

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268B0001

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

**RESPONSES OF GREETING CARD ASSOCIATION WITNESS
JAMES A. CLIFTON TO INTERROGATORIES OF THE UNITED
STATES POSTAL SERVICE (USPS/GCA-T1-66, 71)**

(November 3, 2006)

The Greeting Card Association ("GCA") hereby provides the responses of James A. Clifton to the following interrogatories of the United States Postal Service filed on October 4, 2006: USPS/GCA T1-66, 71.

Each interrogatory is set out verbatim followed by the response.

Respectfully submitted,

/s/ James Horwood

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Date: November 3, 2006

RESPONSE OF GREETING CARD ASSOCIATION WITNESS CLIFTON TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-T1-66. USPS/GCA-T1-24 asked about your equation which models commercial check volume as a function of the First-Class additional ounce rate. In your response, you described this work as “descriptive” and said that “no other explanatory variable was included.”

(a) Is it possible for two variables to exhibit a high mathematical correlation over a 10-year period while having no true causal relationship with one another? Please explain any answer other than “Yes.”

(b) You state in your response to USPS/GCA-T1-24, “Clearly, other factors have been impacting check volumes, but data was not readily available to investigate their relative importance.” Could these other factors account for all of the change observed in check volumes over the time period which you investigated? If your answer is No, please explain how you could make such a determination, given that you did not “investigate their relative importance”?

(c) In your response to USPS/GCA-T1-24, you state, “In periods of low inflation such as the limited period examined here, business and consumer decision making may reflect nominal rates as much or more than it reflects real rates.”

(i) Please confirm that the implicit price deflator for personal consumption expenditures, as presented by witness Thress in LR-L-63 in this case, increased by 18.9% from 1995Q1 to 2004Q4. If not confirmed, please explain fully.

(ii) Do you believe that consumers will respond to an 18.9% price change?

(iii) If your answer to (ii) is yes, please explain why you did not consider the effect of inflation on check volumes.

(iv) If your answer to (iii) is no, please reconcile this with your results here in which you assert that check volumes were affected by changes in First-Class additional ounce rates of less than 10%.

RESPONSE:

- a. Yes it is possible if your sample is not a representative of the population. Either your sample is too small relative to the population size or it is not a random sample of the underlying population.
- b. As is clear from Figure 1 at page 25 of my testimony, commercial checks cleared exhibited modest growth or stability from 1995 through 2001. The rapid drop off in that variable following the hike in the extra ounce rate is clear. “Ceteris paribus” conditions tend to hold in the short run, and we are

speaking here of only a 1, 2 and 3 year effect, not e.g. the 1983 -2005 data series witness Thress employs and for which one cannot assume ceteris paribus but must explicitly correct for other factors. Other factors have been operating over the entire 1995- 2004 period, and these can be summarized as a variety of gradual and evolutionary technological improvements in sundry electronic payments systems which reduced their costs or improved their convenience of use. I am not aware of any particular change in the 2002-2004 period which would have led to a rapid drop off in commercial checks cleared other than the extra ounce rate hike.

- c. i. Confirmed.
- ii. Consumers and small businesses are unlikely to respond to an 18.9% change over so long a time period. If that 18.9% increase (nominal or real) were concentrated in one case, consumers and small businesses would be more likely to react.
- iii. and iv. The time period was too short,-- 3 years and one rate hike-- and as explained I believe small business and consumers react to nominal changes, especially in low inflation environments. While you indicate the rate change was less than 10%, expectations may have played a role here as well. Since the extra ounce rate is not related to cost in any close way, but produces revenue well in excess of cost, it may have been expected that after two reductions in the extra ounce rate, there would be more. When, instead, USPS raised that rate again, expectations were dashed, and competing substitutes began to be emphasized again.

RESPONSE OF GREETING CARD ASSOCIATION WITNESS CLIFTON TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-T1-71. In your response to USPS/GCA-T1-27 you indicate the “firm” to whom you refer in your testimony on page 28 at line 23 is “[a]n oligopolist as defined in the theory of the firm in microeconomics.” The full context here in your testimony is the following paragraph, which begins on page 28 at line 22 of your testimony:

“It has long been recognized in the literature of pricing under oligopolistic conditions that the response to a market price increase by a firm is not necessarily the same as the response to a market price decrease, and that therefore the price elasticities may not be the same for the two situations.”

- a. Please confirm that the “response to a market price” which is discussed “in the literature of pricing under oligopolistic conditions” refers to the pricing strategy of firms which are in competition with the “oligopolist as defined in the theory of the firm in microeconomics”. If not confirmed, please explain fully.
- b. Please confirm that the own-price elasticity of demand for a product is determined by the behavior of consumers of a product in response to changes in prices. If not confirmed, please explain fully.
- c. Please confirm that the “consumers of a product” in part b. of this question are not the “firms which are in competition with the oligopolist” as defined in part a. of this question. If not confirmed, please explain fully.
- d. Please confirm that the textbook definition of "own price elasticity", which measures the degree of demand changes as a response to changes in own price, assumes that all other market conditions be constant. If not confirmed, please explain fully.
- e. Do you agree that "under oligopolistic conditions" a market price decrease by a firm would be followed by a market price decrease by its competitors while a market price increase by a firm would not be followed by a market price increase by its competitors? If not, why not?
- f. If the quantity demanded of a good decreases due to decreases in the competitor's price, which in turn is triggered by the decrease in own price, should this effect be measured by "own price elasticity"? If it is to be measured by own price elasticity, would the result of a positive own price elasticity be self-contradicting? Please explain fully.
- g. "Under oligopolistic conditions" should there be any difference in own price elasticity when a firm increases price and when a firm decreases price if the effect of its competitor's price changes is properly controlled for? If there is any difference, what is the source of this difference? Please explain fully.

RESPONSE:

- a. Not confirmed. I was referring to the issue discussed in my testimony that we really do not know how purchasers of stamps would react to a nominal rate

decrease because it has never been tried, but that the literature on oligopolistic behavior indicates that the reaction to a price decrease may not be the same as that to a price increase.

b. Confirmed.

c. – g. The issue under conditions of oligopoly is far more complicated than you make it out to be, and you are making an artificial separation in what can often be a complex pattern of repeated interactions among oligopolists that precedes but influences those consumers, and is influenced by those consumers. In essence your question implicitly assumes that competition is a static, one shot simultaneous event. Even so, consider static Bertrand competition, in which USPS could face just one competitor and nonetheless emerge with perfectly competitive prices with a very high elasticity of demand indeed. For a textbook summary of dynamic or repeated interaction models of oligopoly, see, e.g., A. Mas-Colell, M. Whinston, and J. Green, Microeconomic Theory, (1995), Chapter 12. For repeated interaction models, including but not limited to the repeated Bertrand model, a useful observation is the so-called folk theorem: “Although infinitely repeated games allow for cooperative behavior, they also allow for an extremely wide range of possible behavior.” (A. Mas-Colell, et. al. 1995, page 404.)