Postal Rate Commission
Submitted 11/28/2006 10:35 am
Filing ID: 55184
Accepted 11/28/2006

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

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

REBUTTAL TESTIMONY OF J. GREGORY SIDAK

ON BEHALF OF

THE NEWSPAPER ASSOCIATION OF AMERICA

Date: November 20, 2006

TABLE OF CONTENTS

INTRODUCTION AND QUALIFICATIONS

My name is J. Gregory Sidak. My business addresses are 6018 Hotung International Law Building, Georgetown University Law Center, 600 New Jersey Avenue, N.W., Washington, D.C. 20001, and Criterion Economics, LLC, 1620 Eye St., N.W., Suite 800, Washington, D.C., 20006. My qualifications and background regarding postal regulation and efficient component pricing are presented in my direct testimony in this proceeding.

In addition to those qualifications, I am also an expert on telecommunications, broadband communications, and the Internet. I was Deputy General Counsel of the Federal Communications Commission from 1987 to 1989. From 1992 through 2005, I was a resident scholar at the American Enterprise Institute for Public Policy Research (AEI), where I directed AEI's Studies in Telecommunications Deregulation and held the F.K. Weyerhaeuser Chair in Law and Economics. From 1993 to 1999, I was a Senior Lecturer at the Yale School of Management, where I taught a course on telecommunications regulation with Dean Paul W. MacAvoy.

I have been a consultant to more than 20 companies in the telecommunications, media, and computing industries in North America, Europe, Asia, and Australia. I have also been a consultant to the Republic of Mexico in the World Trade Organization dispute between the United States and Mexico concerning international telecommunication services. For four years, I have been a member of the U.S. Advisory Board of NTT DoCoMo, Japan's largest wireless telecommunications company. In that capacity, I have met twice annually with the

CEO and senior management of DoCoMo to discuss strategic business, technology, and regulatory matters concerning telecommunications services.

I have written numerous books on telecommunications. With Dan Maldoom, Richard Marsden, and Hal J. Singer, I am the co-author of *Broadband in Europe: How Brussels Can Wire the Information Society* (Springer 2005). I am the author of *Foreign Investment in American Telecommunications* (University of Chicago Press 1997). With Daniel F. Spulber, I am the co-author of *Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States* (Cambridge University Press 1997). With William J. Baumol, I am the co-author of *Toward Competition in Local Telephony* (MIT Press 1994). I am the co-editor of *Competition and Regulation in Telecommunications: Examining Germany and America* (Kluwer Academic Press 2000), and I am the editor of *Is the Telecommunications Act of 1996 Broken? If So, How Can We Fix It?* (AEI Press 1999). I have published more than forty scholarly articles on regulation of telecommunications, broadband communications, and the Internet—several of which have been cited by the Supreme Court.

This is my second appearance as a witness before the Postal Rate Commission. In this rate case I submitted direct testimony on behalf of the Newspaper Association of America on the use of efficient component pricing as an instrument in rate setting.

I am testifying on behalf of the Newspaper Association of America. The views that I present are my own and not those of Georgetown University Law Center, which does not take institutional positions on specific legislative, regulatory, adjudicatory, or executive matters.

My testimony responds to the testimony of Val-Pak witness Robert W. Mitchell (VP-T-1) and Mail Order Association of America witness Roger Prescott (MOAA-T-1) regarding the assignment of institutional costs to Standard Enhanced Carrier Route (ECR) mail. Contrary to their testimony, there is reason to believe that the institutional cost contributions of Standard ECR should be higher, rather than lower as they contend. I reach this conclusion based on the fact that the mail system has changed significantly since 1995.

In particular, the leveling-off—and now decline—in the volume of First-Class Mail means that the Postal Service's business model can no longer presume, as it has in the past, that growth in First-Class Mail volume will be sufficient to fund the growth of the Postal Service's network. Indeed, First-Class Mail ceased to be a majority of the mailstream several years ago, and the Postal Service itself projects that Standard commercial mail will exceed First-Class Mail in volume in the Test Year. This is a profound change in the nature of the mailstream.

I believe that because of diversion of First-Class Mail to electronic communications due to the emergence of broadband communications, the Postal Service can no longer rely on First-Class Mail to fund its institutional costs as it has in the past. Ideally, of course, the Postal Service would be trying to reduce its institutional costs as much as possible so that all classes of mail could enjoy lower cost coverages than at present. However, the Postal Service must fund the revenue requirement that it has. Simply put, someone must pay the Postal Service's growing institutional costs.

Therefore, decreases in Standard ECR rates as proposed by witnesses Mitchell and Prescott are inconsistent with a reasonable response by the Postal Service to this fundamental change in the composition of the mailstream. Such proposals would be a head-in-the-sand response to the profound diversion of First-Class Mail toward electronic communication. The growth of broadband subscription and usage, along with the decline of First-Class Mail volumes, support the testimony submitted by Greeting Card Authority witness Clifton, who recommends a smaller increase in First-Class rates relative to the Postal Service's proposal on the grounds that demand for First-Class Mail has declined significantly.

In addition, I respond to a statement by Val-Pak witness Mitchell, in which he erroneously suggested that Efficient Component Pricing is more likely to result in cross-subsidization than Ramsey pricing.

This testimony is accompanied by rebuttal testimony by Dr. Allan Ingraham (NAA-T-2), which explains that, apart from the failure to recognize the dramatic changes in the mailstream since 1995, certain analyses in the testimony of witnesses Mitchell and Prescott are either flawed or incomplete. Dr. Ingraham's testimony explains why those analytical errors in themselves cast doubt on the validity of the ultimate conclusions drawn by witnesses Mitchell and Prescott.

For these reasons, I conclude that the Commission should reject proposals to reduce the institutional costs assigned to Standard Enhanced Carrier Route mail.

The emergence of broadband communications as a substitute for First-Class Mail means that the Postal Service's old business model can no longer work. Someone must pay the institutional costs, and it is reasonable that the burden of institutional costs borne by Standard Mail—the new largest class—should not decrease but, if anything, should increase.

I. SUMMARY OF WITNESS MITCHELL'S AND WITNESS PRESCOTT'S TESTIMONY

As a major premise of their testimony, witnesses Mitchell (VP-T-1) and Prescott (MOAA-T-1) both rely on testimony from past proceedings dating from 1995 regarding ECR cost coverage since the reclassification of third class mail into Standard Regular and Standard ECR in Docket No. MC95-1.

A. Witness Mitchell's Testimony

Witness Mitchell recounts testimony from Dockets Nos. MC95-1, R97-1, and R2000-1 to support his particular rate proposal. For example, witness Mitchell claims that the Postal Service viewed the cost coverage proposed for ECR mail in docket MC95-1 as "a first step."[1] He then quotes Postal Service witness O'Hara's rate testimony in Docket No. R97-1,[2] which argued that the proposed rate increase for ECR mail was "below the system-wide average increase, reflecting a desire to lower the very high cost coverage of this subclass."[3] Finally, he discusses the direct

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[1] Testimony of R. Mitchell, VP-T-1, on behalf of Valpak Direct Marketing Systems, Inc. and Valpak Dealer's Association, Inc., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 34.

[2] *Id.*

[3] Testimony of D. O'Hara, USPS-T-30, on behalf of the United States Postal Service., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R97-1, at 34.

testimony of Postal Service witness Mayes in Docket No. R2000-1, who, similarly to witness O'Hara in R97-1, proposed a below average rate increase for ECR mail in an attempt "to lower the very high cost coverage of this subclass."[4]

Based on these and similar statements, witness Mitchell contends that the Postal Service's position regarding the cost coverage of ECR and Standard Regular mail was that

> in line with the Act and accepted principles of regulatory ratesetting, the coverage on Regular should be higher and the coverage on ECR should be lower, that it was moving in that direction, but that it was restraining itself due to the effects on mailers who are paying, and will continue to pay, rates that, based on the same principles, are lower than they should be.[5]

As a result, witness Mitchell proposes a significant reduction in the rate for ECR mail and a large increase in the rates for Standard Regular mail.

Witness Mitchell also bases his rate proposal on estimates of the own-price elasticity of demand for ECR and Standard Regular provided by Postal Service witness Thress. Dr. Ingraham addresses that reliance in his rebuttal testimony (NAA-RT-2).

B. Witness Prescott's Testimony

Witness Prescott's testimony on behalf of the Mail Order Association of America, which discusses the proposed rates for ECR mail only, is conceptually similar to Mitchell's testimony. Witness Prescott contends that the reclassification

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[4] Testimony of V. Mayes, USPS-T-32, on behalf of the United States Postal Service, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2000-1, at 36.

[5] Testimony of R. Mitchell, VP-T-1, on behalf of Valpak Direct Marketing Systems, Inc. and Valpak Dealer's Association, Inc., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 35.

that created the ECR subclass in 1995 envisioned lower cost coverages for ECR mail, that the elasticity of demand for ECR has recently increased, and that the PRC should carefully consider rate increases for ECR. During cross-examination, he stated that the cost coverage of ECR should be reduced from the level proposed by the Postal Service.[6]

II. The Profound Change in the Postal Mailstream Since 1995 Due to the Decline of First-Class Mail Volume and the Growth of Broadband Invalidates a Fundamental Premise in the Testimony of Witnesses Mitchell And Prescott

Witnesses Mitchell and Prescott ignore that major changes to written communications have occurred since third-class mail was split into ECR and Standard Regular in Docket No. MC95-1. In particular, First-Class Mail has declined from being the majority of the mailstream and has even declined in absolute volume in recent years. The Postal Service's own testimony projects that Standard commercial mail will be the largest category of mail by the Test Year.

In addition, spurred in part by the tremendous growth in broadband deployment in recent years, electronic communication clearly is now a viable and successful substitute for First-Class Mail. At the same time, however, electronic communication appears complementary in demand to Standard Mail.

These tectonic changes in the demand for electronic communications and mail delivery have profound ramifications for the Postal Service's ability to fund its operations in the future. The decline of First-Class Mail and the ascendancy of Standard Mail means that the Postal Service can no longer rely on its former

[6] Tr. 25/9071.

business model, in which growth in the demand for First-Class Mail was expected to pay the bulk of the institutional costs of the postal network.

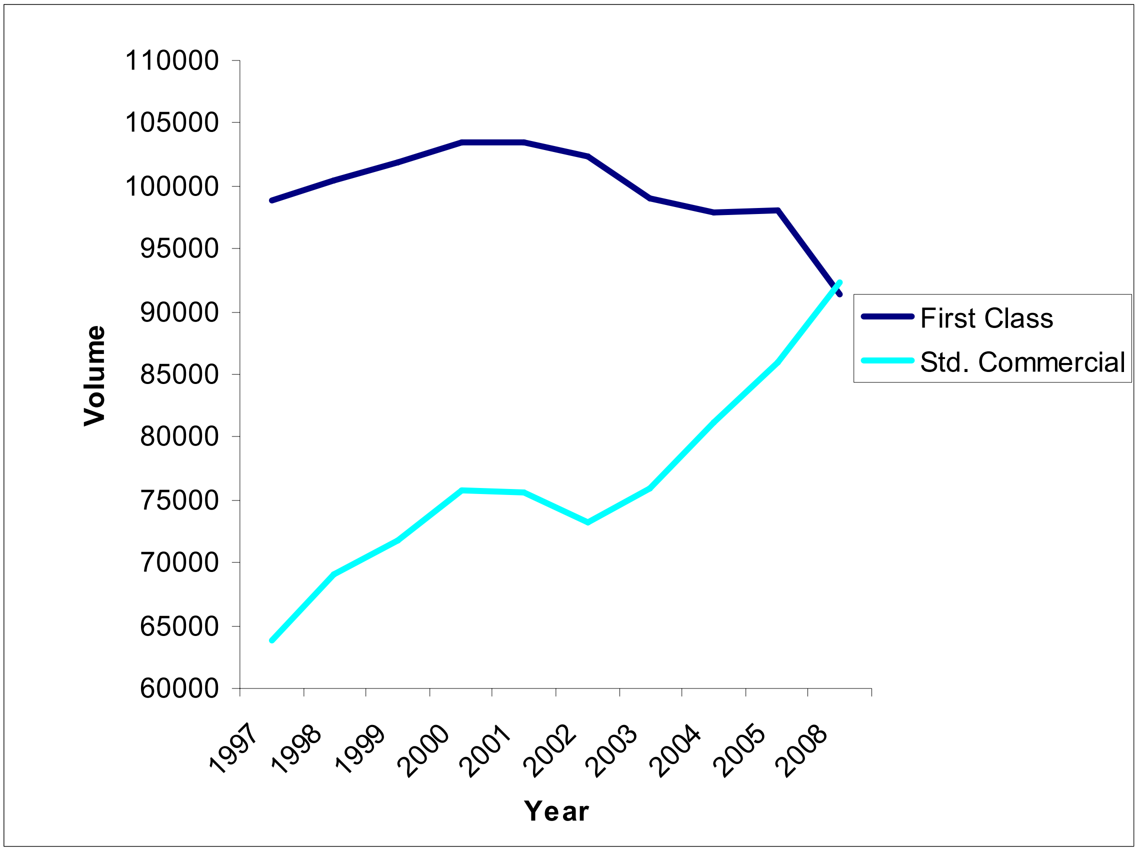
So the Postal Service must find a new business model. Since the Postal Service's overhead costs must be recovered somewhere, it is incumbent that the Service ask how other classes of mail might cover the shortfall. Standard Mail, now the largest category of mail, is the candidate with the most volume over which these institutional costs could be recovered. Reducing the cost coverage of Standard ECR mail is not a responsible reaction to the financial challenges that now confront the Postal Service.

A. First-Class Mail Is No Longer the Largest Mail Class

The emergence of electronic communications as a viable competitor to First-Class Mail has caused major changes to the mailstream in the United States. This can be seen from the recent volume figures presented in Figure 1:

Figure 1: Volume of First-Class and Standard Commercial Mail Since 1997

(millions of pieces)



Source: Source:USPS-LR-L-63 (worksheet “GFY Volumes” within the workbook “Volumes.xls”); USPS-T-7; tbl 1 at 9.

The data in Figure 1 indicate that First-Class Mail volume has declined since 1997. The Postal Service’s own testimony indicates that it will continue to do so. At the same time, the volume of Standard Commercial mail has steadily increased since at least 1997. Postal Service witness Thress has estimated that by 2008, First-Class will no longer be the largest class of mail and will be surpassed, in volume, by Standard commercial Mail. First-Class Mail has already been surpassed by Standard Mail in rate of volume growth.

This fundamental change in the nature of the mailstream appears to have happened relatively quickly. I am advised that no postal rate case has been fully litigated since Docket No. R2000-1, which means that the Commission has not had a real opportunity to consider these changes and their implications for postal pricing.

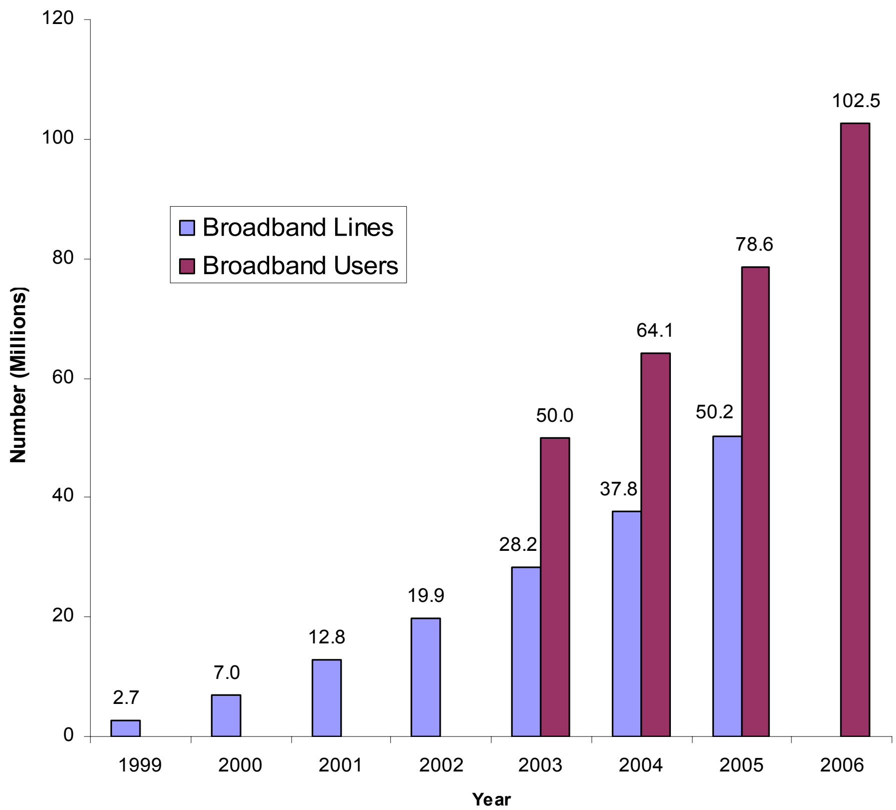
At the least, however, it is reasonable to surmise that comments made in Docket No. MC95-1 and subsequent rate cases regarding ECR cost coverages were made when First-Class Mail predominated in the system and the Postal Service adhered to a business model that is now outdated. Accordingly, testimony in those past cases regarding the appropriate cost coverages for Standard Commercial mailers cannot be considered relevant to this rate case. Put differently, by relying on rate testimony that is at times over a decade old, witness Mitchell implicitly assumes that the economic environment of the current mailstream resembles the economic environment that existed a decade ago. It does not.

B. The Growth of Broadband Penetration Has Enabled Consumers to Substitute Away from Written or Paper Communication

In responding to the testimony of witnesses Mitchell and Prescott, it is appropriate to review how the rapid growth of broadband availability and broadband penetration has contributed significantly to the diversion of First-Class Mail to electronic communications. These trends suggest that the Postal Service's old business model has little prospect of future vitality.

Since 1999, the usage of high speed Internet access has increased dramatically. Figure 2 shows the growth in broadband lines (typically one per household) and broadband users (typically more than one per household) from 1999 through 2006.

FIGURE 2: BROADBAND LINES AND BROADBAND USERS, 1999-2006



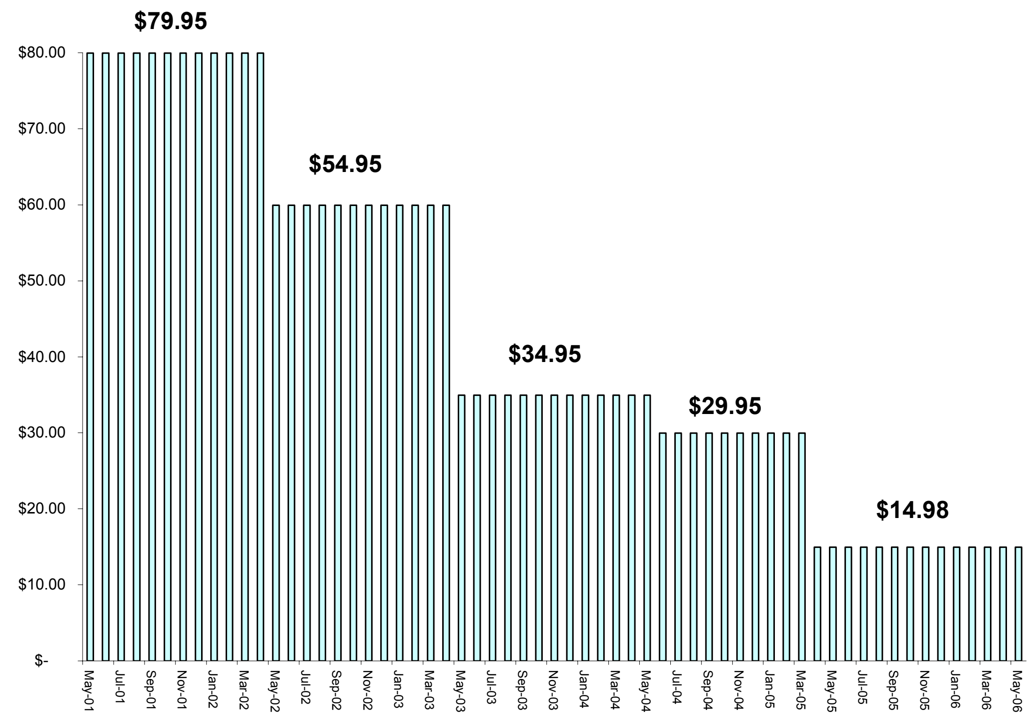
Source: Wireline Competition Bureau, FCC, High Speed Services For Internet Access: Status as of Dec. 31, 2005 (2006); Q4 2003 NetRatings Earnings Conference Call – Final, Fair Disclosure Wire, Feb. 26, 2004; *U.S. Broadband Penetration Tops 40%,* Editor and Publisher, Sept. 28, 2005; Carol Wilson, *Nielson: Broadband Use Nears 75%*, Prism Insight, Jun. 22, 2006.

Specifically, the adoption of residential broadband Internet access, as measured by residential broadband lines into individual households, has increased from only 1.79 million in December 1999 to 42.94 million by December 2005, an increase of nearly 2,300 percent. Furthermore, the number of Internet users with access to broadband Internet service at either home or work has increased substantially. The United

States now has 102.5 million broadband users, whereas there were only 50 million users in 2003. There can be no doubt that the continued consumer adoption of broadband services indicates that the Internet now plays a vastly more important role in the life of the average U.S. consumer than it did even a few years ago.

The price of broadband access service has fallen dramatically in the United States. Figure 3 shows the decrease in Verizon's monthly price of 1.5 Mbps DSL access from May 2001 to May 2006.

FIGURE 3: VERIZON'S MONTHLY PRICE FOR 1.5 MBPS DSL ACCESS, MAY 2001-MAY 2006



Source: BEAR STEARNS, MARCH BROADBAND BUZZ: A MONTHLY UPDATE ON CRITICAL BROADBAND ISSUES 6 (2006)
Note: In April 2005, Verizon began offering 3.0 Mbps DSL access for the same price that it had been offering 1.5 Mbps DSL access, thus doubling the performance of its entry-level DSL product. Figure 1 treats this repricing as halving the price of 1.5 Mbps DSL access. *See* Press Release, Verizon, Verizon Online Offers Twice the Speed of Its Basic Consumer DSL Service For the Same Price (Apr. 4, 2005), http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=90158

As Figure 3 shows, the monthly price of 1.5 Mbps DSL access from one of the largest broadband providers in the United States decreased so sharply that the price for a 1.5 Mbps offering in May 2006 was only 18.7 percent of the price of that offering in May 2001.

The rapid decline in the price of broadband services and the significant acceleration in the availability and adoption of those services indicate that individuals and businesses in the United States increasingly rely on electronic communication. Because electronic communication is a substitute for First-Class Mail, it is erroneous to assume that the Postal Service can continue to fund its increasing institutional costs through First-Class Mail as it has in the past. If a First-Class mailer has already switched to electronic communication, it is indicating that use of the electronic substitute generates substantially higher net benefits than does the continued use of First-Class Mail. A simple example involving the diversion of First-Class Mail to electronic bill payment illustrates this point.

Suppose an Internet user works 2000 hours during a year to earn an annual salary of $30,000. This person's implicit wage is $15 per hour, or $0.25 per minute. Suppose further that the average bill (from a utility or credit card issuer, for example) takes 3 more minutes to pay with a paper check or money order than it would if the consumer were to pay through electronic bill payment. On these hypothetical facts, the consumer's total cost to mail a bill via First-Class mail is the cost of postage ($0.39) plus the opportunity cost of the consumer's time (3 minutes x $0.25 per minute = $0.75).[7] Therefore, in this example the consumer's total opportunity cost of paying a single bill via First-Class Mail is $1.14.[8] If this consumer were to pay twelve bills per given month, the opportunity cost of paying those bills via First-Class Mail would be $13.68 per month, or $164.16 per year. Consequently, for this consumer to be indifferent to paying bills electronically or paying them through First-Class Mail,

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[7] Valuing a consumer's time at his or her implicit wage rate is a standard practice in economic analysis. *See, e.g.*, MICHAEL L. KATZ & HARVEY S. ROSEN, MICROECONOMICS 200-01 (3d ed. 1998). For example, studies of the social cost of congestion externalities value the cost of waiting at the implicit wage rate.

[8] This hypothetical estimate of the consumer's opportunity cost of paying bills by First-Class Mail is conservative. The average hourly wage in the United States in December 2005 was actually higher, $16.34, which would imply an opportunity cost of time per bill paid of $0.82, plus the 39 cent stamp, for a total opportunity cost of $1.21 per bill paid. *See* 2006 ECONOMIC REPORT OF THE PRESIDENT 338 Table B-47 (hours and earnings in private nonagricultural industries, 1959-2005).

the consumer's bank would need to charge the consumer more than $164.16 per year for the option to pay bills electronically, which is not, and is unlikely to become, common practice.

This example conveys the policy conundrum that the Postal Service increasingly faces. When consumers defect from First-Class Mail to electronic forms of communication, the customers who remain are the *inframarginal* users of First-Class Mail, who have fewer competitive alternatives. It seems contrary to the intent of the postal monopoly for the Postal Service to keep raising the price charged to these inframarginal users of First-Class Mail, for the purpose of having a postal monopoly in the first place is to keep the delivery of letters affordable so as to produce positive network externalities of communication. Moreover, one can reasonably argue that a downward spiral by which the remaining consumers of First-Class Mail would be forced to pay continually increasing cost coverage would be inconsistent with "the establishment and maintenance of a fair and equitable schedule" that section 3622(b) prescribes.[9]

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[9] Demographic evidence on the marginal consumer of broadband access can possibly shed light on another aspect of the fairness and equity of increasing the cost coverage of First-Class Mail. In November and December of 2005, the Pew Internet and American Life Project surveyed U.S. households on their decision to subscribe to Internet service, including dial-up Internet service. *See* John Horrigan, *Home Broadband Adoption 2006*, PEW INTERNET AND AMERICAN LIFE PROJECT, May 28, 2006, http://www.pewinternet.org/pdfs/PIP_Broadband_trends2006.pdf, at i. Relative to all broadband subscribers, marginal broadband subscribers had less income and less education. Such a finding implies a consumer's willingness to pay for broadband is positively related to his income and education. If demographic characteristics of inframarginal consumers of First-Class Mail resemble those of marginal (rather than inframarginal) consumers of broadband access, then it would follow that increasing the cost coverage of First-Class Mail would be analogous to imposing a regressive tax. Conversely, reducing that cost coverage would be analogous to imposing a progressive tax.

C. First-Class Mail, But Not Standard Mail, Has Experienced Considerable Erosion of Demand Due to Substitution to Electronic Communication

Other witnesses in this case have recognized these trends in broadband deployment and adoption, and in electronic communication substitution for First-Class Mail, although they differ as to the extent of the trend. For example, the Postal Service's volume forecasting witness found that "[t]he Internet has had a very strong negative effect on First-Class single-piece letters volume, explaining annual losses that have averaged more than 4.5 percent per year over the past decade."[10]

Furthermore, witness Thress explained that the Internet has significantly dampened the demand for First-Class workshared letters. In particular, he found that a variable that captures broadband subscribers, lagged by one year, reduces the volume of First-Class workshared letters in a statistically and economically significant manner.[11] Specifically, he found that broadband adoption "is projected to lead to a further decline of an additional 8.6 percent in First-Class workshared letters volume over the next three years."[12]

As an expert on the market for broadband access, I note here my belief that witness Thress has likely underestimated the true effect of electronic diversion on First-Class Mail volumes. The problem lies in his use of the one-year lagged measure of broadband subscribers in his workshared mail volume forecasting model. The lagged variable trails reality by a year. That might not be serious if

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[10] Testimony of T. Thress, USPS-T-7, on behalf of the United States Postal Service, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 60.

[11] *Id.* at 70, 73.

[12] *Id. at* 70.

subscriptions levels in the most recent years did not differ much from those in the earlier years. A quick glance at Figure 2 above confirms that the broadband subscriptions and users are dramatically higher in 2005 and 2006 than in 2004. It is widely believed that a major stimulus to investment and competition in broadband adoption began in 2005, when the FCC deregulated DSL service[13] and the Supreme Court affirmed that cable modem service was an unregulated information service.[14] It is also highly significant in my opinion that, in an experiment begun in August 2006, Google now offers the 72,000 residents of Mountain View, California free broadband Internet access service—which, of course, is implicitly funded by Google's advertising revenues.[15] These regulatory and business developments are likely to accelerate broadband adoption relative to the trend observed before 2005.

For these reasons, it is my opinion as a telecommunications expert, that it is unlikely that Witness Thress has adequately measured the most important of the recent effects of, and trends in, electronic diversion of First-Class Mail. However, the important point is that his testimony recognizes the trends.

In addition, witness Clifton, testifying on behalf of the Greeting Card Association of America, also found that the Internet has significantly dampened the demand for First-Class Mail. This basic agreement exists despite his disagreement with witness Thress over the extent to which First-Class Mail demand has been

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[13] Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Report and Order, CC Dkt. No. 02-33, 20 F.C.C.R. 14,853 (2005).

[14] National Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 974 (2005).

[15] John Markoff, *Google Says It Has No Plans for National Wi-Fi Service*, N.Y. TIMES, Aug. 15, 2006, at 7.

weakened by electronic communications.[16] Witness Clifton asserted that witness Thress did not properly control for the effects of the Internet in his demand equations and that the Thress estimates consequently understate the effect of electronic communications on First-Class Mail demand.[17]

Therefore, although there is debate in this proceeding regarding the extent to which First-Class Mail has been diverted toward electronic communication, there is no debate over the fact that electronic diversion exists and has had, and will continue to have, an effect on First-Class Mail that is significant in both an economic and statistical sense.

In contrast to First-Class Mail, there is no evidence in this rate case that Standard Regular or ECR mail have experienced statistically significant diversion at the hands of electronic communication. Furthermore, the relationship between the demand for either Standard Regular or ECR mail and electronic communication is likely to be structurally different from the relationship between First-Class Mail and electronic communications.

In particular, witness Thress' testimony provided a descriptive framework for the consideration of the relationship between the Internet and ECR mail. Thress explained that "[a]t one level, the Internet and the mail are competitors for limited advertising dollars."[18] However, he also stated that "[i]n some ways, the Internet

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[16] Testimony of J. Clifton, GCA-T-7, on behalf of the Greeting Card Association, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 2.

[17] *Id.*

[18] Testimony of T. Thress, USPS-T-7, on behalf of the United States Postal Service, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 98.

complements direct-mail advertising by providing a network for making catalog purchases, substituting for telephone orders, for example."[19] Although Thress stated that the Internet may pose a long-run threat to ECR mail, he concludes that electronic communication and ECR mail may be predominantly complements in the time frame considered for the instant rate case.[20]

Thress' econometric analysis of ECR mail demand supports his conclusion regarding the lack of strong substitution between ECR mail and electronic communication. In his ECR equation, Thress included a variable for Internet advertising expenditures. Although the regression coefficient on that variable was negative, it was not statistically significant at the 95 percent confidence level.[21] That is, at a reasonable level of statistical accuracy, one cannot reject the statistical proposition that Internet advertising does not affect the demand for ECR mail.

D. Trends in the Volume of First-Class and Standard Mail Since 1995 Indicate that the Burden of Institutional Costs Should Be Transferred from First-Class Mail to Standard Mail

First-Class Mail has long borne a significant majority of the institutional costs burden, and under the Postal Service's proposal it will continue to fund a majority of institutional costs. A likely effect of reducing the cost coverage of ECR mail would be to increase even more the burden on First-Class Mail.[22] Given the recent decline

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[19] *Id.* at 99.

[20] *Id.* at 99-100.

[21] *Id.* at 122 (recording a t-statistic of -1.709 on the Internet Advertising Expenditures variable).

[22] Witness Prescott does not say what classes of mail should make up for a reduction in ECR's cost contribution. I recognize that witness Mitchell proposes to shift $1 billion of institutional

in the use of First-Class Mail at the hands of electronic communication, this is the wrong approach and the Commission should consider lessening, not increasing, the institutional cost burden placed on First-Class Mail and begin to move that burden to other mail.

In an interrogatory response, Postal Service witness O'Hara listed the cost coverage index (that is, cost coverage relative to the systemwide average) for First-Class and Standard mail since 1994. Table 1 lists the cost coverage and the system wide average cost coverage as reported in O'Hara's response to VP/USPS-T31-9.

TABLE 1: COST COVERAGE INDEXES FOR FIRST-CLASS AND STANDARD MAIL SINCE 1995

		First-Class Mail Cost Coverage Relative to Average			Standard Mail Cost Coverage Relative to Average		
Year	System Average Cost Coverage	Total	Single Piece	Presort	Total	Regular	ECR
1996	164	1.09	0.94	1.60	0.98	0.83	1.38
1997	181	1.13	1.01	1.52	0.93	0.80	1.30
1998	179	1.16	1.04	1.54	0.91	0.76	1.34
1999	168	1.17	1.04	1.54	0.89	0.78	1.19
2000	171	1.18	1.02	1.64	0.91	0.79	1.28
2001	171	1.18	1.01	1.62	0.91	0.79	1.36
2002	173	1.20	1.02	1.65	0.90	0.79	1.29
2003	186	1.17	0.97	1.69	0.94	0.82	1.41
2004	185	1.19	0.97	1.73	0.93	0.84	1.32
2005	176	1.19	0.97	1.71	0.97	0.91	1.16
2006	176	1.22	0.99	1.72	0.99	0.92	1.18
2007	181	1.21	0.98	1.71	0.98	0.93	1.16
2008	189	1.21	0.99	1.66	0.98	0.94	1.14

Source: Response of United States Postal Service Witness O'Hara, VP/USPS-T31-7-9, 9.

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costs from ECR to Standard Regular only, but I am skeptical that the Commission would make such an adjustment without offloading some of the burden to First-Class Mail.

The data in Table 1 indicate that the cost coverage for ECR relative to the system-wide average has in fact declined since 1996 (which, incidentally, is consistent with the recommendations of witnesses Mitchell and Prescott, who argue that it should have declined even more) and the cost coverage for Standard Regular relative to the system-wide average has increased. On the whole, however, the cost coverage index of Standard mail has remained relatively unchanged at slightly below the system average cost coverage since 1996. In particular, the cost coverage index of Standard mail was 0.98 in 1996 and would be the same in 2008 under the Postal Service's proposal and costing methodologies.

While the cost coverage of Standard Regular mail has increased since 1995, the volume of Standard Regular mail has steadily increased as well despite the increase in its cost coverage. Additionally, ECR volume has remained relatively constant as the Postal Service has steadily decreased its relative cost coverage. These data suggest that Standard mail would be able to bear a portion of the institutional cost burden currently borne by First-Class Mail but that will be lost as electronic substitution occurs.

In contrast to Standard mail, between 1996 and 2008, the cost coverage index of First-Class Mail has increased, relative to the systemwide average, from 1.09 to 1.21. Furthermore, some of this increase occurred between 2000 and 2006, a period in which broadband penetration grew by more than 2000 percent as electronic communication in the United States blossomed and First-Class Mail became in increasing jeopardy to diversion. It is clear that since 1995, the Postal Service has more aggressively increased the institutional cost contribution for First-

Class Mail (as measured by cost coverage percent relative to the average) than it has for Standard Commercial mail.

E. A Reasonable Response Would Be To Shift a Portion of the Institutional Costs Burden Borne by First-Class Mail to Standard Commercial Mail

Given the data presented above, I respectfully disagree with the testimony of witnesses Mitchell and Prescott for two main reasons. First, the mailstream and the economic factors that affect First-Class volume have fundamentally changed since 1995. The emergence of electronic communications as a significant competitor to First-Class Mail has decreased the Postal Service's ability to look to First-Class Mail when it needs additional revenues to cover its institutional costs. As a result, other classes—and, due to its sheer size, Standard Mail in particular—must play an increasingly important role in the funding of institutional costs both now and in the future. Statements from past cases that suggest otherwise do not reflect the current reality and have little relevance today.

Second, given that the Postal Service has already lessened the relative cost coverage for ECR, and given that First-Class Mail has seen considerable erosion at the hands of electronic communications, proposals to decrease ECR cost coverage still further seem to go in the wrong direction. Instead, it would seem wiser, with the demise of the Postal Service's old business model, to begin to increase, at the margin, the institutional cost contribution borne by Standard Commercial mail rather than risk further substitution away from First-Class Mail and toward electronic communications. Standard Commercial mail will soon exceed First-Class Mail in volume. ECR mail will, in addition to Standard Regular, have to bear an increasing burden of the contribution to the recovery of institutional costs on an ongoing basis.

III. WITNESS MITCHELL INCORRECTLY STATES THAT RAMSEY PRICING LEADS TO LESS CROSS-SUBSIDIZATION THAN EFFICIENT COMPONENT PRICING

Val-Pak witness Mitchell incorrectly states that Ramsey pricing leads to less cross-subsidization than Efficient Component Pricing (ECP). He does so in his response to interrogatories submitted by Advo, Inc.,[23] where he disagrees with testimony submitted by Dr. Panzar regarding Ramsey pricing and ECP in this proceeding. In particular, witness Mitchell states that ECP is more likely than Ramsey pricing to result in cross-subsidization:

> I do not see that there is any meaningful likelihood of Ramsey pricing causing a cross subsidy. Unless there are significant differences in elasticity, which is not known to be the case among the categories in either Regular or ECR mail, a Ramsey solution goes in the direction of equal percentage markups over costs, which assures that each price is well above costs. On the other hand, ECPR produces different percentage markups, and is thus more likely than Ramsey to get into cross-subsidization territory.[24]

This statement is inconsistent with the principles of both Ramsey pricing and ECP. In particular, for Mitchell's statement to be true, he is implicitly assuming that the Postal System is governed by constant marginal costs. That is, the Ramsey pricing rule involves a percentage markup over *marginal* costs for each good produced.[25] If

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[23] Response of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Witness Mitchell, ADVO/VP-T1-1-14, 10.

[24] *Id.*

[25] This is the special case of the Ramsey pricing rule in the event that there are no substitutes or complements among the set of goods produced. *See* William J. Baumol, *Ramsey Pricing*, in 4 THE NEW PALGRAVE DICTIONARY OF ECONOMICS 49 (John Eatwell, Murray Milgate & Peter Newman, eds., Stockton Press, 1991).

marginal costs are everywhere constant, then Ramsey pricing will generally avoid cross subsidization.[26] However, were the multiproduct firm to have declining marginal costs, cross subsidization would be possible. Specifically, because Ramsey prices are calculated based on marginal prices *at the optimal level of output*, Ramsey prices consider only the multiproduct firm's cost function at specific points. Were a portion of the multiproduct firm's marginal cost curve for good *x* rapidly declining over a range of outputs for *x*, and were the optimal quantity of *x* to exceed that range of output under which good *x*'s marginal cost curve were decreasing, it would be possible for Ramsey pricing to cover the marginal cost of the last unit produced but not the average incremental costs of all units produced. As a result, good *x* would require subsidization by another good produced by the multiproduct firm.

By contrast, ECP ensures that the multiproduct firm is able to cover at least its total incremental costs from the production of the good in question.[27] Total incremental cost to the multiproduct firm of producing good *x* is merely the total cost to the multiproduct including the production of *x* less the total cost to the multiproduct

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[26] *Id* (stating that the marginal cost pricing rule is achieved in instances of constant returns to scale over the relevant range of outputs).

[27] *See, e.g.,* William J. Baumol & J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors,* 11 YALE J. ON REG. 171, 187-89 (1994).

firm without the production of x.[28] Calculated correctly, ECP therefore ensures that cross subsidization of goods produced by the multiproduct firm will not occur.[29]

Hence, I disagree with witness Mitchell. The Commission should conclude that ECP, rather than Ramsey pricing, is less likely to result in cross subsidization.

CONCLUSION

Based on my testimony and that of Dr. Ingraham (NAA-RT-2), the Commission should reject the proposals by Val-Pak witness Mitchell and MOAA witness Prescott to reduce the institutional cost contribution of Standard ECR mail.

First, as I explained above, the postal marketplace has changed dramatically in the past decade. Many of the statements from earlier postal proceedings upon which witnesses Mitchell and Prescott rely are outdated, and are not sound guidance for the Commission to use in this case. In particular, the Postal Service's business model of relying on growth in First-Class Mail to pay for the great majority of the institutional costs of the system is not sustainable because First-Class mail volume is now declining, not growing. Standard Mail will surpass First-Class Mail in volume by the Test Year. The substantial recent deployment, and continuing consumer adoption, of broadband communications has increased the availability and variety of electronic communication substitutes for First-Class Mail and these trends

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[28] *Id.* at 176-77.

[29] *See, e.g.,* Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises,* 65 AMER. ECON. REV. 966 (1975); Gerald R. Faulhaber, *Cross-Subsidy Analysis with More than Two Services,* 1 J. COMPETITION L. & ECON. 441 (2005).

are likely to continue. In contrast, electronic communications may be complementary to Standard mail.

Thus, pricing proposals that require First-Class Mail to bear a large majority of institutional costs are flawed. Standard mail, which is taking its place as the largest type of mail, can be expected to have to bear more of the institutional costs of the system. Accordingly, the proposals of witnesses Mitchell and Prescott should be rejected.

Finally, witness Mitchell incorrectly has asserted that Efficient Component Pricing is more likely to lead to cross-subsidization than Ramsey pricing. This is erroneous, for the reasons I have explained above.