of the fact that the Commission considers specific fixed costs to be attributable to the class or subclass of mail for which those fixed costs are incurred?

A Specific fixed costs specific to services, yes.

Q Is it your understanding that the Commission's attribution of those specific fixed costs to be based on causation?

A The attribution of specific fixed costs would, in my understanding, be to the services that cause them, yes.

Q You don't have any problem with using causation as a basis for attribution in this case, do you, in specific fixed costs?

A No.

Q Do you think that the principle of causation is misapplied when it's used to attribute specific fixed costs?

A No, except to the extent they are included in marginal costs, as has sometimes been an issue in rate cases, but in terms of their being assigned to the incremental costs of a particular service, no, I have no problem with that.

Q So, in fact, you have no problems with the attribution of those specific fixed costs, not just incremental costs for purposes of cross-subsidy check but attribution of the specific fixed costs. That doesn't present a problem to your analysis and your model and your way of looking at postal costing.

A NO.

Q Is the reason that you accept specific fixed costs as the Commission uses them, is the reason you accept that as being appropriate under your model, even though they are fixed costs -- is it because of the fairness aspect of this that the mailers who cause the cost to be incurred are paying that cost?

A I wouldn't put it exactly that way, but it is an issue of causality. Those costs are caused by the service in question.

Q And if they are caused by the service in question, such as registered mail, the cost of the registry cage, which is fixed, irrespective of volume -- that's one of the classic illustrations that I know I worked on in R87-1. The registry cage is a fixed cost. Correct? It's there, irrespective of whether there is one piece or 10,000 pieces in the cage.

A Within certain limits, yes. They have some rule for adjusting the number of registered cases.

Q So, in other words, it may not be completely fixed; it may be partially fixed.

A But let's take it as a fixed cost.

Q And if it is, and you charge those costs to registry, to registered mail, then you're not asking any other mailer who didn't use registered mail to help pay for them. Correct?

A Correct.

Q And there is a fairness in that, is there not? I didn't come up with fairness out of the air. It is a criterion that we've talked about a lot.

A Yes. There is a certain intuitive fairness in that.

Q Let me ask you, based on our discussion of registered mail and specific fixed costs, is it your testimony that no fixed costs should ever be, under any circumstances, attributed, as I had thought you to say before, or perhaps I misunderstood. A moment ago, you said you didn't have any problem with the Commission attributing specific fixed costs, but from your testimony, I have the concept that you thought that attributing fixed costs would be the wrong thing in any case.

A Attributing fixed costs. I don't recall saying that.

Q So that's not a position you take as the consequence of your theory in your testimony.

A No. You have to distinguish between specific fixed costs and complement fixed costs. Specific fixed costs refer to a particular service and are caused by that service and would disappear if that service went away.

Component fixed costs refer to a level of the postal value chain, sorting or delivery, in terms of my example, those F and F,. Those costs wouldn't go away unless the entire component went away. They wouldn't go away if one particular service that used that component went away. That's why they are not assignable to a particular service in the way that service-specific fixed costs are.

Q Let me come at it from a different angle. Let's talk about the private sector and a company like

Pitney Bowes that has a subsidiary that presorts mail. You would expect that that kind of service bureau would have costs that are fixed, i.e., not volume variable, would you not?

A Yes.

Q And you would expect that Pitney would price its services to recover both its volume variable costs and its fixed costs and even a profit. Correct?

A Presumably.

Q So what I want to ask you is, if Pitney Bowes' presort subsidiary had to recover their fixed costs from mailers who use their upstream services -- they are the oniy ones they have to charge, their customers -- why shouldn't the Postal Service recover its upstream fixed costs from the mailers who use its upstream services? I'm talking about the F_u costs, the fixed costs associated with the upstream network.

A They are recovered from all mailers because they are not specific to any particular service. If one service that used the upstream facilities went away, the fixed costs wouldn't go away. I don't understand the fairness aspect of your question.

If one wants to ask whether mailers who don't use the upstream function are being unfairly treated, then it's a very simple test for that. You compare the rates they pay with the unit cost of the components that they do use. In this example, you would compare the rate of the delivery-only service with the average cost of delivery, and as long as the rate was less than that, you couldn't argue that that mail was being unfairly burdened.

Put another way, the mail that did use the upstream functions, as long as it covers the incremental costs of its operation, you couldn't say it was unfairly burdening the other categories of mail.

Only when you start talking about eliminating all of the upstream function can you start addressing the issue of whether or not those component fixed costs will go away.

Q Well, I still think there is a fairness issue here I would like you to address one more time. What is the rationale, fairness rationale or other rationale, for assessing component-specific, fixed costs on those customers who don't use that portion of the network? They have no need for that portion of the network. They don't care if that portion of the network exists. What is the fairness argument that supports assessing those component-specific, fixed costs on mailers who use delivery only?

A Again, you're posing the fairness question backwards, as it were. The question is, are those mailers who use the delivery portion of the network only paying more than what it would cost them to provide delivery themselves, a standard, standalone cost test for cross-subsidization.

There is nothing in the application of cost-based differences, or ECPR, as recommended and discussed in my testimony, that would result in mailers you're talking about being unfairly treated in the sense of providing a subsidy to mailers generally. The standard test for cross-subsidization would be passed.

Q So can I summarize your answer as saying, as long as the mail that uses all of the upstream portion of the network -- sortation and transportation -- as long as they cover their volume-variable costs, that that's the end of the investigation, and you cannot think about fairness in terms of all of the burden of all fixed costs, including the fixed costs associated with the upstream network, being imposed on delivery and thinking that's unfair. Economics does not allow you to think that way, good economics.

A The upstream fixed costs are not assignable or attributable to any particular upstream service that uses them. You would have to look at the totality of those services. You would look at the incremental costs and be sure that they are covering -- each service or group of services covering their incremental costs and no services paying more than their standalone costs. That's as far as economists are typically willing to go in terms of the fairness issues you're raising. By that standard, ECPR doesn't create difficulties the way Ramsey pricing might, depending on the elasticities involved.

CHAIRMAN OMAS: Excuse me, Mr. Olson. Could you tell me how much longer you have with this witness?

MR. OLSON: Probably 15 or 20 minutes. I would be glad to break now.

CHAIRMAN OMAS: Why don't we take a 10-minute break and come back at eleven-fifteen?

(Whereupon, a short recess was taken.)

CHAIRMAN OMAS: Mr. Olson, you may continue.

MR. OLSON: Thank you, sir.

BY MR. OLSON:

Q Dr. Panzar, as we've been discussing your thoughts as to why certain specific fixed costs, like registry, could be properly attributed but not costs of upstream activity, the key point you seemed to be mentioning was that there are more than one upstream activity product as opposed to one in the case of, say, registered mail. Is that part of what you said?

A Yes. That's part of my response, yes.

Q Well, let's take a simplifying assumption and ask you to consider a different type of worksharing scenario for the Postal Service that we have never had. Let's assume that there was just one type of workshared discount offered. Let's assume, say, that all mail is handled the same. It's all in one class, but you get a discount if you drop it off at a DSCF, and that's it. That's the total rate structure of the Postal Service in terms of upstream/downstream.

In that scenario, where there is only one upstream product, would that allow you to, based on your economics, to attribute the F,, fixed costs of the upstream network, to that product?

A I believe so. Let me make sure that I have your hypothetical correct. There is only one generic service, and it's either workshared or not. The workshared function doesn't use the upstream portion; it uses only delivery. Correct so far?

Q Basically.

A Then you would need to check to see that the workshared product did not pay more in rates than the standalone cost of delivering it alone. The nonworkshared product would have to cover its incremental costs, and in this hypothetical but not in the general, typical postal situation, but in this hypothetical, the incremental cost of that end-to-end, nonworkshared product would include those upstream fixed costs because if that end-to-end service went away, so would those upstream fixed costs.

So, in that context, those fixed costs would be entirely caused by the nonworkshared product. As soon as you have two nonworkshared products or a hundred nonworkshared products, you wouldn't be able to make that simple, clean assessment.

Q Before you go further, I'm going to lose my question, but with respect to the simplifying assumption of one nonworkshared, upstream product where all of the costs would go away if the product went away, you would be comfortable in attributing the fixed costs to the upstream product, having the burden of the F_u fixed upstream costs imposed on the price charged for the upstream component. Correct?

A Correct.

Q I'm sorry. I didn't mean to --

A I think we covered that. The key

distinction is between components and services, and that distinction tends to get blurred when you only have one service using a component when, in general, there are typically many services using a component.

Q Mercifully, I'm going to change topics to your response to our Interrogatory 13. I know this is a long interrogatory with a long response, and I don't want to, at the moment, focus you on anything but the preamble for the purpose of this question. You recall this interrogatory generally?

A Yes.

Q Okay. The preamble -- before we get into Question A -- described a situation where there is a for an end-to-end service, and that price is the stamp price that you identify as "P," but there is a price for delivery, which is P,. You used those terms in your testimony. Correct?

A Yes, to describe worksharing discounts, yes.

Q Okay. And, again, let's make a simplifying assumption. Let's assume there is only one workshare discount, and we'll call it "W," as I think you do in your testimony, for both mailers, especially for those who are evaluating using the Postal Service's end-to-end service versus looking at Pitney Bowes, let's say, and using their presort services and then have it entered at the Postal Service

Would it be reasonable for mailers to view the Postal Service discount, "W," as the implicit price which the Postal Service wants them to pay for providing the upstream functions?

A It's the implicit price of that service component, yes. but you can't buy that component separately on a standalone basis from the Postal Service; that. is, you can't give them a letter, have them sort it, and then have them give you back the letter.

Q Exactly. But a mailer that has to choose between using the Postal Service end-to-end, full bundle of services and choosing Pitney to do some of the presort and then having the Postal Service finish up and deliver it, they could view your "W" as an implicit price of the upstream activities. Correct?

A Yes. They are more likely to view the discounted service and compare that to the full stamp price, but it comes to the same thing, especially in this example.

Q I just went through four pages that your answer has helped me get through from yesterday. Thank you.

If I could ask you to look at our

Interrogatory 11(b), and this is purely a question about terminology. In 11(b), you say that "marginal costs are evaluated at a particular level of output." Correct?

A Correct.

Q I want to contrast that, if you can hold your hand in there and go to 15(c) where you use a different term, in three lines up from the bottom of your response to 15(c), you talk about "marginal avoided component costs." Do you see that phrase?

A Yes.

Q My question is, are marginal costs, which are evaluated ai a particular level of output, the same thing or identical to what you call "marginal avoided component costs"?

A "Marginal costs" usually refers to the entire cost of a unit of a particular service, but, in discussing discounts, it's sometimes used to refer to the marginal cost of one component only. That's certainly the way I'm using marginal avoided component costs here in my response to 15(c). That sort of clearly specifies which kind of marginal cost I'm talking about.

Looking back at 11(b), it looks like I'm talking about marginal costs in respect to a particular component as well, so I think they are the same concept.

Q So marginal avoided component costs in 15(c) --

A Because 11 talks about avoided costs as well.

Q Let me just put it -- see if I can state it and see if this is what you're saying. In 15(c), where you say "marginal avoided component costs," is that just another way of saying the change in costs when mail volume changes by a single piece of volume?

A The change in the cost of that component, yes.

Q Okay. That's all I wanted to figure out.

If you could turn to 6(f), the question generally asked about applying Ramsey to letters and flats in the same subclass, assuming that the elasticities are equal and that there is a cross-elasticity, and it asked about the effect of that cross-elasticity, as to what effect it should have on the resulting pass-through. You don't use the word "pass-through." That's about what the question dealt with.

A Right.

Q And then, in F, you say, "I did not deal with the details of Ramsey price and formula in my testimony. This question calls for a detailed analysis of a particular cost, i.e., equal own price elasticities with a non-zero, cross-elasticity that I have not analyzed, nor do I know the paper in the literature where the case is explicitly discussed." Correct?

A Yes. That was my response.

Q Just a question or two about the literature, which I'm certainly not expert in, but are you familiar with the concept of super elasticity?

A Yes.

Q And is super elasticity a way to express both own price elasticity and cross-price elasticity in a sort of simplifying manner for equations and such, or can you give me a better definition?

A That's the concept used to address this case; that is, you would have to look at the formula involving the super elasticities, and a particular situation posited here is looking at a super elasticity where the own price elasticities were equal, a special case of the super-elasticity analysis.

Q Are you saying that none of the papers that you're familiar with on super elasticity are applicabl to the question at hand in six?

A Oh, no. I'm not saying that at all. You could find many papers which have a general formula stated in terms of super elasticity, and then you could plug in the particulars of your example. So I just meant that I hadn't done that, nor did I know of a paper that looked specifically at the case where the own price elasticities were equal. I guess what I'm saying is I couldn't easily look up that answer for you.

Q Are you familiar with a paper, and I'm sure I've seen the name, but I'm sure I'll mispronounce it, Villemeur, Cremer, Roy, and Toledano, that was presented at one of Michael Cru's meetings in April '02?

A That group has presented many papers. What year was this?

Q April '02. "Pricing and Worksharing Discounts in the Postal Service."

A I've looked at the paper. I've seen it.

Q The paper discusses situations where the rate differences under Ramsey would be larger than under ECPR wit.; cross-elasticities. Does that help your recollection at all?

A Man;. of their papers discuss that case.

They essentially analyze Ramsey prices and compare the resulting Ramsey prices to ECR-based standards **as** a benchmark.

Q That, in and of itself, isn't helpful in responding to this -- that's all I'm asking -- that paper.

A That's probably one of the papers you could go to find the formula that would be useful in answering this question, but I doubt that it has the precise answer to this hypothetical.

Q They cite two other papers, one by Robert Mitchell in '98 in Montreaux and one by Roger Sherman called "Optimal Worksharing Discounts" in the Journal of Regulatory Economics. *Any* idea as to whether those are helpful?

A Sherman's paper wouldn't be helpful on comparing this -- which was the other one?

Q Rohert Mitchell's paper. It was given in Montreaux in '98, "Postal Worksharing Welfare Technical Efficiency in Parado Optimality," which I don't know if you're familiar with that one also.

A Yes. Again, you'll probably find formulas in there which could be specialized to the context of this hypothetical, but I doubt that it deals with it as specified here.

Q Okay. I just have a couple of quick, finishing questions from what you provided us yesterday, an2 I want to end with that. If you have that set of interrogatories, let me ask you to turn to Interrogatory 16(e).

We asked you to look at Section 6(b)(2) of your testimony, which begins on page 35 and runs through 39, and in that section, you deal with avoided costs. Correct?

A Yes.

Q Just again, trying to get at the terminology here, we asked ycu if your use of the term "cost avoided" in these approximately four pages of testimony meant marginal cost, average marginal cost, volume variable cost. or average volume variable cost, and you said, "Depending on the details of the situation, they would correspond to any of these terms mentioned."

A Because when reading over that section, the only term I used is, I believe, is the avoided --

Q You used "avoided costs" and "cost avoidance" seven times.

A But I didn't specify structure of the component cost function. In that case, the unit avoided cost, which is the relevant concept, could correspond to -- let's see --

Q -- marginal cost, average marginal cost, volume variable cost, average volume variable; those are all different economic concepts.

A But in most of the examples, as the circumstances under discussion in Section 6(b)(2), you have a constant cost of sorting for the Postal Service, and if it's constant, these terms are essentially going to coincide: marginal cost, average marginal cosi. If this said "unit volume variable cost" and "average volume variable cost" --

Q So you're saying not that you have to look at the context and then decide which of the four meanings it is, but in these pages of your testimony, they are all equal, pretty much.

A I don't know that I would go so far as to say they are all equal, but it should be clear from the context what type of avoided costs I'm talking about.

Q So we have to look at each of the seven or so references and then, by context, decide which of the four definitions.

A Well, my recollection is I talk about this in fairly general terms, not in the context of the specific algebraic or diagrammatic analysis.

Q Okay. Let me ask you to look at your response to 28(c).

BY MR. OLSON:

Q No. 28 is the one that had that chart that we had to replace earlier and I'm not sure if you had the complete chart when you responded here because in the middle of (c) you say the example does not make it clear how much that mail would have cost the Postal Service to process. See that sentence?

A Yes.

Q I mean, if you look at the chart do you see that there's a cost curve for the Postal Service?

A Yes.

Q And that in Scenario K it crosses at three cents and at N it's two cents?

A Yes.

Q You say then, thus one cannot be sure that the attributable costs of the remaining mail would be four cents as assumed. I mean, we're asking you to assume that in a hypothetical. Are you saying it's impossible that it be four cents, it's an illogical assumption, or you just didn't want to assume it?

A Let's see. What the hypothetical says is suppose instead that the Postal Service cost curve and the competitor cost curve are shown in the following graph, right?

Q Yes.

A Okay. Now, the problem with these graphs is that they're trying to collapse basically a two-dimensional issue down to one dimension. You specified that each curve orders the mail of the Postal Service or the competitor according to its own cost of processing from highest to lowest, but that doesn't tell us what the costs of the other entity would be unless the costs are perfectly correlated.

That is unless you assume that if you have two pieces of mail and one piece always costs the Postal Service more to process than the other that rhat same ordering will apply for the competitor and there's really no reason to assume that.

The paper that is cited from the recent postal conference that was cited earlier discusses that in excruciating detail which I hope to avoid here, but basically your curve indicates that at a discount of three cents all that mail that costs the competitor less than three cents to sort would disappear

That's true, but in the absence of perfect correlation we don't know how much that mail would have cost the Postal Service had it retained those volumes. That's why I couldn't complete the answer to this question.

Q So are you talking about the difficulty of trying to measure costs that are not incurred by the Postal Service to handle mail that it doesn't process and transport?

A Well, in terms of this diagram, yes.

Q That is actually a broader question, isn't it --

A Yes. It certainly is.

Q -- when you talk about avoided costs? You certainly can't go to look at the balance sheet of the Postal Service, or their financial systems, or whatever to measure costs that they don't incur. Do you have a method to do that, measure costs avoided?

A Well, as I think I stated in one of the interrogatories when the cost to the Postal Service of sorting mail is heterogeneous then you're faced with a trade off involving how many rate categories you have on the one hand to make -- if you have enough rate categories then you can make the cost to the Postal Service more or less homogeneous, but you make the rate schedule more and more complex.

If you have to group mail with different cost characteristics to the Postal Service and the costs of the Postal Service are not perfectly correlated with those other mailers any time you set a discount that's going to determine what the mailers do, but some of that mail may end up costing the mailers more than it would have costed the Postal Service.

As I said I went into excruciating detail in a recent conference paper, but you're always going to be faced with that trade off between how finely you divide up the rate schedule and the risk that if you have only one instrument, one discount, you're going to make both Type 1 and Type 2 errors, some mail inefficiently sorted by the Postal Service and some mail inefficiently sorted by the discounters.

What I tried to do in that paper was set up a framework that specified well, you know something about how mailer costs and Postal Service costs are correlated and you sort of try and come to the best version of that trade off as you can, but there's no simple or simplistic solution as the basic ECPR analysis with homogeneous costs at the Postal Service would allow you to do.

It's a complicated question and many of the details of your interrogatories are addressing it.

Q I was a co-conspirator with you in getting us away from the interrogatory I started with. I just want to go back to it quickly to say can you assume that this is the cost curve that the Postal Service faces at these various volume points and help us with a response to the question or is it just impossible to do?

A It's not a question of being unwilling to assume that this is the ordered cost curve that the Postal Service would face. It's that even assuming that is not enough to answer the question. That's my difficulty.

Q Thank you. I need not understand all answers. Let me just finish with No. 26. This is my last question, your response to that. In No. 26(b) we said is it fair to interpret your response to this prior interrogatory to mean that you recommend the Commission not apply the noncost factors in Section 3622(b) below the subclass level?

You say no. So I guess that we have a lot of negatives there.

A Yeah. There's too many negatives I guess.

Q Three negatives. You go on to explain, you quote your prior answer. You say, "my testimony does not suggest that noncost factors should be applied below the class and subclass level". Let me ask it another way. Let me just say are you recommending that the Commission not apply noncost factors of the act below the subclass level?

A Isn't this the same? I'm just trying to make sure I understand whether you've changed the question or not so I know whether it's -- like I said it's hard to keep track of it.

Q Well, with three negatives I sort of flipped it around to what it is you are actually recommending as opposed to what you may not --

A Basically I'm not recommending anything on that point.

Q Can I restate it just to make sure that the record is clear as to what my question is and then I think you'll have exactly the same answer, but lest we be confused when we try to reconstruct this. The question is are you recommending to the Commission that it not apply the noncost factors of the act below the class and subclass level?

A I don't believe I'm making a recommendation either way on that. As I explain with my discussion of the ECPR rules they implicitly say that well, we're going to only deal with cost factors within a subclass, so in the sense that I'm recommending ECPR that's kind of an answer to your question saying well, you don't need to look at noncost factors.

This gets back to the statement I made about the presumption that elasticities are presumed equal across members of a subclass, but of course elasticities are not the only noncost factors that the Commission might want to consider, so I wouldn't presume to try to dictate to the Commission where to apply and where not to apply noncost factors in large part because as an economist I don't really have any particular expertise on noncost factors with the exception of the elasticities used in the Ramsey pricing analysis.

Q So you're not making a recommendation either way to the Commission as an economist as to whether rhey should apply the noncost factors of the act below the class and subclass level?

A Now I've turned myself around in this. No. I'm just recommending that differences in rates within a subclass be based on cost differences.

Q Only?

A That's my basic recommendation. Yeah. There are other, I mean, as distinct from using demand elasticities as has come up in previous questions, but it came up in other interrogatories where it talks about well, if you introduce a discount or a change in a discount that's going to have a big impac on rates and revenues and things like that.

Well, one of the noncost factors is as I understand it is to avoid rate shock, so I wouldn't say don't take that into consideration when following my recommendation to base intra subclass rate differences on cost differences if it involves a large change.

Q Basically rate differences within a subclass are to be based on costs according to your approach?

A Yes.

MR. OLSON: Okay. Thank you so much. I really appreciate your responsiveness today.

Thank you, Mr. Chairman.

CHAIRMAN OMAS: Thank you, Mr. Olson.

Is there any follow-up cross-examination?

Mr. Koettinq?

MR. KOETTING: Thank you, Mr. Chairman.

FURTHER CROSS-EXAMINATION

BY MR. KOETTING:

Q Professor Panzar, you had some discussion earlier with Mr. Olson in which as I recall you kept trying to use the terms marginal cost, and incremental cost and stand alone cost and he kept returning to the concept of attributable cost. To your knowledge does the term attributable or attribute have a specific meaning in economics?

A No. As far as I know it's a postal term of art.

Q Do you recall testimony that you provided on behalf of the Postal Service in R1997 in which you tried to lay out your recommendations in terms of the best way for postal rate makers to apply the economic concepts of marginal cost and incremental cost to avoid some of what I believe you termed the ambiguity in the statutcry term attributable cost?

A Yes.

Q Would it be safe to say just generally speaking that it wasn't your intent in any of the things you said in response to Mr. Olson's question to retreat from the framework that you laid out in your P.1997 testimony in that regard?

A No, it wasn't. That's why I made the parenthetical remark about the inclusion of specific fixed costs in the calculation of marginal costs.

MR. KOETTING: That's all I have, Mr. Chairman

Thank you, Professor Panzar.

CHAIRMAN OMAS: Is there anyone else?

(No response.)

CHAIRMAN OMAS: Dr. Panzar, I'd like to ask you one question before I ask the rest of the Commissioners if they have any. Starting at page 35 of your testimony you address benchmark selection for the estimation of cost avoided of first-class workshared mail. If I understand you correctly you say that the Commission should be looking at the type of mail just at the margin of being profitable for mailers to workshare.

I have a couple of questions about what exactly you mean by that. First the last time the Commission addressed this issue was in R2000-1. It defined the benchmark as the mail most likely to convert to worksharing and also the category to which currently workshared mail would be most likely to revert if the discounts no longer outweighed cost of worksharing.

Could you explain the difference between the mail described by this definition and what you consider to be the more appropriate benchmark?

THE WITNESS: I think I understand the first definition you gave. Chairman Omas, but could you repeat the second one? I understand the usage of the mail most likely to be workshared, but then you gave an alternative characterization.

CHAIRMAN OMAS: It defines a benchmark as the mail most likely to convert to worksharing and also the category to which currently workshared mail would be the most likely to revert if discounts no longer outweigh the cost of worksharing.

THE WITNESS: Okay. The concept of the average Postal Service avoided cost of mail most likely -- I'm sorry. At the margin of being workshared was a theoretical concept that came out of my theoretical analysis in the paper that's been cited in my testimony. I have thought long and hard about how to make that a practical quantifiable measure without coming to what I think is any particularly implementable or helpful solution, but this is still an area of research in progress

I think the distinction between what's at the margin of being workshared and what's most likely to be workshared is quite clear. Mail that's most likely to be workshared is arguably mail that's very clean sort of intrinsically. It comes out of the mailer's computer system and is easily printed out with a barcode or whatever.

That mail would be profitably workshared by the mailer even if the discount were much, much less than it currently is, maybe a cost of a computerized large bank. The addresses come out in a way to satisfy the worksharing conditions at an incremental cost to the mailer of a half a cent, then a discount of four cents. They're certainly going to go.

If you interpret most likely to be workshared as the mail that's sort of most suited intrinsically which is the way I interpreted that statement from past cases then that mail is certainly not going to be at the margin as described in my theoretical analysis. If the discount is four cents well, then the mail at the margin is that which costs mailers 3.7, 3.8 cents to make suitable for worksharing, so conceptually the distinction is I think fairly clear

The problem is saying well, we look at the mail that the Postal Service actually has and we want to try and find which of it was at the margin of being workshared and not workshared and calculate the Postal Service cost of that. Well, it's not so clear how to do that at this point. I think the previous benchmark was bulk metered mail. It's clear that's not at the margin. That's way inside the margin.

That makes it too clean a benchmark to use, but of course that was the last case, this case which is what I was referring to when I wrote that paper.

We know what a benchmark is not I think on the basis of this analysis, but the Postal Service isn't doing that anymore. They're doing a delinking approach which as I mentioned briefly in my testimony I view as a way of reducing the heterogeneity problem that I talked about earlier.

They're looking for a cost measure within the category of workshared mail which is much less heterogeneous in the costs they face than the whole universe of first-class single piece mail. Now, I think that's about all I can say on that. I wish I could give you a more practical answer.

CHAIRMAN OMAS: Well, thank you. My second question. Given the data that could reasonably be made available to the Commission could you explain how to identify and measure the cost of the efficient benchmark mail as you've defined it?

THE WITNESS: Well, I think the short answer is no for the reasons that I was just talking about. We need a way of usefully identifying which type of mail is at the margin of worksharing and that's easy to do in a mathematical model, but not in practice although I hope that as I talk to people more involved with the details of the costing system that a shorthand approximate way for doing that will emerge, but I can't give you one at the moment.

CHAIRMAN OMAS: Well, thank you, Dr. Panzar.

Commissioner Goldway?

COMMISSIONER GOLDWAY: My question has something to do with the Chairman's former question, but it's more general in nature and that is I'm sure you're aware of the questionable nature or the approximate nature of many of the costs, most of the costs, that we review in rate case proceedings, so while efficient component pricing rates would theoretically perhaps be the most sensible and efficient way to establish a rate system when you're not sure of what your costs are should you insist upon a 100 percent pass-through of what may or may not be the real worksharing savings?

THE WITNESS: This is a question that usually comes up in the context of Ramsey pricing, but if you don't know your costs how can you hope to do Ramsey pricing? As you indicated it comes up any time where your costs are uncertain. The simple economist's or statistician's answer is well, you have the point estimate of the cost or guess at the unit cost that's provided by the Postal Service and you base your decisions on that.

A couple of aspects to distinguish the use of these guesses in setting efficient component pricing versus say Ramsey pricing, one of the nice things about the ECPR methodology is that you're guessing the amount of the differences of a workshared versus nonworkshared product, so you could be quite a ways off at the overall level in terms of the amount of error that your estimates were subject to, but the amount of error at the difference, the differences between these two levels, will typically be considerably smaller, so in a world of uncertain cost estimates that's a relative advantage of ECPR as opposed to some other methods.

In terms of literally the recommendation to set the pass-throughs at **100** percent **I** think that's an area where the noncost aspects ***of*** the act may come into play, but the basic economic recommendation is **well**, you take the best estimate you have and put the pass-throughs at 100 percent of that difference.

If you think there's a substantial risk ***of*** revenue erosior.. or rate shock, or whatever that would result from that well, that's one of the noncost factors that you're always considering as I understand it.

COMMISSIONER **GOLDWAY:** ***So*** then my other question along those lines is it's hard to estimate what the 100 percent is, but in the context of the legislation that's been considered over the last dozen years we've been talking about rate bans and we've had disputes among ourselves about whether one should do cost of living increases or cost of living minus one, the notion being that you want to make it a little more difficult for the Service to raise prices.

It has to have an incentive to do it for less. Could the same notion apply that you would want to give less than the 100 percent discount because you want to give an incentive to the system to be even more efficient?

THE WITNESS: That's a somewhat complicated and separate question. As discussed in my testimony and most of the discussion about worksharing discounts when I talk about productive deficiency I'm talking about combining the resources of the Postal Service and outside mailers as they are now in the most efficient way. It doesn't do anything directly to improve the efficiency of the Postal Service.

Those price caps or ban proposals you've talked about are arguably a way to give the Postal Service an incentive to be more efficient because then it's not held to a simple break even condition. If it can save more money it -- well, it's not clear what it gets to do with it since it's not a private corporation, but we won't get into that degradation. It gives an incentive to cut costs because the rates aren't automatically reduced to reflect cost savings

Within that context you can introduce worksharing discounts into the structure of the price cap regime as you've talked about and then the issue of whether or not they're going to be at 100 percent or not will be -- if we get a price cap regime implemented when you have the first case that has to settle the parameters of it one of the big bones of contention will be whether or not the price cap regime includes worksharing discounts and if it does, which it probably should, whether those initial rates are at a 100 percent pass-through.

Once the price cap regime gets rolling those pass-through rates will be subject to revision by the Postal Service subject to the overall minus one, or minus two, or whatever it is. So it's a long answer to what you though: was a simple question, but yes, you would include --

COMMISSIONER GOLDWAY: Yes, but I guess what I'm focusing more on is in the past we haven't given 100 percent discounts for a variety of reasons including some of the noncost issues that are in the act, but it seemed to me that by giving the private mailers a smalier area in which they had to save and they could in fact do that that the whole system was made more efficient?

The discount mechanism was in some way forcing the private sector to be more efficient and therefore the whole system was more efficient.

THE WITNESS: Well, suppose you make the pass-through at **90** percent so that the function costs, the Postal Service 10 cents, then any mailer who could do it for nine cents would --

COMMISSIONER GOLDWAY: So the mailer has to figure out a way to do it for less and less?

THE WITNESS: Right, but what about the --

COMMISSIONER GOLDWAY: Then the whole system gets to be more efficient.

THE WITNESS: That's certainly possible, but what about the mailer who can do it for nine and a half cents under your proposal? He wouldn't do it, yet the entire system would be more efficient if he did because it costs the Postal Service 10 cents. In a more complicated scenario where one can't assume that private firms are efficient it would be an interesting exercise to figure out whether you should shade the discounts in that way.

In my analysis and virtually all the sort of ECPR analyses that I've seen we may or may not assume that the Postal Service or the incumbent monopolist is efficient, but we always assume that these profit maximizing private firms are efficient, so that issue doesn't come up, but it might.

COMMISSIONER GOLDWAY: Okay. Well, thank you.

CHAIP!**OMAS**: Are there any other questions from the bench?

Mr. McKeever?

MR. MCKEEVER: Thank you, Mr. Chairman. John McKeever for United Parcel Service.

FURTHER CROSS-EXAMINATION

BY MR. MCKEEVER:

Q Dr. Panzar, I just wanted to follow-up briefly on your exchange with Commissioner Goldway. If a discount is understated, it's too low, there is a loss of productive efficiency. Is that right? That's what you just said.

A In general there might be because there are mailers who could do it at a cost less than the Postal Service who wouldn't find it profitable under a discount, but there's always a possibility of that when you have a wedge.

Q Okay. Now, if the discount is too high there is also a loss of productive efficiency?

A In that case you may induce mailers who can't do it as efficiently as the Postal Service to do it anyway and that would also reduce productive efficiency.

Q That would be a productive inefficiency?

A Yes.

Q Okay. If the discount is too high the Postal Service doesn't get as much revenue as it should get. Is that correct?

A Yes. Well, I'm not sure what you mean by should get, but --

Q Well, if the discount were set 100 percent accurately. Yes.

A Correct.

Q Okay. Of course that means that someone else would have to pay that revenue, is that correct, to put the Postal Service back whole?

A Back on the break even. Yes.

MR. MCKEEVER: That's all I have. Thank you.

CHAIRMAN OMAS: Thank you, Mr. McKeever.

Is there anyone else?

MR. KOETTING: Mr. Chairman?

CHAIRMAN OMAS: Mr. Koetting?

MR. KOETTING: Yes. Thank you.

FURTHER CROSS-EXAMINATION

BY MR. KOETTING:

Q Professor Panzar, I'd like to f 1 -UP n your response to Chairman Omas on the appropriate benchmark and I think you identified some of the things that you struggle with in trying to identify what the benchmark should be, but you seemed to think there was a little more hope in terms of what the benchmark shouldn't be.

If I understood you correctly and correct me if I'm wrong, but I thought you were suggesting that what the benchmark shouldn't be is the piece that's most likely to workshare. Is that something along the lines of where --

A Correct.

Q I guess my question is we are approximately 30 years into the presort program in terms of discounts, correct?

A Yes.

Q What I'm specifically going to try to focus on is when you say the mail is most likely to workshare that mail is well and truly workshared, correct? I mean, if you're talking about for example a credit card company, a utility that's generating hundreds of thousands, if not millions, if not tens of millions of bills off a computer, the cost on a unit basis for worksharing for those mailers is pretty trivial.

I think that was the point that you were suggesting.

A Yes.

Q In your mind that is the mail within the entire set of first-class mail that's the most likely to workshare, correct?

A That's my interpretation. The term most likely to be workshared is not easy to translate into a formal model.

Q Would you agree though that the intent of the BMM benchmark was not to focus on the entire set of first-class mail, but to focus on the set of mail that's left as nonworkshared mail and within that subset look at the mail that's currently paying single piece rates that's most likely to workshare, and isn't that much more closely going to approximate that marginal piece than the piece that we're talking about that's just absolutely a no brainer is going to be workshared?

A Well, that would more closely approximate the marginal piece, but intuitively I think it's still a ways from the margin, but that's the problem I confessed not having been able to solve to Chairman Omas is what's a practical **way** to approximate that marginal mail type so you can do the appropriate benchmark calculation.

Q Just to conclude that in terms of order magnitude if there's going to be some misstatement or misfocus using the BMM benchmark that misfocus is not going to be nearly as great as it would be if we were to think of that most likely to workshare credit card piece. It's pretty much a different order of magnitude.

A Well, I don't know that it's an order of magnitude, but I would think there should be a substantial difference.

MR. EOETTING: That's all. Thank you, Mr. Chairman.

CHAIRMAN OMAS: Thank you, Mr. Koetting.

Is there anyone else?

(No response.)

CHAIRMAN OMAS: There doesn't seem to be any.

Mr. Scanlon, would you like some time with your witness?

MR. SCANLON: Five minutes, please, Mr. Chairman?

CHAIRMAN OMAS: Absolutely.

(Whereupon, a short recess was taken.)

CHAIRMAN OMAS: Mr. Scanlon?

MR. SCANLON: Mr. Chairman, we do have a brief redirect.

REDIRECT EXAMINATION

BY MH. SCANLON:

Q Dr. Panzar, wanted to revisit the colloquy that you've had now with respect to the appropriate benchmark and BMM mail. What you've discussed is the problem you're trying to solve is a heterogeneous mailstream in terms of identifying those costs. Does delinking help solve that problem?

A Yes. As I believe I mentioned, as I understand it the delinking proposal separates the workshared category from the first-class single piece category. This greatly reduces the extent of heterogeneity in that workshared category and that should make much easier the solution of what we'll call the benchmarking problems -- there really is no single benchmark anymore under delinking, but should make that problem of calculating the appropriate cost avoidances easier.

Although I'm not aware that anybody has solved it yet I think a practical solution is more likely.

Q Okay, and now I want to take you back to a discussion you had with Mr. Olson earlier and specifically page 20 of your testimony, lines 2 through 5. You set up a hypothetical postal network with two vertical components, a downstream delivery component and an upstream composite component for various collection, transportation and sortation functions?

A Yes

Q Are you aware that in first-class mail there are no distance related or destination entry discounts?

A That's my understanding. Yes.

Q Okay. Consistent with your recommendation for efficient component pricing do you think there should be discounts that would reflect costs avoided related to distance?

A Yes. There would be a form of worksharing through which the CPR principles would apply.

Q Okay. The final question, and this goes back to the discussion you had with Commissioner Goldway with respect to the importance of estimating costs not only for Ramsey pricing, but also for efficient component pricing, assuming that the costs are less than certain would you advocate trying to remodel or re-estimate those costs to make them more accurate if possible as part of the process of setting ECPR discounts?

A Yes. You'd want to use the best available cost methodology possible. That wouldn't necessarily remove uncertainty, but it gives you the best point estimate possible.

MR. SCANLON: Nothing further, Mr. Chairman.

CHAIRMAN OMAS: Is there anyone who wishes to re-cross Dr. Panzar?

(No response.)

CHAIRMAN OMAS: There being no one, Dr. Panzar, that completes your testimony here today and your appearance. We appreciate your testimony and your contribution to our record, and you're now excused. Thank you.

(Witness excused.)

CHAIRMAN OMAS: That concludes our hearings today and we will reconvene tomorrow morning at 9:30 when we will receive testimony from Witnesses McAlpin, Haldi, Glick, Luciani and Angelides. I hope I pronounced that correctly. Thank you very much and have a nice afternoon.

(Whereupon, at 12:41 p.m., the hearing in the above-entitled matter was adjourned, to reconvene on Thursday, November 2, 2006, at 9:30 a.m.)

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DOCKET NO.: R2006-1

CASE TITLE: Postal Rate and Fee Changes

HEARING DATE: 11/1/06

LOCATION: Washington, DC

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the Postal Rate Commission

Date: 11/1/06

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