

**BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON DC 20268-0001**

CONSIDERATION OF WORKSHARE)
DISCOUNT METHODOLOGIES)

Docket No. RM2009-3

**COMMENTS OF
NATIONAL POSTAL POLICY COUNCIL
(May 26, 2009)**

Pursuant to the Commission's Notice of Proposed Rulemaking published in Order No. 192, 74 Fed. Reg. 12295 (March 24, 2009), the National Postal Policy Council ("NPPC") respectfully submits these comments on the price structure for First-Class Mail. The Commission's Notice asks, in effect, whether the Postal Service should be required to return to the method of setting rate differentials between presort and single-piece mail that the Commission generally imposed before the Postal Accountability and Enhancement Act ("PAEA") took effect. That method generally limited the rate spread between the two kinds of First-Class Mail to the cost differences between the *average* piece of presort mail and Bulk Metered Mail ("BMM"), a hypothetical category of single piece mail defined by the Commission as having extremely low costs. For the reasons summarized here, the Commission should decline to resurrect the pre-PAEA price linkage methodology.

BACKGROUND

The pricing issue raised by the Commission's notice stems from the enormous range of costs of First-Class Mail, and the lack of separate rate elements for many of these cost drivers in the First-Class rate structure. Both presort and single-piece First-

Class Mail are, as the Commission has recognized, heterogeneous products. Their costs are affected by many attributes other than the degree of presortation—e.g., weight, shape, length of haul, accuracy and legibility of the address, retail sales channel or method of payment evidencing, rigidity and durability of the mailpiece, and (for single-piece mail) the extent to which the mail is already trayed and faced upon entry. The cost effects of these quality attributes, however, are recognized only partially in the rate structure. Some (e.g., length of haul) are not recognized in the First-Class rate structure at all. Other attributes (e.g., the degree of traying and facing) are not recognized in the single-piece rate structure. Other important cost drivers (e.g., shape), while recognized through separate rate elements, are recognized only partially because cost passthroughs are less than 100 percent.

Before the effective date of the Postal Accountability and Enhancement Act (“PAEA”), the Commission generally required the Postal Service to set rates for presorted First-Class Mail by deducting “cost avoidances” from a supposedly representative rate benchmark for single-piece mail. The benchmark for determining the costs avoided by presorting mail, however, was not the cost of the *average* or *marginal* piece of single-piece mail, but the cost of Bulk Metered Mail (“BMM”), a hypothetical low-cost category of single-piece First-Class Mail defined as mail consisting of “machinable, homogeneous, non-barcode pieces with machine printed addresses that are properly faced and entered in trays.” R2006-1 Kobe Direct (APWU-T-1) at 15 (quoting R2005-1 Tr. 4/952 (Abdirahman)); R2006-1 Op. & Rec. Decis. (Feb. 26, 2007) at 129.

By assuming an extremely low-cost subset of single-piece mail as the cost benchmark, but applying the cost avoidances so determined to the entire gamut of

presort mail, the traditional methodology led to rate differentials between the single-piece and presort categories that were much smaller than the average cost differences between the two kinds of First-Class Mail. See MC95-1 PRC Op. & Rec. Decis. ¶ 4221.

The result was a large rate preference for single-piece mail at the expense of presort mail. By 2007, the end of the pre-PAEA ratemaking era, the average Presort letter paid approximately 3.4 cents more in contribution per piece under the rates set in R2006-1 than did the average Single-Piece letter. See FY 2007 CRA (PRC version) at 2. The same CRA data also showed that Presort letters had only 38 percent of the unit attributable cost of Single-Piece letters (11.8 cents vs. 31.2 cents), and that the cost coverages of the two kinds of First-Class Mail were 279 percent and 157 percent, respectively, and the percentage markups over attributable costs were 179 percent and 57 percent, respectively. *Id.*

Similarly, in FY 2008, the Commission found that the average percentage *markup* of Single-Piece First-Class letter mail over attributable costs was 67.1 percent, only about *one-third* the corresponding percentage markup over attributable costs generated by Presort First-Class letter mail (198.1 percent).¹

After the enactment of PAEA, the Postal Service began a modest move away from the pre-PAEA linking approach. In Docket Nos. R2008-1 and R2009-2, the Postal Service set its First-Class rates without reliance on a traditional linking analysis. In the latter docket, the non-linked approach widened the average spread between single-

¹ See USPS FY 2008 Annual Compliance Report (Dec. 29, 2008) at 18, Table 1, “cost coverage” column. The percentage markup is the cost coverage minus 100 percent.

piece and presort First-Class prices. See R2009-2, Order No. 191 (March 16, 2009) at 19.

The Commission's responses to these initiatives have varied. In Docket No. R2008-1, the Commission, after noting a challenge to the proposed delinking by APWU, held that the "workshare discounts" proposed by the USPS for First-Class Mail "satisfy the requirements of 39 U.S.C. § 3622(e)" and allowed them to take effect without modification. Docket No. R2008-1, Order No. 66 (March 17, 2008) at 22 & 57. In Docket No. ACR2007, *Annual Compliance Determination* (Mar. 27, 2008) at 63-64, the Commission noted but declined to decide the issue of whether the Postal Service was still required in the post-PAEA world to link presort rates to the BBM benchmark. In Docket No. R2009-2, the Commission, while criticizing the Postal Service for failing to seek advance approval of delinking from the Commission, concluded that the merits of relinking presort and single-piece rates should be decided in a separate rulemaking. Order No. 191, Docket No. R2009-2 (March 16, 2009) at 22-25; Docket No. ACR2008, *Annual Compliance Determination* (March 30, 2009) at 51-53.

The instant rulemaking ensued. See 74 Fed. Reg. 12295, 12296 col. 1.

ARGUMENT

I. THE PRICE LINKAGE BETWEEN PRESORT AND SINGLE-PIECE FIRST-CLASS MAIL IMPOSED UNDER THE POSTAL REORGANIZATION ACT HAS BECOME A LUXURY THAT THE POSTAL SERVICE CAN NO LONGER AFFORD.

A. Restoring The Pre-2008 Linkage Between Single-Piece And Presort Rates Would Decrease The Net Contribution From First-Class Mail When The Postal Service Stands On The Brink Of Insolvency.

The evidence on cost and demand characteristics in Docket No. ACR2008 demonstrates that the existing rate differentials between Presort and Single-Piece First-Class Mail in the present docket are too small, not too large, and that restoring the pre-2008 price relationship between the two products would make matters worse. The evidence indicates that the own-price elasticities of Single-Piece and Presort First-Class Mail are roughly the same: -0.218 for Single Piece letters and -0.250 for Presort letters.² By contrast, the average percentage *markup* of Single-Piece First-Class letter mail over attributable costs (67.1 percent) is only about *one-third* the corresponding percentage markup over attributable costs generated by Presort First-Class letter mail (198.1 percent). See p. 3 n. 1, *supra*.

Hence, the Postal Service almost certainly could improve its financial position by substantially reducing presort First-Class rates (or increasing them at a below-average rate) and using the resulting headroom under the overall CPI cap for First-Class Mail to raise single-piece rates. Conversely, increasing rates on the more price-elastic product, presort First-Class Mail, while offsetting reductions in rates on the more price-inelastic

² USPS, Econometric Demand Equation Tables for Market Dominant Products as of November 2008 (submitted to PRC on January 16, 2009).

product, single-piece mail, would reduce the net contribution from First-Class Mail as a whole. These conclusions are corollaries of the standard economic formula for maximizing the overall profit of a multi-product firm, with or without an overall regulatory constraint on profits.³

NPPC emphasizes that it is not asking the Commission to undertake in this docket a further widening of the rate spread between single-piece and presort mail. Forcing the Postal Service to *narrow* the current rate differential, however, would clearly be a step in the wrong direction. Moreover, the financial hit to the Postal Service would occur just when a “grave”⁴ financial “crisis”⁵ has pushed the Postal Service to the brink of insolvency.⁶

B. Restoring The Pre-2008 Linkage Between Single-Piece And Presort Prices Would Not Benefit Consumers.

The traditional rate preference for single-piece First-Class Mail clearly owes its durability to a longstanding desire to shield the average consumer from disproportionate

³ See William J. Baumol and David Bradford, “Optimal Departures From Marginal Cost Pricing,” 60 *Amer. Econ. Rev.* 265-283 (June 1970); Jean-Jacques Laffont and Jean Tirole, *A Theory of Incentives in Procurement and Regulation* 30-31 (1993).

⁴ Statement Of Postmaster General/CEO John E. Potter Before The Subcommittee On Federal Financial Management, Government Information, Federal Services And International Security Of The Committee On Homeland Security And Governmental Affairs United States Senate (January 28, 2009).

⁵ Statement of PRC Chairman Dan G. Blair before the Senate Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security (January 28, 2009).

⁶ See USPS Form 10Q for the second quarter of Fiscal Year 2009 (May 6, 2009) (“We do not expect to generate sufficient cash flow from operations in the second half of 2009 to enable us to fully fund [our retiree benefit and other] obligations. . . . Without legislative change . . . we project a cash shortfall of approximately \$1.5 billion on September 30, 2009.”)

postage increases. The long-term decline in mail usage by households, however, has reduced this concern to insignificance. The average household sent only 3.4 pieces of First-Class Mail (other than parcels) per week in 2007. 2007 Household Diary Study at 9, table 1.5. Reducing the price of single-piece First-Class Mail clearly would not have a significant effect on the budget of the average household.

Moreover, any savings enjoyed by households would be largely if not entirely offset by increases in the cost of presort First-Class Mail. The average household receives 9.8 pieces of First-Class Mail per week, approximately three times the volume sent. *Id.* The difference appears to consist largely of business-to-household mail, which consists disproportionately of bills, statements and other presorted First-Class Mail. See *id.* at 25, 27. Firms operating in competitive markets shift a large portion of the incidence of postage costs to consumers through higher prices or lower returning investment accounts.⁷ And the shifting of the incidence of postage costs further offsets any savings to households from reduced single-piece rates.

Finally, consumers are unlikely to benefit from regulatory action that hastens the Postal Service's descent into insolvency. As noted above, restoring the linkage between single-piece and presort rates is likely to worsen the Postal Service's financial straits. This is no longer just a theoretical possibility: the dramatic fall in First-Class Mail volume during the current recession has demolished the notion that First-Class Mail volume is insensitive to economic conditions. Even with the current rate structure,

⁷ Changes to the costs of inputs used by firms in competitive industries tend to be passed on to consumers, often quickly. See George J. Stigler, *The Theory of Price* 183-184 (3rd ed. 1966) ("The Quicksilver Character of Competitive Industries"); Paul A. Samuelson and William D. Nordhaus, *Economics* 74-75 (14th ed. 1992).

the overall volume of presort First-Class letters and cards fell by 8.7 percent in the second quarter of Fiscal Year 2009 vs. the second quarter of the previous year. USPS Preliminary Revenue, Pieces and Weight Report (April 2009) at 1. While the volume of single-piece First-Class letters and cards fell as well, the effect of a rate rebalancing that favored single-piece mail—and thus increased single-piece volume while suppressing presort volume—would not be contribution-neutral. The average contribution of presorted First-Class Mail to Postal Service institutional costs is almost *five cents per piece* greater than the average contribution from single-piece mail. *Fiscal Year 2008 Annual Compliance Determination, supra*, at 48. If the Postal Service runs out of cash, the consequences are likely to include disruption of mail service for the average consumer, higher taxes for the average taxpayer if a federal bailout is necessary, layoffs for postal labor, or all of the above. None of these are consumer-friendly outcomes.

C. The Efficient Component Pricing Rule Does Not Justify Restoration Of The Pre-2008 Linkage Between Single-Piece And Presort Prices.

The parties that support linking sometimes claim that it is required by the Efficient Component Pricing Rule (“ECPR”). This claim relies, however, on a highly restrictive form of the ECPR whose assumptions do not fit First-Class Mail. Generalizing the ECPR to reflect the actual cost characteristics of First-Class Mail demonstrates that the price spread between single-piece and presort mail should be wider, not narrower.

The ECPR is a rule for achieving lowest combined costs through the pricing of individual components of vertically integrated goods or services offered by a regulated monopolist. The rule requires that a vertically integrated firm offer potentially competitive components at the marginal cost of supplying those components. Applied to the

Postal Service, ECPR requires that the discounts offered to mailers for private sector activity that reduces Postal Service costs should be set equal to the per unit avoided costs of the Postal Service. Prices that satisfy this standard induce mailers to engage in such private sector activity if (and only if) the savings to the Postal Service exceed the added costs to society of the additional private sector activity. See PRC Op. & Rec. Decis. MC95-1 ¶ 4256; R2006-1 Op. & Rec. Decis. (Feb. 26, 2007) at 81-91.

If single-piece First-Class Mail were homogeneous, the choice of a cost benchmark would be unimportant, for any benchmark could produce ECPR-compliant rate differentials. Regardless of the starting point on the presort ladder, subtracting the cost savings produced by the specified level of presorting should arrive at the same rate for the latter presort category. The choice of a rate benchmark would also be immaterial if the First-Class rate structure fully recognized all of the various non-presort cost drivers that cause the costs of single-piece First-Class Mail to vary. As long as estimates of presorted-related cost avoidances were controlled fully for all of the non-presort characteristics, the results should be the same regardless of the presort category used as the benchmark.

Unfortunately, however, neither of these conditions holds. First-Class Mail service is “heterogeneous”—i.e., its costs vary with multiple dimensions of quality other than the amount of mail sorting performed by the Postal Service. Many of these non-presort quality attributes are recognized only partially, if at all, in individual rate elements. For example:

- First-Class rates include neither destination-entry discounts nor distance based rate zones, and thus do not recognize the cost effects of the distance between the entry point and the addressee.
- Rates for single-piece mail do not reflect the extent to which the mail is trayed and faced before entry.

- Until now, the First-Class rate structure has offered little recognition of the cost effects of the shape of the mailpiece (letter, flat, or parcel). Although the USPS has given increased rate recognition to shape as a cost driver in recent years, the recognition is far from complete; the passthroughs of shape-related costs are still below 100 percent.
- The unit cost of First-Class Mail is also affected by the number of pieces in a mailing, and the total volume of all mail pieces entered by a given mailer in a year. Greater mail volumes reduce the *unit* transaction costs of mail acceptance and enforcement of mail design and address quality requirements.
- The First-Class rate structure recognizes none of the unit cost differences caused by the sales channel (e.g., retail window or CAPS account) or postage evidencing methods (postage stamps vs. meters vs. permit indicia) used by the mailer.
- Mail addressing requirements allow wide variations in the correctness, completeness, and legibility of addresses, particularly for Single-Piece Mail.

The lack of rate elements for many individual cost drivers might be of little concern if the overall cost effects of these quality characteristics were distributed evenly between the Single-Piece and Presort categories of First-Class Mail. In fact, the non-presort characteristics are *not* evenly distributed. Compared with Single-Piece Mail, the average piece of First-Class Presort Mail is less costly in multiple respects, and has significantly lower unit costs than Single-Piece Mail *even after* presort cost avoidances are netted out:

Presort mail tends to be “cleaner.” In comparison to the nonpresort benchmark, presort mail is normally printed (or typewritten), and more uniform than nonpresort mail. These factors, and possibly others, which are unrelated to mailer preparation, may contribute to the magnitude of the cost difference between presorted and nonpresorted mail.

R90-1 Op. & Rec. Decis. ¶ 5067.

This heterogeneity produces a wide spectrum of attributable costs, as the Commission has noted:

There are a myriad of reasons why the pieces of mail within [single piece First-Class Mail] have varying costs. For example, they are sent different distances; they are sent in different parts of the country; they are to be delivered to rural or urban areas; they are addressed in different ways; the paper used is different; the mail-piece is shaped differently; the list goes on and on.

MC95-1 Op. & Rec. Decis. ¶ 3064; *accord*, R2006-1 Notice of Inquiry No. 3 (July 26, 2006) (“NOI #3”) at 3 (quoting R84-1 Op. & Rec. Decis. (Sept. 7, 1984) ¶¶ 5093 and 5129).

Proper application of the ECPR standard in these circumstances requires a more robust and precise specification of ECPR. Because the costs of single-piece mail vary widely, maximizing incentives for productive efficiency requires the Commission to set presort rate differentials equal to the unit cost differences between Presort Mail and the *marginal* piece of Single-Piece mail. See John C. Panzar, “Efficient Worksharing Discounts With Mail Heterogeneity,” in M.A. Crew and P.R. Kleindorfer, eds., *Liberalization of the Postal and Delivery Sector* 121-134 (2006). Using the typical, median or average piece of Single-Piece mail as the benchmark produces incorrect results. *Id.* And using a *low-cost* subset of Single-Piece mail produces results that depart even further from ECPR. *Id.*⁸

⁸ In Docket No. R2006-1, the Commission found that BMM is the best proxy for the marginal piece of mail because BMM “represents not only that mail most likely to convert to worksharing, but also, to what category current worksharing mail would be most likely to revert if the discounts no longer outweigh the cost of performing the worksharing activities.” R2006-1 Op. & Rec. Decis. ¶ 5109 (quoting R200-1 Op. & Rec. Decis. § 5089). In making this finding, however, the Commission simply brushed off the evidence from both a presort bureau operator and a USPS witness that the typical single piece mail at the margin of conversion is collection mail, not BMM; that most mailers lack the know-how, trays, or access to USPS facilities needed to enter large volumes of BMM; and that most or all of the mail in the postal network that looks like BMM is in fact mail that has been processed by a presort bureau or an upstream USPS facility. R2006-1 Brief of NAPM and NPPC (Dec. 29, 2006) at 12-21 (citing record); R2006-1 Reply Brief of NAPM and NPPC (Jan. 4, 2007) at 4-6 (citing record). The Commission’s failure to give serious attention of the NAPM/NPPC evidence is

II. REIMPOSING A PRICE LINKAGE BETWEEN PRESORT AND SINGLE-PIECE FIRST-CLASS MAIL WOULD CONTRAVENE THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT.

For the reasons noted above, requiring the Postal Service to relink single-piece and presort First-Class rates would frustrate important objectives of the PAEA, most notably the objectives of “allow[ing] the Postal Service pricing flexibility” (39 U.S.C. §§ 3622(b)(4) and 3622(c)(7)) and “assur[ing] adequate revenues, including retained earnings, to maintain financial stability” (*id.*, § 3622(b)(5)). The advocates of linkage have argued, however, that 39 U.S.C. § 3622(e), which constrains “workshare discounts,” requires such a linkage. This claim is unfounded for several reasons:

(1) Section 3622(e) does not apply to the price spread between presort and single-piece First-Class Mail because they are separate products. In Docket No. RM2007-1, the Postal Service proposed, and the Commission approved, a mail classification schedule (“MCS”) that defined presort and single-piece First-Class Mail as separate products. See Docket No. RM2007-1, *Regulations Establishing A System of Ratemaking*, Order No. 43 (Oct. 29, 2007) at ¶¶ 4013-4018.

This decision was clearly correct. The PAEA defines a product as “a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied.” 39 U.S.C. § 102(6). Even single-piece mailers have conceded that presort and single-piece First-Class Mail differ in both characteristics. As the Greeting Card Association acknowledged in Docket No. ACR2007:

unsurprising, given the number of issues that the Commission had to resolve in Docket No. R2006-1. We ask, however, that the Commission consider the issue anew in this docket, now that the Commission has the times and resources to consider the issue carefully.

[O]n a broad level, the nature of the communication and its purposes differ between bulk and single piece letters/postcards, with the former generally used for business applications involving groups such as customers and the latter generally used for individual correspondence or transactions. Thus, from both a cost and a market perspective, bulk letters and postcards are a much different product than are single-piece letters and postcards.

Docket No. ACR2007, *Annual Compliance Report*, Reply Comments of GCA (Feb. 13, 2008) at 4 (quoting with approval PRC Docket No. RM2007-1, USPS Submission of Initial Mail Classification Schedule In Response to Order No. 26 (Sept. 24, 2007) at 12).

Moreover, the PAEA gave the Postal Service considerable discretion in deciding whether to classify two groups of mail as the same or separate products. The Commission emphasized this fact in overruling the objections of APWU to the bifurcation of single-piece and presort mail into separate products:

The Postal Service has the flexibility to initially describe its product lines in conformance with the statutory requirements of the PAEA. . . . It is possible to apply this definition and categorize First-Class Mail postal services into products in several different ways. *The selections made by the Postal Service comply with the definition, and represent postal services with distinct cost or market characteristics.* The product lines are subject to adjustments in the future as conditions change. *The Commission finds that the Postal Service has appropriately described product lines applicable to First-Class Mail.*

Docket No. RM2007-1, Order No. 43 at ¶ 4017 (emphasis added).

The bifurcation of Single-Piece and Presort First-Class into separate products effectively bars a challenge to rate differences between the two products under Section 3622(e). The structure of PAEA strongly indicates that the restriction on worksharing discounts imposed by Section 3622(e) does not apply to rate relationships between different products. The primary mechanism established by Congress for enforcing

compliance with Section 3622(e) is the Commission's review of the Postal Service's annual compliance report under 39 U.S.C. §§ 3652 and 3653. Section 3652(b), however, clearly limits the required information about "workshare discounts" to rate differentials *within* "each market-dominant product." As the Postal Service has correctly noted, the language of 39 U.S.C. § 3652(b),

which directs the Postal Service to provide the specified workshare data "*with respect to each market-dominant product* for which a workshare discount was in effect," suggests that the proper analysis is to measure worksharing differences on an intraproduct, rather than inter-product, basis. This is buttressed by the fact that section 3652 generally requires the reporting of data by product.

USPS FY 2008 Annual Compliance Report (December 29, 2008) at 50-51.

This does not imply that Congress has deregulated the price relationship between presort and single-piece mail entirely. Rate relationships between separate products may be challenged under other provisions of Title 39. For example, rate differentials that are insufficiently wide may be challenged as unreasonable, discriminatory or anticompetitive. Overly wide rate differentials may be challenged under 39 U.S.C. § 3622(a)(8) as unjust and unreasonable. The outer bounds of the zone of reasonableness allowed by these provisions remain to be clarified in further Commission cases. It is clear, however, that rate differentials between presort and single-piece mail may not be challenged under Section 3622(e).

(2) Even if (contrary to fact) the rate relationship between presort and single-piece mail were subject to the requirements of Section 3622(e), the statute clearly exempts rate differentials from the 100 percent-of-avoided costs constraint. First, reducing the price spread between presort and single-piece mail would impede the

efficient operation of the Postal Service (39 U.S.C. § 3622(e)(2)(D)). Whether pricing efficiency is defined in terms of allocative or productive efficiency, Ramsey pricing or the ECPR, the relinking of presort and single-piece rates would make postal prices less efficient for the reasons noted above.

Second, the price spread between the two products is exempt from Section 3622(e) because reducing the price spread would reduce the aggregate contribution to Postal Service institutional costs from the “category or subclass subject to the discount” (39 U.S.C. § 3622(e)(3)(A))—i.e., First-Class letter mail. See pp. 5-6, *supra*.

CONCLUSION

For the foregoing reasons, the Commission should not require the relinking of presort and single-piece First-Class rates.

Respectfully submitted,

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