

DOCKET SECTION

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

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Postal Rate and Fee Changes, 1997

Docket No. R97-1

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**NEWSPAPER ASSOCIATION OF AMERICA
WITNESS SHARON CHOWN
ANSWERS TO INTERROGATORIES OF
ADVERTISING MAIL MARKETING ASSOCIATION (AMMA/NAA-T1-4-8)
February 9, 1998**

The Newspaper Association of America hereby provides answers of witness Sharon Chown to the following interrogatories of Advertising Mail Marketing Association: AMMA/NAA-T1-4-8, filed on January 28, 1998.

Each interrogatory is stated verbatim and is followed by the answer. A declaration is attached.

Respectfully submitted,

NEWSPAPER ASSOCIATION OF AMERICA

By:



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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the instant document on all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

February 9, 1998



William B. Baker

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AMMA/NAA-T1-4.

The following is a general statement of the system of cost functions, classes (or products), volume variable costs, and institutional costs discussed in NAA-T-1:

- | | | | |
|----------|-------------------------|---|---|
| I_j | | = | Institutional costs that are "identifiable" with cost function j |
| $I.$ | $= \sum_{j=1}^m I_j$ | = | The total of all "identifiable" institutional costs |
| V_{ij} | | = | The total volume variable costs in cost function j that have been shown to vary with a change in volume of subclass i |
| $V_{.j}$ | $= \sum_{i=1}^n V_{ij}$ | = | The total of all volume variable costs for all classes served by cost function j |
| $V..$ | $= \sum_{j=1}^m V_{.j}$ | = | Total volume variable cost in the system |
| j | | = | Name (index) of the cost function ($j = 1, 2, \dots, m$) |
| m | | = | The total number of cost functions |
| i | | = | Name (index) of the subclass ($i = 1, 2, \dots, n$) |
| n | | = | The total number of subclasses |

- a. Please confirm that your R90-1 Method with equal markup for the recovery of "identifiable" institutional costs at the cost function level distribute a markup of the volume variable cost of the i th subclass and the j th cost function equal to:

$$I_j * \frac{V_{ij}}{V_{.j}} \qquad \text{(equation a)}$$

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If you cannot confirm, please explain and provide the correct expression for equation a.

- b. Please confirm that the total of these distributed "identifiable" institutional costs for all cost functions used by the i th subclass is equal to:

$$\sum_{j=1}^m [I_j * V_{ij} / V_{.j}] \quad (\text{equation b})$$

If you cannot confirm, please explain and provide the correct expression for equation b.

- c. Please confirm the weighting factor proposed in R97-1 for the j th cost function is equal to:

$$\frac{I_j}{V_{.j}} * \frac{V_{..}}{I} \quad (\text{equation c})$$

If you cannot confirm, please explain and provide the correct expression for equation c.

- d. Please confirm that the R97-1 weighting factor that you propose for the j th cost function, when used to weight the volume variable cost of the i th subclass, is equal to:

$$\frac{I_j * V_{ij}}{V_{.j}} * \frac{V_{..}}{I} \quad (\text{equation d})$$

If you cannot confirm, please explain and provide the correct expression for equation d.

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- e. Please confirm that the total of the R97-1 weighted volume variable costs for the i th class is equal to:

$$\left(\frac{V_{..}}{L}\right) * \sum_{j=1}^m [L_j * V_{ij} / V_{.i}] \quad (\text{equation e})$$

If you cannot confirm, please explain and provide the correct expression for equation e.

Answer:

- (a) Confirmed, assuming equal markups across all subclasses.
- (b) Confirmed.
- (c) Confirmed.
- (d) Confirmed.
- (e) Confirmed.

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AMMA/NAA-T1-5. In responses to our interrogatory AMMA/NAA-T1-2 you state, in part, "First, I do not understand how a subclass of mail can "consume" institutional costs."

- a. Do you believe that a subclass of mail can cause the Postal Service to incur institutional costs?
- b. If your answer to part (a) is affirmative, do you contend that the "metric" advocated in your testimony reflects this cost-causative phenomenon and, if so, how?
- c. How do you define the terms "cause" and "cost-causation" as you have interpreted them in framing your answers to parts (a) and (b) above?

Answer:

a. No. A *single* subclass of mail cannot *cause* the Postal Service to incur institutional costs. Costs caused by a single subclass of mail are attributable costs. Institutional costs are those costs for which a reliable causal connection has not been found.

b. Not applicable.

c. Costs are "caused" by a subclass of mail if the elimination of that subclass would result in the elimination of the cost.

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AMMA/NAA-T1-6. Professor Panzer (sic), in his testimony for the Postal Service, states:

Applying mark-ups to average incremental costs instead of to marginal (unit volume variable) costs reduces economic efficiency unnecessarily. This is because, as explained above, the efficient pursuit of any objective subject to a break-even constraint requires that one trade-off costs and benefits at the margin. Marginal costs provide relevant information for conducting this trade-off, while average incremental costs do not.

Direct Testimony of John C. Panzer (sic) on behalf of the United States Postal Service, Docket No. R97-1, USPS-T-11 at 28 ll. 14-19.

- a. Do you agree with this statement?
- b. If you do agree with the statement, how do you justify using weighted attributable costs instead of volume variable costs to determine contribution to institutional costs?
- c. If your answer to part (a) is negative, please provide arguments from economic literature and/or regulatory proceedings to support your reason(s) for disagreement, including specific citations to published materials.

Answer:

a. As explained below, I agree with Dr. Panzar's statement in part and I disagree in part.

First, Dr. Panzar states that:

"Applying mark-ups to average incremental costs instead of to marginal (unit volume variable) costs reduces economic efficiency unnecessarily."

I disagree with the term "unnecessarily." It is necessary to deviate from rates that would achieve economic efficiency in order to meet other objectives of the Postal

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Reorganization Act. As Dr. Panzar himself confirms, economic efficiency is not the sole objective for setting rates under the Act. (See NAA/USPS-T11-1, Tr. 9/4630)

Second, I agree that economic efficiency requires a trade-off between costs and benefits at the margin and that marginal costs provide relevant information for making this tradeoff. However, it is also necessary to have relevant information on incremental costs. As Dr. Panzar points out:

"If the monopolist's prices are set below per unit incremental costs, firms with superior productive techniques would be inefficiently deterred from entering the market." (USPS-T-11, page 10, lines 24-5 and page 11, line 1)

Therefore, it is necessary to have information on both marginal costs and incremental costs when setting rate levels and determining the rate structures.

Third, it is important to note that the Postal Service is not proposing that rates be set *equal* to marginal costs. In order to achieve the break-even constraint, it is necessary to set rates above marginal costs and thus "[p]rices necessarily lose some of this efficiency role in markets served by a multiproduct monopoly firm operating under conditions of economies of scale." (USPS-T-11, page 10, lines 17-19)

Since rates are not set equal to marginal costs, mailers are not comparing marginal costs and benefits when making the tradeoff at the margin. Instead, mailers are comparing the actual rate (which exceeds marginal cost) and the benefit. (See NAA/USPS-T20-13, Tr. 2/193) Rates *based upon but not equal to* marginal costs are not, by definition, economically efficient.

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Finally, economic efficiency requires that tradeoffs between marginal costs and benefits be made for individual products, not for a mix of products. As noted below in my response to part (b), the overall rate level for each subclass is currently determined jointly for all functions provided by the Postal Service. Rate levels are not determined separately for each function provided by the Postal Service. As explained in more detail in part (b) below, it is precisely the fact that a single aggregate measure of the attributable costs is used when determining institutional cost contribution that necessitates, in my view, a better metric for assigning institutional costs.

b. Historically when the Postal Rate Commission established the institutional cost contribution for each subclass, it relied upon a single aggregate measure of attributable costs and hence it considered all the functions provided by the Postal Service simultaneously. By so doing, a dollar of mail processing attributable costs was given the same weight as a dollar of delivery costs when assigning institutional costs, even though the provision of the delivery function accounts for a far greater share of the institutional costs of the Postal Service. Using the unweighted attributable costs as a markup base makes an implicit assumption that institutional costs are incurred to provide the different functions of the Postal Service in proportion to the attributable costs of these functions. As demonstrated in my testimony, this is clearly untrue. By weighting attributable costs for markup purposes, I do not make this faulty assumption and provide a better measure of how the subclasses of mail benefit from institutional effort.

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If rate levels were established for each function separately, then there would be no need to weight the attributable costs of the functions and marking up the actual attributable costs would be appropriate. However, since rate levels are not established in this manner, it is necessary to correct for the erroneous assumption that each function gives rise to institutional costs in proportion to the function's attributable costs.

c. See (a).

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AMMA/NAA-T1-7, You say that "weighting the attributable costs to reflect the relative mix of services used by each subclass...will provide the Commission with a better basis for evaluating the assignment of the institutional costs." Response to AMMA/NAA-T1-2.

- a. Does the word "weighting" in this recitation refer to anything other than the factors set out on line 39 of your Exhibit NAA-1D and, if so, what?
- b. If your answer to part (a) is in the affirmative, why does the percentage of institutional costs divided by the percentage attributable costs for what you define as USPS functions (Exhibit NAA-1C line 5) improve the Commission's power to apply the statutory cost assignment criteria correctly?
- c. Would an index created by dividing the percentage of attributable costs of each function by the percentage of institutional costs of that function equally serve the Commission's interest and, if not, why not?

Answer:

- a. No.
- b. First, I would change the word "correctly" to "better" as there is no single correct way to assign institutional costs.

As discussed in my response to AMMA/NAA-T1-6(b), the current metric for assigning institutional costs -- total attributable costs -- rests upon the assumption that each dollar of attributable costs should be given equal weight when assigning institutional costs. Yet, as I have explained in my direct testimony, the different functions of the Postal Service give rise to very different proportions of institutional costs relative to attributable costs. By weighting the attributable costs by the weighting factors I propose, the attributable costs of the functions that give rise to large shares of

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the institutional costs of the Postal Service are given greater weight when assigning these institutional costs.

c. No. Your suggested weighting factors would not provide a better metric of how the various subclasses of mail benefit from institutional effort. If attributable costs were weighted by a factor equal to the percentage of attributable costs divided by institutional costs, then (contrary to common sense) those functions that give rise to a large portion of attributable costs and few institutional costs would be given greater weight when assigning institutional costs. In contrast, the attributable costs of those functions which account for a large share of institutional costs would receive little weight when assigning institutional costs.

To understand how your suggested weighting factors defy common sense, consider a function whose costs are almost entirely attributed, with few remaining institutional costs. Assume 95 percent of the costs are attributed for a given function. Using your suggested weighting factors, the attributable costs of this function would be weighted by a very large factor. (For example, 95% divided by 5% or a factor of 19.0.) As a result, the majority of the institutional costs of the Postal Service would be assigned to the subclasses of mail based, in large part, upon their relative use of this function, even though the Postal Service incurs few institutional costs in providing the function. Other functions that give rise to large portions of institutional costs relative to attributable costs would be given little weight when assigning institutional costs. Yet, it is these very functions that generate a large portion of the institutional costs.

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Therefore, your suggested weighting factors would provide a very poor measure of how the subclasses of mail benefit from institutional effort.

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AMMA/NAA-T1-8. If your "Better Metric" is adopted, will sortation and destination entry discounts be impacted? If your answer is affirmative, please provide a detailed explanation of the impacts and give separate examples of impacts on sortation discounts and destination entry discounts.

Answer:

No. I propose that my "better metric" be used only to determine the institutional cost contribution of each subclass of mail.

DECLARATION

I, Sharon L. Chown, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information and belief.

A handwritten signature in black ink, appearing to read "S. L. Chown", is written above a horizontal line.

Date: Feb 9, 1998