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DIRECT TESTIMONY

OF

ROGER SHERMAN

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

September 30, 1996

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STATEMENT OF QUALIFICATIONS

My Name is Roger Sherman. I am Brown-Forman Professor of Economics at the University of Virginia. I was awarded the M.B.A. degree by Harvard University and the M.S. and Ph.D. degrees by Carnegie-Mellon University. I have been at the University of Virginia since 1965 and served as Economics Department chair from 1982 to 1990. I have published five books, including an edited volume on postal issues, and over 80 articles, including 10 that can be related to postal matters. I currently serve on the editorial boards of two academic journals, including the Journal of Regulatory Economics. In the past I have served as consultant to the U.S. Postal Service and the Postal Rate Commission. My curriculum vitae is attached.

I. PURPOSE OF TESTIMONY

The purpose of my testimony is to discuss pricing and classification principles used by the Postal Service in Docket No. MC96-3. Attention will be given to the market power of the Postal Service and to evidence of competitive pressure, and how such elements affect optimal pricing according to accepted principles. Cost information is the crucial basis for pricing in any circumstance, and the use of cost information will be considered.

II. THE PIECE-MEAL APPROACH AND THE MARKETPLACE

The Postal Service proposal in Docket No. MC96-3 has features that are unusual. First, it focuses on only a few special services, rather than on all services. Second, it gives attention to something called marketplace considerations, and gives less than expected attention to costs. Observations will be made about these features of the case, and then the proposals will be taken up in turn.

This is an unusual proposal for making price increases on a piece-meal basis rather than in context, as in an omnibus rate case, where all rates for all services can be compared. In setting out goals of the proposal, Witness Lyons (USPS-T-1) says the first goal is to place services "on a more economically rational, businesslike basis." (page 2) In trying to give content to that vague statement he says the proposals are designed "to reflect marketplace considerations, as well as the costs of providing services." (page 2) He adds that "Specific pricing reform objectives include more market-based prices, more equitable contributions from the services to institutional costs, and the realignment and streamlining of certain special services offerings to make them more commercially attractive." These may be nice-sounding statements but they are still vague. It is not at all clear what market-based prices are. They are not defined well enough to be related to principles of optimal pricing. To pursue equitable contributions to institutional costs calls for an omnibus rate case, where comparisons across services are possible. That goal is practically impossible to pursue when only piece-meal proposals are made. And the recommended realignment and streamlining sometimes seems aimed more at raising revenue than at making offerings more commercially attractive.

The second goal Mr. Lyons cites (USPS-T-1) is to make improvements in services so "they are more useful to the customer." (page 2) The only concrete example he gives is the special fee that is proposed for postal cards, which will raise the price by 2 cents per card; this would not seem to make the postal card any more useful to customers. Another improvement noted along this line is reducing the number of fees for certain services. Of course the number of fees is reduced by eliminating choices for consumers, which would usually make a service less rather than more useful. Eliminating a service is cited as another such improvement. While eliminating a service may make good profit and loss sense, it can hardly make the service more useful. The third goal cited is to improve contributions, consistent with overall financial policy objectives (USPS-T-1, page 3). This goal seems to be served by practically every proposal that is made.

The influence of the marketplace is described generally in the testimony of Witness Steidtmann (USPS-T-2), who rationalizes the Postal Service proposals as fitting a retailer's procedures and point of view. In defense of the piece-meal approach of selective pricing, he says that "retailers will tend to adjust prices selectively," and "it allows for greater analysis of those products that would most benefit from adjustment." (page 1) Selections of services to consider apparently were not made on that ground, however. Money order and C.O.D. services currently appear to be priced below their attributable costs, so they obviously are most in need of adjustment, but they are not among the services being adjusted. In any case, a retailer's way of looking at revisions to services and prices would not ordinarily include welfare considerations and so is not what is expected from the Postal Service.

Witness Steidtmann's review of the proposals repeatedly finds them consistent with sound retailing practice. In the case of certified mail/return receipt service, for example, he notes the certified mail price is to be increased and the choice of return receipt service without address information is to be eliminated. About eliminating the return receipt choice he says that "it is sound retailing practice to simplify a product offering." (page 5) About the price increase in certified mail he says: "This increase in certified mail price reflects the fact that comparable service is currently offered at much higher prices. The certified mail fee increases thus comports with retail industry practices." (pages 5-6) Having alternative services available only at higher prices means the Postal Service has market power. The point has been made often: "...monopoly power is present when a firm is sufficiently insulated from competitive pressures to be able to raise prices...without concern for its competitors' actions because its rivals cannot offer customers reasonable alternatives."[1] That such monopoly power would be exploited by a retailer is unsurprising. The fact that a retailer would exploit monopoly advantage is also irrelevant as far as pricing the services of the Postal Service is concerned.

Marketplace considerations alone seem often to leave great latitude for Postal Service prices. If alternative services can be offered at prices not far from those of the Postal Service, however, that emphasizes the importance of cost information. Indeed, cost information is really more important than competitive price information. For even when informed about competitive prices, a provider of services must know its own costs in order to judge where its services can offer consumers the greatest advantage relative to competitors. This is clearly true if technologies differ, so

[1] From F.M. Fisher, J.J. McGowan, and J.E. Greenwood, Folded, Spindled, and Mutilated: Economic Analysis of U.S. vs. IBM, Cambridge, Mass.: MIT Press, 1983, p. 99.

costs of different service features differ among providers, because then advantage should be taken of one's own technology to lower prices where costs are lower. That is how consumers can benefit from the different technologies. If technologies are similar and costs are similar among producers, information about costs is still crucial. Then the provider who is better informed about costs, and who prices based on costs, will win the business where it has lower costs, leaving the less profitable business for a less informed competitor. Cost information in the Postal Service proposal is very limited, however. There is often little cost information for detailed offerings within broad service categories, making analysis of specific pricing proposals impossible.

Of course cost information also is crucially important for pricing in the absence of close competitors offering alternative services. Optimal pricing theories often stress relative prices—how prices relate to one another—or relative contribution margins as in the case of Ramsey prices. And to see the pattern of such relative price relationships it is desirable to consider all prices at once, as in an omnibus rate case. In addition, a price change in one service can alter quantities of other services, through cross-price-elasticity effects. This interrelationship among services also makes it desirable to consider entire sets of prices rather than to take them up in a piece-meal way, since in the piece-meal approach it is difficult to deal with effects on services that are not under consideration. Thus, to take account of optimal pricing ideas and to reflect effects across services, omnibus rate cases have great advantages.

It is still possible to consider effectively only a subset of services, if added care is given to the subset and effects of relations to other prices and services are included. Only limited attention is given to such effects by the Postal Service. For instance, in pricing post office boxes no attention is given to possible delivery-cost savings in the major mail classes due to post office box use. The Commission has rejected this so called "cost avoidance" effect in pricing post office boxes before (R77-1; R84-1; R87-1), but it always had to do so for lack of sound information on what the consequent delivery cost savings might be. This would be an appropriate time to deal feasibly with the question. When the subject came up in prior cases the Commission was confronted with fairly extreme proposals to be accepted or rejected, whereas here a reasoned analysis might have been provided as an influence on post office box pricing.

If socially optimal pricing is a goal, some reference to the relation between costs and prices across services is needed. Otherwise one subclass, or a small group of subclasses, could be out of line with others regarding contribution made to institutional costs, yet this would not be known. To pursue socially optimal prices, a piece-meal approach has to include an explicit plan for future proposals, so the intended pattern of price-cost relationships in effect over time can be seen. Only then would it be possible to estimate in an overall way which consumers benefit or which bear added burdens under a proposal. The Postal Service offers no such plan. Even though it would not be binding, such a plan would still allow comparisons of effects across services.

One goal of the Postal Service's proposal is to raise greater revenue and increase the contribution to institutional costs. It stands to reason that increased prices for only some services will distort overall Ramsey price relationships or any other form of relative relationship from whatever existed before, unless attention is focused on services where price-cost relationships have fallen out of line. But attention clearly is not focused in that way, since two money-losing special services, C.O.D. and money orders, are not given any attention. By failing to cover their attributable costs these two services fail to satisfy virtually any guideline for optimal pricing. By failing to cover their attributable costs they also are not in compliance with the law, in the form of pricing requirements of the Act (§ 3622(b)). In any consideration of increases in special services prices they would therefore seem to deserve the highest priority.

Thus, the new features of this case do not appear to bring real advantages. The goals stated for them are vague and not always descriptive of what is actually proposed. Sound cost information is crucial, as always, but seems not to have been given great attention relative to information on alternative supplier's offerings. Where they are provided, these marketplace considerations indicate mainly that few alternatives are available at reasonable prices for Postal Service customers. Such evidence of market power indicates that optimal pricing principles are still important. But they are not emphasized and are not easy to apply because only a few services are under consideration.

III. SPECIFIC POSTAL SERVICE PROPOSALS

In turning to examine specific proposals for individual services, we shall begin with proposals that are easy to judge favorably, such as the proposal to eliminate special delivery service. Its role is now being served by faster means of expedited delivery and it can barely cover its attributable cost, so it is reasonable to eliminate it. Raising indemnity limits for insurance service is a desirable expansion of offerings and should be adopted. No longer charging for registry service based on declared value above $100 when it is uninsured—that is, when cost probably does not depend on value—may be a step that should have been taken long ago. It would be very simple to decide the question if cost information were available, but lack of cost information is serious. Adequate cost information is also lacking for certified mail service, where a simple price increase is proposed. Elimination of return receipt service that does not include address information, which is shown to be preferred by nine-tenths of users, seems misguided. Why force consumers to choose the address service when they show so clearly by their choices that they do not want it? Finally, proposals for post office box and caller service prices in relation to estimated costs seem crudely jumbled, and it is difficult to see how the proposal can be acceptable when it is so lacking in consistency.

A. Special Delivery

The introduction of alternative expedited mail services has narrowed the role available for special delivery and threatened its usefulness. For example, Postal Service Express Mail service does two things: (1) it speeds movement of the mail to the destination post office and (2) it then accomplishes expedited delivery. By offering faster movement to destination in addition to expedited delivery, Express Mail dominates special delivery service. It might be desirable to separate these two features of speed in movement to destination post office and speed in delivery, so users could choose only the latter when they wish. This might be preferred when seeking faster delivery within the same city, for example, where speed of movement to a distant post office is not needed. But apparently because of competition from courier services, the Postal Service is unable to offer that service at a price much above attributable costs. The Postal Service now proposes to eliminate special delivery service. Based on the declining usage of special delivery and its inability to contribute above its attributable costs, this might be a wise course.

B. Insured Mail

Insured mail is the only service for which a genuine improvement is proposed. Higher indemnity levels are to be offered for domestic insured mail, which now has a limit of $600, and for Express Mail, which now has a limit of $500. Both limits are to be raised to $5,000. Charges for these greater indemnity levels will be made based on value, in $100 increments. The current insured mail fee is $0.75 for values up to $50, $1.60 for values from $50.01 to $100, and an added $0.90 per $100 in value up to $600. The proposal will simply continue that fee of $0.90 per $100 of value past $600 up to $5000. For Express Mail, an indemnity level up to $500 is currently included in the service and will continue to be included without additional fee. Should greater insurance be desired it will be offered under the proposal at $0.90 per $100 up to $5,000.

Some evidence is provided by the Postal Service indicating that users of insured mailing services want higher indemnity levels and would rely more on Postal Service services if they could obtain it. A survey of customers shows that significant usage of the greater indemnity levels is likely (USPS-LR-SSR-109, cited by Witness Needham, USPS-T-8, page 8). Thus, there appears to be sufficient interest to warrant offering the higher indemnity levels, and to try to see what effect it might have on usage by the mailers of valuable items. One drawback of the proposal is that it is difficult to identify costs for the new levels of insurance service.

Since this increase in indemnity limit would essentially be a new Postal Service offering, provision should be made to gather cost information as a basis for later adjustment of these fees, should that be appropriate. And a procedural change may be warranted—as described by Postal Service Witness Needham (USPS-T-8, pages 28-29)—to reduce the probability of claims at higher indemnity levels for insured mail. The change should make the exposure of insured mail and Express Mail comparable and therefore help to support equal insurance charges.

The Postal Service also proposes to make an insurance service offering less attractive. It proposes to lower the indemnity limit for document reconstruction from the current levels of $50,000 per piece and $500,000 per occurrence down to 1/100th of these amounts, to $500 per piece and $5,000 per occurrence. Although it is a very substantial reduction in what has been offered, the $50,000 limit per piece is probably inappropriate at the present time, and the new offering seems adequate.

C. Registered Mail

Registered mail offers high security and accountability that is appropriate for the care of valuable items. Currently the price for registered mail depends on its declared value, starting with value categories $0.00 to $100, $100.01 to $500,

$500.01 to $1,000, and rising thereafter in $1,000 increments to $15,000,000. Two options, with different prices, are now available for every value category, one with insurance and one without insurance. Without insurance the lowest value category is charged $4.85 and for each rising declared value category thereafter the price rises by $0.35. With insurance the lowest value category is charged $4.95 and for each rising category thereafter the price rises by $0.45. (For example, under this fee structure an item with a declared value of $1,000,000 will be priced at $355.20 without insurance and $455.40 with insurance.)

The proposed rate structure eliminates the option of sending an item by registered mail without insurance if its declared value exceeds $100. An item in the first value category of $0.00 to $100 can be sent without insurance, but no item with a higher declared value can be sent without insurance. The rates for insured registry mail will remain unchanged, and are to continue as described above.

The question this proposal raises about the current rates is: For mail that had no insurance, why were such significant distinctions made in price in the current rates, based on declared value? It would seem that, without insurance, declared value would not greatly affect handling cost, and thus should not greatly affect rates. David Popkin argued in R94-1 (Initial Brief dated September 22, 1994) that accepting, transporting, and delivering a registered item that is not insured costs no more simply because it is more valuable. The rate structure proposed by the Postal Service, which essentially offers no rate distinction for uninsured items by declared value, is consistent with his argument. Any major cost difference that is based on value would seem to turn on the insurance cost, which presumably does depend on value. The Commission endorsed exploration of this question that Popkin raised in R94-1, but lacked a record on which to consider it at that time. It is possible the logic of Mr. Popkin's argument would be supported with postal cost information by value category, which could then justify the proposed rate structure. But costs for insured or uninsured registry items by declared value are not provided, so although the proposal is appealing no basis is provided for evaluating it.

There is some survey information from Postal Service customers showing positive interest in the proposal (Witness Needham, USPS-T-8, pages 6-15, and USPS-LR-SSR-108). Indirect support for the proposed fee schedule comes from the pattern of usage, which shows that 88 percent of registry mail without insurance has declared value of $100 or less and only 12 percent has declared value above $100. It might be surprising to find even 12 percent of the mailers of uninsured mail declaring a value higher than $100—doing so only entitles them to pay a higher fee. After all, the existing fee structure looks like a form of "value of service" pricing.

The November 1993 survey of high claim filers and mailers of high value items shows that most do not object to eliminating the no-insurance option above $100 and those who do are not heavy users of uninsured registry mail.

The Postal Service projects that enough current users of uninsured registry mail valued above $100 will switch to insured so revenue per transaction will increase under the proposal (USPS-5G, 5J. But see USPS-T-1, WP-E, page 2, where revenue per transaction is unchanged.) Since the proposal eliminates the uninsured option for declared values above $100, it is also possible that users of this service will send items at the $100 value rate rather than declare a higher value and pay for unwanted insurance. So there actually could be a decline in revenue per transaction. But the effect in any case will not be enormous, since only about 4 percent of registry business is affected.

D. Certified Mail

Certified mail was created to provide a service somewhat like registry service, but at lower cost, for the portion of registry mail that had no monetary value. It has grown handsomely and continues to be well accepted by consumers. The Postal Service proposes to raise the fee for certified mail from $1.10 to $1.50. It is difficult to interpret how the result of this price increase would relate to the overall structure of rates, because costs and revenues are not consistently presented. The cost report of Witness Patelunas (USPS-5G, 5J) shows a cost coverage for certified mail at current rates of 202.2 percent, and a cost coverage under proposed rates of 271.0 percent. These are very high cost coverages. Witness Needham reports (USPS-T-8, page 71) that the Postal Service historically has included return receipt revenue but not return receipt cost in the cost coverage calculation for certified mail, but that it is not doing so in this case. Perhaps Witness Patelunas used the historical practice, because Witness Needham reports lower cost coverages, claiming that certified mail cost coverage is only 107 percent under current rates and would be 146 percent under proposed rates.

If there is a longstanding error in the way costs have been evaluated for pricing certified mail service, that should be demonstrated and new rates might be proposed based on correct costs. At present the argument is not put explicitly and the reason for the increase—cost increases or previously incorrect costs—is not perfectly clear.

Evidence is provided from a survey of perceived certified mail users, showing that alternative services are much more costly to use. The average cost of an alternative service was greater than the cost of Postal Service certified mail by $10.68. This difference applies whether return receipt, which often accompanies certified mail service, was included or not

(Witness Needham, USPS-T-8, page 67, and USPS-LR-SSR-110). Once again, this shows the great market power the Postal Service has in the market for certified mail.

E. Return Receipt

Return receipt service gives proof of delivery. It is available for mail matter sent C.O.D., insured at over $50, registered, certified, or Express Mail. For such mail matter—which requires signature on receipt—even after it is mailed it is possible to request the name of the person who signed for it and the date it was delivered. But generally the return receipt service is requested when the item is mailed. Merchandise sent by First-Class Mail, Priority Mail, and much of Standard Mail also qualifies for the return receipt service, but only if requested at the time such items are mailed. Currently the return receipt service for mail matter after it has been mailed is available for a charge of $6.60, and no change in that rate is proposed. For mail matter and merchandise there are now two levels of service, one that provides the name of the recipent and the date delivered, and another that provides those two facts plus the address delivered to. For mail matter the first service is available for a fee of $1.10 and the second for a fee of $1.50. These same two levels of service are also available for merchandise at fees of $1.20 and $1.65.

A reclassification is proposed to simplify the service offerings by eliminating the choice of return receipt with date and name of recipient only, and requiring that the address information be chosen as well (the address will be provided only when it is different from the original address). The simplification would apply to return receipt use in both mail matter and merchandise. Eliminating the lower price option of choosing date and name only would have the effect of forcing all users to the higher price service level that includes address information, so it will effectively be a price increase for those who had selected only date and name information before. Since roughly 90 percent of the current volume falls in the date and name category that is being eliminated, the effect is essentially like a price increase, and a substantial one. Currently the cost coverage for this service is reported as 127 percent by Witness Needham and is estimated to rise to 171 percent under the proposal (USPS-T-8, page 92).

Witness Steidtmann uses the auto industry move to offering option packages, rather than allowing complete consumer choice of options, as a suggestive analogy (USPS-T-2, page 5). In that auto case there was a great reduction in cost as benefit to the consumer; no such benefit is provided here in the return receipt case to justify the elimination of consumer choice. Perhaps it is advantageous to the Postal Service to have customers use the address service, so that more addresses will be correct and fewer pieces of mail will have to be forwarded because they were sent to the wrong address. But if that is true the address service should be offered at a lower price, not a higher one.

If the cost for providing the additional address information in the present optional return receipt service is very small, of course, a case might be made for including it as part of a simpler, single-package return receipt service. But the cost information that is given (USPS-T-1, WP-D at page 3) indicates an added cost for the address service of $0.24, which leads to a $0.40 price difference with a cost coverage of 167 percent. This cost difference thus seems sufficient to warrant the existing $0.40 price difference, and no argument is offered to the contrary.

It is obvious from their present choices that consumers want the no-address option, because nine-tenths of them choose it in preference to the additional, more costly, address information. The opportunity to have address information might usefully be preserved as an extra-cost option for consumers, since some consumers use it, especially recently with merchandise, but the vast majority of consumers clearly do not value it enough to pay the fee set for it. The fact that nine-tenths of consumers now show by their choices that they do not value the address information as much as they would be charged for it is compelling evidence against the proposal to force them to take it. Simplification is to be considered in rate setting, but as the Commission has noted before, it must be weighed against other effects (see, e.g., Recommended Decisions in Docket No. R77-1, page 434, and Docket No. R80-1, page 583). Simplification is no justification for forcing the vast majority of consumers to buy the more expensive address service, which they demonstrate overwhelmingly that they do not want. The choice of the lower cost and lower price service their choices show they prefer should not be taken away from them.

F. Stamped Card

The Postal Service proposes to add a $0.02 fee to the postal card to pay for its manufacture and for affixing a stamp to it, to make the full price of the postal card $0.22. The rate for the private card is to remain at $0.20. The proposal would make the postal card analogous to the stamped envelope, which requires a $0.06 charge for the envelope and for affixing the stamp (although it would depart from the practice followed in Express Mail and Priority Mail of providing envelopes, and even boxes, free). Pursuing this analogy, the postal card would be renamed a stamped card. The Postal Service estimates test-year volume for postal cards of 428,618,000 (USPS-T-1, WP-E, page 1) at current rates. This volume would yield $85,723,600 in revenue. The Postal Service proposal assumes a very small decline in postal card volume in response to the 10 percent price increase that the proposal imposes, based on an assumed demand elasticity of only -0.17. At the proposed new rate, volume is estimated at 421,302,000 (USPS-T-1, WP-D, page 10 and WP-E, page 1), which would yield revenue of $92,686,440. Thus there would be a net increase in revenue of $6,963,000. Postal Service forecasts of revenue effects (USPS-T-1, Exhibit A and WP-E, page 2) show a larger revenue gain of $8,426,000, which is obtained by merely multiplying the $0.02 increase times the forecast volume at the new rate. This calculation fails to take account of the loss in postal card revenue (at $.20 per card) due to the decline in volume that the $0.02 rate increase is assumed to cause, so it overstates the net revenue gain that can be expected. But even with that extra revenue loss accounted for (see USPS-T-1, WP-E, page 1, line 4, column 5), the revenue forecast may be far too optimistic because of the elasticity assumptions that lie behind the volume forecast.

The main difficulty with this Postal Service proposal is that it ignores the remarkable difference in processing cost between postal cards and private cards, postal cards costing at least $0.08 per piece less to process than private cards (USPS-T-5C at 10). Witness Patelunas' response to interrogatory OCA/USPS-T5-11 notes plausible sources of this cost difference, including greater compatibility of postal cards with mechanization and automation due in part to their uniform size and shape. They also may have cleaner addresses, in part because private cards are more apt to be hand addressed and sent, for example, from vacation spots. It is unfortunate that costs are not provided, to show the effects of these possible influences. But it surely is uneconomic to raise the effective price of the postal card and thereby discourage the use of a Postal Service offering that costs so little to process, while at the same time encouraging the use of a service that costs more to process. And these effects may be stronger than is currently being assumed.

The newly created "stamped card" will be a very close substitute for private cards. Past elasticity estimates have not been based on changes in either the postal card or the private card rate alone, and might have yielded a greater elasticity estimate had such an estimate been possible. So the extremely low elasticity of -0.17 that is being assumed for a change in price of postal cards may be inappropriate. Consideration should be given to the possibility that more of the postal card volume will move to the very close—and now lower priced—substitute, private cards. Should such migration occur, the financial consequences could be unfortunate. The reported contribution above attributable cost (price minus attributable cost) is less than $0.04 per private card and roughly three times as great at $0.12 per postal card. To shift volume from the much more profitable postal cards over to private cards in this situation by raising the price of postal cards will lower the efficiency of the mail stream. Indeed, the proposal may not even yield the short-term profit contribution that can be calculated from the proposal's optimistic assumptions about demand elasticities.

Thus, despite the apparent similarity with stamped envelopes as a basis for charging for a card with a stamp affixed to it, the stamped card proposal would discourage use of an extremely efficient item in the mail stream. It is not needed for consistency, since mailing materials are given free with some other services. And the proposal could encourage greater use of private cards that are less efficient to process. The effects of this proposal could be worse than projected by the Postal Service because these projections make optimistic assumptions about cross elasticities of demand between the two categories of card service.

G. Post Office Boxes and Caller Service

The Postal Service proposes price increases for post office boxes and caller service (a decrease is also proposed for box service in those few areas where carrier delivery is not offered, from the nominal $2 per year fee to provision of box service at no charge). Difficulties arise in pricing post office boxes with a single rate structure that must apply all across the country. Costs can vary among urban areas and between urban and rural areas. When areas are categorized and prices are set to reflect average cost differences some of the resulting prices may seem irrational, as when a suburban area and a rural area are in close proximity and have essentially the same costs, but have different rates. Proposed price adjustments are intended to moderate disparities that exist among delivery areas in the present rate structure. Costs also are imputed to post office boxes by size and by location, so rates can be compared with costs and adjusted to reflect differences. A nonresident fee is also proposed, a charge of $36 per year to receive service in a post office box outside the 5-digit ZIP Code area where the customer either resides or has a business address.

The delivery areas that are now identified are: I-A, post offices in high cost areas in New York City; I-B, post offices in other parts of New York and in eight other large cities; I-C, other city post offices; II, mainly rural post offices that provide delivery service; and III, post offices that do not provide delivery service. These categories are preserved under the proposal, but rather than being called I-A, I-B, I-C, II and III, they are to be renamed as delivery areas A, B, C, D and E. Rates also vary by box size, which obviously influences costs, and the same five box sizes that are now offered are still to be offered. The smaller sizes tend to be used more by individuals and small businesses, while the large sizes are used more by large organizations such as corporations.

There is a broad general problem in pricing post office boxes that is not considered explicitly in the proposal. That problem is that there may be a cost savings in delivery to a post office box rather than to a business or residence. It is interesting that two Postal Service post office box proposals, having a fee for nonresident use of a post office box, or providing post office boxes free of charge to mail recipients who do not have delivery service, may both be consistent with such delivery savings. In the latter case of no delivery to mail recipients at their own locations, such delivery must be so costly that it is more economical for the Postal Service to use post office boxes instead, even when the boxes are given away free. Such cost savings in delivery to parties that have post office boxes might extend to other areas, and if so it can warrant a reduction in the post office box fee to take account of that effect. If fees are not lowered to reflect any savings that post office boxes allow in delivery, then post office box use might be discouraged, with the result that total delivery costs will be higher.

Conceptually, the nonresident fee may also be consistent with there being a cost saving when mail is delivered to a post office box, rather than to a residence or place of business. For when a post office box is provided to a party living in, or at a business address in, another ZIP Code, delivery at that other location may be more extensive than when a box is obtained at the recipient's own post office. So the full potential saving from delivery to a post office box may not be realized for the nonresident post office box. If the saving cannot be realized, it may be reasonable to charge an extra fee for the post office box used by a nonresident.

Only minor administrative expenses, which might be traced to nonresident mailboxes at some locations, have been offered in an effort to justify the nonresident fee. Thus, in principle, delivery cost savings—or rather the lack of it—is the only cost justification for the nonresident fee, and it has not been presented either. The nonresident fee is thus unsupportable as presented, with no added cost information for nonresident post office boxes to justify it. If post office boxes are properly priced so they cover their costs they should be provided wherever they are requested by consumers. If the added delivery cost to nonresident boxes is significant it should be estimated and offered as support for any proposed nonresident fee.

Despite the failure to consider possible savings in delivery cost explicitly, the proposed post office box fees are not extremely high, so the degree of discouragement in their use may not be great. There are significant differences by delivery area and box size, however, that do not seem to be justified by differences in costs. Average cost coverages are presented below that were calculated from Witness Lion's cost estimates (USPS-T-4, Table 18) and Witness Needham's revenue information (USPS-T-7, Table 1). These estimates show a surprising reliance on

Delivery Area Old	New	Cost Coverage
I-A	A	148
I-B	B	149
I-C	C	194
II	D	73
III	E	0

high revenues from delivery area I-C, city areas outside the largest cities. There the cost coverage is 194 percent, whereas the next highest cost coverage (from large cities) averages 149 percent. The post office boxes in rural areas are priced below cost. Raising fees sufficiently to avoid pricing rural post office boxes below costs would require increases greater than 100 percent above current rates, because current rates are so low. But the absolute increases would be smaller than many other increases in the proposal, so they would not be unreasonable. Avoiding prices that are below cost would seem to be a compelling goal, and it requires higher fees for delivery area II, or proposed area D, post office boxes.

By box size, the highest average cost coverage is for the middle box size, at 153 percent, and coverages decline in moving either to smaller boxes, with a coverage of only 129 percent for the smallest box size, or to larger boxes, with a coverage of only 118 percent for the largest box size.

Box Size	Cost Coverage
1	129
2	143
3	153
4	137
5	118

These substantial variations in cost coverages are not justified by any facts or arguments that are presented. It is claimed by Witness Needham that fees should be lower for larger boxes. The main reason given is that users have a tendency to choose boxes that are too small, which burdens the Postal Service with costs from overflow mail problems. If facts are known for such a pattern, it should be included as an added cost of smaller boxes. Then there would be a basis, in both principle and amount, for taking the effect into account in setting prices.

The proposed rate structure now encourages the use of the smallest boxes through lower cost coverages, as well as the largest boxes, so the goal of encouraging use of larger boxes is not consistently served by the proposed rates. Another reason given for having lower rates for large boxes is that those boxes are used by businesses. They sometimes have alternative opportunities for service from commercial mail receiving agents (CMRA's) and they may purchase other postal services if the need to pick up mail gives them reason to be in the post office. This latter point could be true but it is speculative and is given no concrete support. The former point about users of large boxes having alternative opportunities is not itself persuasive. The large USPS post office boxes are considerably larger than CMRA boxes. If revenue obtainable from large boxes is so low, it might be best for the Postal Service to allow those users to go elsewhere for service so the large boxes could be converted into smaller boxes to meet excess demand for them, or the space might be devoted to other more productive uses.

The evidence about alternative services that is presented is interpreted as showing that users would accept the proposed increases in post office box rates (Witness Ellard, USPS-T-6). Specifically, the rates for CMRA boxes are shown to be substantially higher than USPS boxes (Witness Needham, USPS-T-7, pages 12-13), and CMRA boxes tend on average to be smaller (Witness Lion, USPS-T-4, page 23). Indeed, Postal Service post office box size 4 is roughly twice as large as the average for the largest CMRA box size, and of course Postal

Service box size 5 is even larger. Since the Postal Service has economies of scope in providing post office box service, and may even avoid some cost of delivery in doing so, there is little doubt that alternative box services are more costly. The Postal Service has market power, in other words, in the market for post office boxes.

Caller service allows recipients of mail to call at the post office to pick up mail. Slightly different fees exist now for this service in delivery areas I-A, I-B, and I-C, and the proposal calls for applying the highest semi-annual fee, that of $250 for New York City post offices in area I-A, to the other delivery areas. The fee will rise 4 percent from $240 in delivery area I-B and 11 percent from $225 in area I-C. It is also proposed that this fee will apply to delivery area II, where caller service is now available as a substitute for a box when boxes are scarce, but where some broader demand for caller service may develop. This service is currently offered in post offices in delivery area II for the same price as a large box, which is currently $55 per year. For consumers in this situation in rural delivery areas, the increase in price for caller service from $55 per year to $500 per year will be slightly more than 800 percent. It is difficult to consider this proposal to increase caller service prices in the absence of information about how much it costs to provide the service.

Thus the proposed post office box rates lack a coherent rationale. Although implicitly consistent with proposals for no fee in delivery area III and for the imposition of a nonresident fee, the idea that delivery into a post office box costs less than delivery to a remote location is not explicitly considered. Cost coverages are very high for cities that are not in the largest categories, and they are actually negative for rural areas. Cost coverages are highest for the middle size post office box, low for the smallest size box, and exceptionally low for the largest size box that is used mainly by larger businesses.

It is noted that proper pricing will motivate more efficient decisions by the Postal Service about space allocation to post office boxes (Witness Lyons,USPS-T-1, pages 18-19). But there is no evidence the proposed rates will serve that end. Distortions across delivery areas make box revenues actually lower than costs in some areas and well above costs in other areas, so allocation by area will be distorted. And some box sizes are much more profitable than others, so allocation of space to boxes by size within post offices will not be properly motivated either.

OCA-101
Docket No. MC96-3

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Committee on the Role of Research in the University (Chairman) (1977-78)
Danforth Foundation Selection Committee (1978-80)

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Faculty Senate Committee on Faculty Relations (1989-93)
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Richard Shipe, "Cost and Productivity in the U.S. Urban Bus Transit Sector, 1978-1989," 1992.

Zhenhui Xu, "Essays on the Economy of China in the 1980's," 1993.

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