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

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

Rebuttal Testimony of

ROBERT W. MITCHELL

Concerning

RATEMAKING FOR LETTERS AND FLATS IN STANDARD MAIL

On Behalf of

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

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AUTOBIOGRAPHICAL SKETCH

For a copy of my autobiographical sketch, see VP-T-1 in this docket.

I. PURPOSE OF TESTIMONY

The purpose of this testimony is to rebut the prescription of Pitney Bowes Inc. witness John C. Panzar on the issue of how rates for letters and flats should relate to their respective costs when the letters and flats reside in the same subclass of mail.

II. INTRODUCTION

Witness Panzar argues in his direct testimony that efficient component pricing ("ECP") should apply to *all* rate differences within a subclass, including those based on shape. *See* PB-T-1, p. 45, l. 1 through p. 47, l. 9. Then, because the alternative to ECP for shape-based rate differences (as well as other rate differences) would be to apply more broadly the policies of the Postal Reorganization Act of 1970 ("the Act"), including the recognition of value of service, he proceeds to provide reasons why guidance relating to ECP should be

preferred to emphasis on economic efficiency.[1, 2, 3] PB-T-1, p. 47, l. 10 through p. 50, l. 7.

If the categories of letters and flats were in different subclasses, witness Panzar would apparently agree that elasticities and value of service should be given explicit recognition. *See* response to VP/PB-T1-6(e), Tr. 26/9186-90. In fact, when asked on oral cross-examination about a situation where the elasticities of two categories (of parcels) in the same subclass were different, witness Panzar responded: "Looking at this example, my reaction would be, why are these two services in the same subclass?" Tr. 26/9259, ll. 16-17. Nevertheless, he went on to explain that in such a case, "the argument ... shifts more to the use of price-elasticity-based differences [than ECP-based differences]." Tr. 26/9259, ll. 23-24.

To the contrary, Newspaper Association of America ("NAA") witness J. Gregory Sidak argues in his testimony that "ECP is not an appropriate concept to use in calculating shape-based rates in the same manner that would be used to determine worksharing discounts." NAA-T-1, p. 11, ll. 20-22, and *see generally*

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[1] For Standard Mail letters and flats, I see no reason for rate differences based on the non-cost factors of section 3622(b) of the Act, except for the possibility of a difference in value of service, which leads immediately to questions of how value of service should be recognized and therefore to matters modeled in the Ramsey formulas.

[2] My response to ADVO/VP-T1-10, Tr. 25/8824-35, explains why witness Panzar's reasons for preferring ECP to Ramsey do not apply well to the question of rate differences between letters and flats. That explanation is not repeated here.

[3] In general, witness Panzar recognizes two kinds of efficiency: (i) *productive* efficiency, which is the focus of ECP, and (ii) *economic* efficiency, which is the focus of the Ramsey formulas. *See* PB-T1-1, p. 47, ll. 11-16.

p. 11, l. 9 through p. 12, l. 3. He explains in his response to an interrogatory: "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." Response to ADVO/NAA-T1-4(b), Tr. 26/9132.

Witness Panzar's own reasoning may not support the application of ECP to rate differences based on shape. Drawing on his reasoning, my purpose is to explain why his prescription of ECP should *not* be applied to shape-based rate differences. The following section discusses this issue.

III. RATESETTING FOR LETTERS AND FLATS

If letters and flats in Standard Mail had different own-price elasticities and different costs, and if the cross-price elasticities were zero and there were no policy constraints, they would be obvious candidates for separate subclasses. To make them separate subclasses would be consistent with Commission practice, which I describe at some length in my direct testimony. *See* VP-T-1, p. 20, l. 2 - p. 24, l. 3. So designated, their separate cost coverages would be selected in accordance with the policies of the Act. In doing this, a range of factors would be considered, including their value of service. If other factors did not provide a basis for differences, the role of value of service could be substantial, consistent with notions of economic efficiency.

To illustrate, suppose letters are more elastic than flats and have lower costs. Specifically, suppose letters cost 10 cents each and flats cost 20 cents

each,[4] and assume notions of economic efficiency suggest coverages of 150 percent for letters and 200 percent for flats.[5] These coverages lead to a rate for letters of 15 cents and for flats of 40 cents. The rate difference is 25 cents (40 cents minus 15 cents) and the cost difference is 10 cents (20 cents minus 10 cents). Thus, the rate difference represents 250 percent of the cost difference, which can be viewed reasonably as a passthrough.

If a decision were made to house these letters and flats in a joint subclass, the same recognition could be given to economic efficiency. Specifically, rates for letters and flats within the subclass could be developed with a passthrough of 250 percent, yielding the same 15-cent and 40-cent rates. This result would be consistent with witness Panzar's suggestion, noted above, that in such a situation, "the argument ... shifts more to the use of price-elasticity-based differences [than ECP-based differences]." Tr. 26-9259, ll. 23-24.

Making the simplifying assumption of equal volumes of letters and flats, the cost coverage of the joint subclass discussed above is 183.3 percent. If the average elasticity of the joint subclass is known and category-specific elasticities for letters and flats are not available, it might be considered reasonable to develop the rates as though the elasticities of letters and flats were the same.

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[4] These figures and the elasticity relationships were selected to keep the illustration simple, not because they have a particular relation to the actual situation in any Standard Mail subclass.

[5] Under the condition that the cross-price elasticities are zero, these coverages would be consistent with the ordinary inverse elasticity rule. If the own-price elasticities for letters and flats were the same, each coverage would be 183.3 percent.

Under these conditions, notions of economic efficiency would suggest rates with a letter-flat passthrough of 183.3 percent, equal to the subclass coverage. One way of looking at this is that creating separate subclasses is hardly necessary when the elasticities are presumed to be the same, because economically-efficient rates can be developed easily by applying a passthrough equal to the subclass coverage.

Under the conditions of a letter-flat passthrough of 183.3 percent, the rate difference between letters and flats would be 18.33 cents (1.833 times the cost difference of 10 cents). Though lower than the 25-cent difference begun with above, this is still a substantial rate difference, at least relative to the ECP rate difference of 10 cents. As a qualitative matter, witness Panzar's position under these conditions would seem to be that: (i) as long as the elasticities are different, separate subclasses are warranted, which in the above example would lead to a passthrough above 183.3 percent and a rate difference larger than 18.33 cents, but (ii) as soon as the elasticities become essentially the same, the appropriate thing to do would be to set the passthrough at 100 percent, to yield a rate difference of 10 cents.

On both theoretical and practical grounds, witness Panzar's position strikes me as unacceptable. I do not see that it is reasonable for decreases in the elasticity difference to cause decreases in the passthrough — from 250 percent down toward 183.3 percent in the example, accompanied by a smooth decline in the rate difference from 25 cents to 18.3 cents — and then for an additional decrease in the elasticity difference, this time to zero, to cause a giant

decrease in the rate difference, *i.e.*, a decrease to 10 cents. This approach presents a discontinuity in the way efficiency is recognized. The alternative, which I endorse, is a default passthrough equal to the subclass coverage, particularly when the elasticity differences are unknown (or believed to be small). As I explain in my response to ADVO/VP-T1-10 (Tr. 25/8824-35, cited above), the reasons witness Panzar gives for applying ECP do not apply well to letters and flats,[6] and the unreasonableness of applying them regardless becomes ever more apparent when they cause a discontinuity of this kind.

One further step needs to be taken, and that is to introduce cross-price elasticities. The solution described above, a passthrough equal to the subclass cost coverage when letters and flats are in the same subclass and the own-price elasticities are treated as though they were the same (maybe for lack of evidence to the contrary), applies strictly when the cross-price elasticities are zero. But since it would be unusual for them to be zero, what if they have some value, but not a high value? Let's begin by assuming that the cross-price elasticities rise to a level just above zero. That is, they are not zero, but they are low.

Witness Panzar was asked about this situation of products having equal elasticities and non-zero cross elasticities. He explained that he has not performed the required analysis and does not "know of a paper in the literature where this case is explicitly discussed." Response to VP/PB-T1-6(f), Tr.

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[6] My response to ADVO/VP-T1-10 also explains why the reasons witness Panzar gives for not emphasizing economic efficiency are not convincing.

26/9189. *See also* Tr. 26/9292, ll. 2-10. I have not performed the analysis either,[7] but I think it is possible to say something about where the solution lies.

I believe the relationships involved are smooth and continuous, and that, as the cross elasticities begin to grow, the solution of economic efficiency moves slowly *from* the solution of a passthrough equal to the subclass coverage. Can we say in which direction it moves? I find it difficult to believe that an increase in the cross elasticities, which suggests an increase in the propensity of buyers to move between the products due to price differences, would suggest that the prices of the two products should be further apart. Moreover, if this *were* the outcome, policy considerations might suggest rejection of that kind of price adjustment. Therefore, although I cannot provide a mathematical proof, I believe the reasonable and likely effect of the presence of some cross elasticity would be to move the passthrough downward from the level of the coverage of the subclass (183.3 percent in the above example) — but not down to a level of 100 percent, which is the ECP solution. Unless the cross elasticity becomes unusually high, I believe the passthrough would remain well above the 100-percent level.

It is on this basis, as described herein, that I believe the default passthrough of the letter-flat cost difference should be equal to the subclass cost

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[7] For one particular case, however, involving presort and non-presort First-Class Mail, I did find that the passthrough of economic efficiency is above 100 percent and below the coverage of the subclass. *See* Robert W. Mitchell, "Postal Worksharing: Welfare, Technical Efficiency, and Pareto Optimality," in *Emerging Competition In Postal and Delivery Services*, edited by Michael A. Crew and Paul R. Kleindorfer, Boston, Kluwer Academic Publishers, 1999, pp. 311-334.

1 coverage. I have not argued that there are no reasons for a passthrough below
2 the subclass cost coverage — indeed, I propose such passthroughs in my direct
3 testimony and provide reasons supporting them. *See* VP-T-1, p. 159, l. 5 and p.
4 178, l. 12. In the example above, the presence of cross elasticities might be a
5 reason to lower the passthrough *from* 183.3 percent, but it is not a reason to
6 adopt a passthrough of 100 percent.