006132 ORIGINAL

RECEIVED
DEC 6 4 ... PM
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

USPS-RT-2

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

SPECIAL SERVICES REFORM, 1996	Docket No. MC96–3

REBUTTAL TESTIMONY
OF
ALTAF H. TAUFIQUE
ON BEHALF OF
UNITED STATES POSTAL SERVICE

DEC 6 1996
BFP

CONTENTS

AUTOBIOGRAPHICAL SKETCH

My name is Altaf H. Taufique. I currently serve as an economist in the office of Pricing at the United States Postal Service. Prior to joining the Postal Service in July 1996, I was employed by the Gulf States Utilities Company (GSU) in Beaumont, Texas from 1980 to 1994. At GSU, I served as an economic analyst in the Corporate Planning department and was subsequently promoted to Economist, Senior Economist and finally to the position of Director, Economic Analysis and Forecasting. My responsibilities at GSU included the preparation of the official energy, load and short-term revenue forecasts, and the economic forecasts for the regions served by the Company. I have testified before the Public Utility Commission of Texas in Austin and the Federal Energy Regulatory Commission in Washington, D.C. My testimony defended GSU's official energy and load forecasts. This is my first appearance before the Postal Rate Commission.

I received a Master's Degree in Economics from Central Missouri State University in Warrensburg, Missouri in 1976, and a Bachelor's degree in Economics & International Relations from Karachi University in Karachi, Pakistan. I have also completed thirty-three credit hours of coursework towards a Ph.D. in Economics at Southern Illinois University. I taught economics at Chadron State College in Chadron, Nebraska between 1978 and 1980, and during my employment at GSU in Texas, I taught courses in economics at Lamar University in Port Arthur, Texas.

I. PURPOSE OF TESTIMONY

The purpose of my testimony is to rebut the testimonies of OCA witnesses Sherman and Thompson, which oppose the Postal Service's fee and classification proposals for selected special services. I begin by demonstrating an apparent inconsistency between witness Thompson's criticism of the proposal to increase fees for selected special services while maintaining rate stability for First-Class Mail with Dr. Sherman's past writings. Next, my testimony shows why the use of market prices as a means of determining value is appropriate in postal ratemaking. My testimony then challenges Dr. Sherman's contention that the post office box proposal is an exercise of the Postal Service's monopoly or market power in the box market. Finally, I address Dr. Sherman's concern regarding the pricing of post office boxes with a single rate structure.

II. WITNESS THOMPSON'S CRITICISMS APPEAR TO BE INCONSISTENT WITH DR. SHERMAN'S PAST WRITINGS.

Witness Thompson reserves her harshest criticism for the decision to maintain First-Class Mail rate stability while increasing fees for the selected special services. Her testimony labels this aspect of the Postal Service's proposal as "unfair," "inequitable," and "capricious."[1] Witness Thompson's criticism is baffling because it appears to be inconsistent with concerns

[1] Tr. 5/1364.

expressed by several observers, including OCA witness Sherman, that postal cost allocations and pricing have operated to the detriment of those mailers, particularly First-Class mailers, whose alternatives to mail delivery are limited by the Private Express Statutes. It is ironic that, in a case in which the Postal Service would obtain additional revenues from categories other than First-Class Mail, Dr. Sherman has opposed such a proposal.

Dr. Sherman has written extensively on postal pricing issues in the past,[2] and has appeared as an expert witness in several Commission proceedings. His past writings and testimony reveal a consistent theme that appears to be inconsistent with his and witness Thompson's analysis of the proposals in this docket. The gist of his writings is that monopoly products, especially First-Class Mail, have contributed the lion's share of the recovery of institutional costs, and other postal products have received rather favorable treatment at the expense of this low elasticity, monopoly product. For instance, in an article written with James C. Miller, III, Dr. Sherman criticized excessive institutional cost burdens borne by First-Class Mail:

> We do not mean to imply that attributing cost to classes of mail is a simple task for, as Fuss indicates, the problem is a difficult one. But if costs are traced only partially to mail classes and inverse elasticity rule is applied, resulting prices may exploit the classes of mail where monopoly power is greatest. Prices will be high, not necessarily because costs of providing services are great but because monopoly power is high as indicated by less elastic demand. And where .

---

[2] *See* Tr. 7/2308-13.

> demand is more elastic, perhaps because competing services exist, prices may be set low, even below true marginal costs.[3]

Dr. Sherman and his co-author reaffirmed their criticism when they quote the administrative law judge in Docket No. R74-1 with approval:

> The Postal Service has become a tax collecting agency, collecting money from [F]irst-[C]lass mailers to distribute to other favored classes. Every time a person pays 10 cents to mail a [F]irst-[C]lass letter he is paying his appropriate attributable cost plus his proportionate share of residual cost, and in addition, he is contributing almost 2 cents to pay the costs of other services.[4]

Dr. Sherman re-emphasized these criticisms in another essay:

> The USPS initially argued that most of its costs were fixed and independent of the volume of mail it handled; it claimed it could assign or attribute less than half its total costs to individual mail services, with the result that the fractions of costs that varied with volumes of those services were very low. When used as a basis for setting welfare-maximizing Ramsey prices, these cost representations would lead to a relatively high rate for first class mail, where the postal monopoly resulted in the lowest elasticity of demand, and low rates for other classes, where there was more competition.
>
> * * * * *
>
> For its part, the USPS presented cost analyses at rate hearings that quite obviously were designed to sustain the long existing rate structure, to keep the rate high where monopoly power was greatest, on [F]irst-[C]lass mail, and to offer relatively low rates on other classes of mail.[5]

Dr. Sherman has not changed his view on this subject. As recently as Docket No. R94-1, when discussing the relative merits of Ramsey pricing versus equal

---

[3] J.C. Miller, III, & R. Sherman, *Has the 1970 Act Been Fair to Mailers, in* PERSPECTIVES ON POSTAL SERVICE ISSUES 62-63 (R. Sherman, ed., 1980) (footnote omitted).

[4] *Id.* at 64 (quoting Docket R74-1, vol. 1. p. 13).

[5] R. Sherman, *Competition in Postal Service,* in COMPETITION AND INNOVATION IN POSTAL SERVICE 193-94 (M.A. Crew & P.R. Kleindorfer, eds., 1990).

markups, Dr. Sherman warned against pricing "monopolized services," presumably First-Class Mail, too high:

> The temptation then to choose low markups for more competitive services with high perceived demand elasticities could be very great, and the result might be underpricing of those services relative to their true costs, while monopolized services are overpriced.[6]

Dr. Sherman's past writings cautioned against the adoption of pricing approaches that led to higher rates for First-Class Mail while keeping rates for more competitive products lower. The fee change proposals for post office boxes and certified mail in this case appear to be consistent with Dr. Sherman's view, because fees for these services, for which there are alternative providers of similar types of services,[7] are being raised to achieve modest objectives, *i.e.,* to cover their attributable costs or provide a reasonable contribution to institutional costs, or both.[8] Thus, one would expect the OCA to view the fee change proposals more charitably, particularly given Dr. Sherman's writings on this subject.

---

[6] Docket No. R94-1, OCA-T-400 at 9, Tr. 12B/5516.
[7] *See, e.g.,* USPS-RT-3 at 17, USPS-T-4 at 15-33, USPS-T-7 at 39 and USPS-T-8 at 72-73.
[8] *See generally* USPS-T-1, USPS-T-7 and USPS-T-8.

III. MARKET PRICES CAN BE USED TO DETERMINE THE VALUE OF POSTAL PRODUCTS.

Dr. Sherman states that, "[t]he Postal Service proposal in Docket No. MC96-3 has features that are unusual. First, it focuses on only a few special services, rather than all services. Second, it gives attention to something called marketplace considerations . . . ."[9] He finds the terms used by witness Lyons to describe the Postal Service's proposals, such as "economically rational", and "businesslike basis,"[10] to be "vague."[11] Dr. Sherman dismisses witness Lyons' statement that prices for services at issue here reflect marketplace considerations, as well as the cost of providing services, as "nice sounding but still vague."[12] He further goes on to say that, "[i]t is not at all clear what market-based prices are. They are not defined well enough to be related to principles of optimal pricing."[13]

Dr. Sherman's professed unfamiliarity with the meaning of market-based prices in this case appears to contradict his previous, published remarks. In his highly regarded text on antitrust, Dr. Sherman wrote:

> market prices actually can guide production. For example, suppose a good's competitive market price were well above the long-run cost of production. This would mean that consumers valued that good at more than it would cost to produce it on a long-

---

[9] Tr. 7/2274.
[10] USPS-T-1 at 2.
[11] Tr. 7/2274.
[12] Tr. 7/2274.
[13] Tr. 7/2275.

run basis. So there would be high profit that would spur expansion by existing producers and invite entry by new producers. A system of competitive markets would move resources -- capital, workers, managers, materials -- to increase the production of these goods that consumers valued so much. The expanded quantities would make the goods more plentiful and force market prices down again until it was again close to the cost of production so further expansion of output no longer was motivated.[14]

The Postal Service's fee proposals in this docket combine market information with the pricing criteria in section 3622 to better reflect value to customers and to have the services at issue here make more reasonable contributions. Indeed, the Postal Service collected substantial research on marketplace conditions to inform its pricing proposals. For example, with respect to the post office box proposal, the Postal Service conducted a post office box study,[15] a study of CMRAs,[16] and market research to measure customer reaction to a range of fee increases for post office boxes.[17] These studies have enabled the Postal Service to acquire new information about the box market, including supply and utilization rates, the presence of competition, the value of this service to its own customers, and the revealed preference of its competitors' customers.

The terms "marketplace considerations", "businesslike basis" and "economically rational" are neither "vague," nor unfamiliar. They are the

[14] R. Sherman, ANTITRUST POLICIES AND ISSUES 7 (1978).
[15] USPS-T-4, at 3-13.
[16] USPS-T-4, at 15-33.
[17] USPS-T-6.

standards of basic economics and have well-defined meanings. Socially optimal pricing must rely upon them.

IV. THERE IS NO EVIDENCE THAT THE POSTAL SERVICE HAS MONOPOLY POWER IN THE BOX MARKET.

Dr. Sherman states that, "[s]ince 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."[18] In his written testimony, Dr. Sherman defines market or monopoly power in the context of the Postal Service as follows:[19]

> 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.[20]

Dr. Sherman cites Fisher, et al., FOLDED, SPINDLED, AND MUTILATED: ECONOMIC ANALYSIS OF US VS. IBM, in support of his definition of market and monopoly power. The underlying source Dr. Sherman cites, however, is not consistent with his monopoly theory. Indeed, during oral cross-examination, Dr. Sherman

---

[18] Tr. 7/2303.

[19] Dr. Sherman uses the terms "market power" and "monopoly power" interchangeably. *See, e.g.*, Tr. 7/2354.

[20] Tr. 7/2277.

essentially conceded as much.[21] A more complete definition of market or monopoly power is found on page 20 of FOLDED, SPINDLED, AND MUTILATED. In essence, market power involves more than the mere power to raise price; rather, it is exhibited when the firm has the ability to raise price above competitive levels without losing market share.[22] Fisher, *et al.*, observe:

> A firm has monopoly power when it is sufficiently insulated from competitive pressures to be able to raise its prices or withhold the introduction of new technology, either in product innovations or in process (cost reducing) innovations, without concern about the actions of its competitors and with relative impunity because its customers lack reasonable alternatives to which to turn. Monopoly power is the ability to *raise* prices above competitive levels or to

---

[21] When asked if monopoly power was exhibited when a firm had the power simply to raise price, or to raise price above competitive levels, Dr. Sherman conceded that "[a]bove competitive levels would be preferable, more exact." Tr. 7/2449.

[22] A common misconception is that market share is, in and of itself, indicative of monopoly power. Fisher, *et al.*, in FOLDED, SPINDLED, AND MUTILATED, the same source Dr. Sherman cites in his testimony, explain that the two do not necessarily go hand-in-hand. The authors state that "market share can be high for more than one reason. One such reason, of course, is monopoly power. However, a firm may have a large market share by reason of being there first." Fisher, et al., FOLDED, SPINDLED, AND MUTILATED: AN ECONOMIC ANALYSIS OF U.S. V. I.B.M 99 (1983). Indeed, a large market share does not, in and of itself, confer monopoly power:

> a firm's large market share does not imply power if firms not in the market can readily enter or if existing firms (whatever their share) can readily expand so that customers will have realistic alternatives if the given firm attempts to raise prices or hold back technology."

Id. at 99. They also add that "[t]he crucial question is not what market share *is* but what it would *become* were the firm to attempt to exercise monopoly power. This is the question of ease with which buyers can turn to other sellers and substitute products and the readiness with which competitors will expand output if it appears that monopoly returns are being gained." *Id.* at 100.

> market inferior products while excluding competition. This is the economist's version of the law's definition of monopoly as the "power to control prices or exclude competitors." The ability to gain business through lower, remunerative prices or through better products is not monopoly power but the manifestation of "superior skill, foresight, and industry."[23]

The authors add that, "[m]onopoly power is not present when a firm can keep its business only by means of *lower prices* or better products *than* its competitors' . . ."[24]

In order for the Postal Service to exercise market or monopoly power, it must have the power to raise prices above competitive levels without losing market share. For Dr. Sherman to prove his claim that the post office box fee proposal is a manifestation of the Postal Service's monopoly power, he would have to show that prices charged by the Postal Service are presently at or above competitive levels, or that the proposed fees would qualify as such, and that the Postal Service would not lose market share. No information provided in this docket, however, supports those conclusions.

Indeed, statements made by Dr. Sherman appears to suggest a contrary view. First, Dr. Sherman confesses that his conclusions about CMRA costs are drawn from a review of CMRA *prices*.[25] Second, in order to draw conclusions about costs from prices, Dr. Sherman must also be assuming that the box

---

[23] Fisher et al., FOLDED, SPINDLED, AND MUTILATED: AN ECONOMIC ANALYSIS OF U.S. V. I.B.M 20 (1983).(footnotes omitted)
[24] *Id.* 99 (emphasis added).
[25] Tr. 7/2431-2433.

market is in long run equilibrium, since he supposes that the only circumstance in which one can draw conclusions about costs, on the basis of prices, is when a market is in long run equilibrium.[26] These statements imply that Dr. Sherman believes that existing CMRA prices are at competitive levels. If so, as the Postal Service's proposed fees are well below those of CMRAs, their adoption could not constitute an exercise of market power.

Notwithstanding what Dr. Sherman's views may be, my own review of the available information suggests that the competitive equilibrium prices for post office boxes will fall somewhere below the prices currently charged by CMRAs. Although it is tempting to say that the competitors' box prices are at "competitive levels," the evidence shows that these types of retail outlets are experiencing phenomenal growth.[27] Such growth is indicative of a market that is not yet in long-run equilibrium, but rather one in which suppliers are earning economic profits. Long-term equilibrium in a competitive market occurs when prices equal marginal costs. When a market is in long-run equilibrium, sellers are unable to earn economic profits, thereby discouraging new entrants to that market. The substantial growth in Commercial Mail Receiving Agency (CMRA) outlets demonstrates that there are no significant barriers to entry in this industry and the firms in the market are earning economic profits. It is not, therefore, a market in long run equilibrium.

[26] Tr. 7/2434.
[27] USPS-RT-3.

The very idea of determining competitive prices in the absence of market forces reminds me of an old economist's joke made during the height of the Cold War. It was said that the Soviets wanted to conquer the world, but they wanted to let Switzerland continue to operate in a free market environment. The reason: they wanted to know market prices. The information provided in this docket is not sufficient to definitively establish the competitive price for post office boxes. It does, however, permit drawing general inferences. I can say that the competitive prices in the post office box market are above the current and proposed fees in this docket, but probably below the prices charged by CMRAs. The reasons for this assessment are as follows. First, CMRAs are growing at a spectacular rate, which would lead one to believe that economic profits are being earned. CMRA prices have to be above long-run marginal costs. Second, Postal Service reported costs and fees are below what a competitive CMRA market would ultimately generate, for three reasons: 1) Economies of scope, as asserted by Dr. Sherman,[28] may give the Postal Service a cost advantage;[29] 2) CMRA costs must reflect the full costs of sorting mail to individual boxes, while the Postal Service can offset those costs with reduction in sorting costs that have already been paid by the mailers;[30] and 3) As witness Lion points out,

---

[28] Tr. 7/2303

[29] Of course, CMRA operators can (and do) mitigate this effect by also providing other services besides box rental.

[30] The fact that much of the labor costs have already been paid by the mailer minimizes the impact of what are probably lower hourly labor rates paid by CMRAs.

space provision costs for CMRAs should be higher than those reported by the Postal Service, because of the utilization of book costs rather than market costs.[31]

Ultimately, we can only speculate whether the proposed fees are above or below hypothetical fee levels under "perfect competition." Fortunately, however, the applicable rate making standards do not require us to address, much less resolve, this question. The existence and rapid growth of CMRAs, offering box rentals at significantly higher fees, provide direct support for the Postal Service's proposals under the statutory ratemaking standards. For example, the impact on customers, 39 U.S.C. 3622(b)(4), cannot be considered undue when other consumers are already paying higher fees to CMRAs. Moreover, for many customers, CMRAs do constitute an available alternative, 39 U.S.C. 3622(b)(5). In addition, if box service did not have a high value of service, 39 U.S.C 3622 (b)(2), customers would not be flocking to CMRAs.[32] Lastly, given the situation with CMRAs, it is untenable to assert that a fee increase that will result in a cost

---

[31] USPS-RT-3

[32] One standard approach to evaluating 39 U.S.C. 3622 (b) (2) is comparing own price elasticities of demand. This allows the "value" of different postal services to be compared. Elasticities have not customarily been used in this respect for post office boxes, however, because of the effects of the unique relationship between demand and supply for this service on observed time series. The absence of elasticity information makes it more important to observe other market features such as growth of CMRAs, their fee levels, etc., when contemplating the value of post office box service.

coverage that is still below the systemwide average is either "unfair" or "inequitable", 39 U.S.C. 3622(b)(1).

Moreover, there are apparently no overwhelming barriers to entry in this market, as evidenced by the explosive growth of private post office box providers.[33] To the extent that there might be more limited barriers to entry, they are unintended consequences of the current fee levels. Increasing fees to the proposed levels might actually stimulate additional entry.[34] More importantly, the current fee levels may constitute the practical equivalent of a barrier to entry in some markets against the Postal Service. As discussed in witness Lion's testimony, there are situations in which customers want boxes, are willing to pay for boxes, but the Postal Service cannot expand its box operations (or establish new box operations) and still cover its additional costs at the current fees that the Postal Service is required to charge. These situations represent a serious breakdown of the regulatory process, and cause real harm to the Postal Service, its current customers who could have their institutional cost burden spread over a broader base, and to prospective customers whose needs go unfulfilled. This leads me to my conclusion on this subject: The Postal Service is not exercising monopoly or market power in seeking to increase fees for this service to the levels proposed.

[33] USPS-RT-3.
[34] Tr. 7/2390.

V. LOCAL MARKET FACTORS COULD BE USED TO SET PRICES FOR POST OFFICE BOXES.

Dr. Sherman commented on the difficulty of pricing post office boxes with a single rate structure that must apply nationwide.[35] To stimulate thinking along these lines I offer the following comments.

The Postal Service acknowledges that a "one price fits all" approach may not be the most efficient method of pricing post office boxes. The current proposal is designed to begin taking differences in costs and demand into account. A comprehensive consideration of the demand, supply, and cost differences of post office boxes could evolve into local adjustments to prices at each facility depending upon market factors. This task, of course, would present administrative burdens due to the sheer size of this business, given that there are over 30,000 facilities with approximately 20 million boxes of various sizes. One approach could be a framework that ranks postal facilities based on factors such as capacity utilization, cost of providing the service, population or population density, per capita or household income, presence of competitive providers and the level of service, such as lobby access hours.

As the Postal Service evaluates various approaches to pricing post office box service in the future, it may be useful to have feedback and suggestions from interested parties, including the Commission.

---

[35] Tr. 7/2296.