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

Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products	Docket No. RM2017-3

**COMMENTS OF THE MAJOR MAILERS ASSOCIATION,
THE NATIONAL ASSOCIATION OF PRESORT MAILERS,
AND THE NATIONAL POSTAL POLICY COUNCIL**

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March 20, 2017

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(March 20, 2017)

The Major Mailers Association ("MMA"), the National Association of Presort Mailers ("NAPM"), and the National Postal Policy Council ("NPPC") ("First-Class Business Mailers") respectfully submit these comments in response to Order No. 3673,[1] initiating the review required by 39 U.S.C.§3622(d)(3).

I. INTRODUCTION AND SUMMARY: CONTINUING AND IMPROVING THE PRICE CAP IS VITAL TO ENSURING THE POSTAL SERVICE'S CONTINUED COMPETITIVENESS

The current price cap system for regulating market-dominant postal rates that was established by Congress, and implemented by this Commission, has proven remarkably successful and resilient in achieving the goals that Congress established in the Postal Accountability and Enhancement Act ("PAEA"). Most importantly, the current price cap system has created the pricing affordability, stability, and predictability that has enabled the Postal Service to remain relevant in an era of electronic diversion and

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[1] Order No. 3673 (Dec. 20, 2016) (Advance Notice of Proposed Rulemaking) ("*ANPRM*").

provide service throughout the entire past decade without interruption, despite the most severe recession since the Great Depression.

Congress enacted the PAEA to reform fundamental aspects of the Postal Service. Its overriding goals were to encourage the Postal Service to reduce costs and streamline operations, and to provide both stable, predictable rates for mailers and greater pricing flexibility for the Service than under former law.[2] By any reasonable measure, the PAEA has accomplished these goals with remarkable success.

Most importantly to the mailing community, Congress enacted the current price cap system as a *fundaBreamental* cornerstone of PAEA "to protect mailers by providing predictable and stable rates." Order No. 3441, Docket No. R2013-10R, at 17 (on reconsideration July 20, 2016), *quoting* Order No. 3047 at 14. The price cap has successfully achieved this goal by restraining price increases on a class basis close to the level of inflation, thereby encouraging the Postal Service to undertake necessary restructuring and cost reductions. Over the past decade, the Service has responded to Congress and the price cap system by doing just that. During that time, it has taken a number of actions to right-size its operations and reduce its costs. It streamlined its network; eliminated and/or downsized unnecessary post offices, processing, and other facilities; and reduced the size of its labor pool by more than the entire population of many cities. These efforts to date have reduced its costs by about $14 billion annually.[3]

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[2] Postal Regulatory Commission, *Section 701 Report Analysis of the Postal Accountability and Enhancement Act of 2006*, at 29 (Sept. 22, 2011) ("*2011 Section 701 Report*").

[3] *Testimony of Postmaster General Megan Brennan before the House Committee on Oversight and Government Reform*, at 2 (Feb. 7, 2017) ("*Brennan Testimony*"). The First-Class Business Mailers

In return for the price cap system, the PAEA gave the Postal Service greater pricing flexibility. The Postal Service now routinely files notices of market-dominant rate adjustments about 90 days before they are scheduled to take effect, and the Commission nearly always approves them unchanged. The Postal Service may and does raise rates on, essentially, an annual basis in line with inflation and without having to justify doing so on the basis of costs. The process for changing market-dominant prices is blazingly swift and simple compared to the 10-month long cost-of-service rate cases litigated under prior law. The PAEA also enabled the Postal Service to change prices for its Competitive Products even more swiftly.

The Postal Service also now enjoys much more flexibility on major aspects of pricing than under the prior law. It has far more control over the final prices than under the former law, under which the Rate Commission in practice had the final say on rates. As a result, the Postal Service has been free to price as it wishes, subject to constraints spelled out in the PAEA. With this Commission having essentially a "negative option" on price cap increases, the Postal Service can count on increases when it believes they should go into effect, so long as they comply with the cap and a few other requirements. This freedom has allowed pricing innovations as well, and it has introduced pricing changes, rate incentives, and experiments far more easily than would have been the case under the previous law.

Most importantly, the current price cap system has preserved and financed the Postal Service's ability to deliver the mail six days a week, without interruption, despite a major recession, Hurricane Sandy, and other natural calamities, along with the

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recognize that portions of Periodicals mail are not subject to the Private Express Statutes, but the vast majority of market-dominant mail products are protected by the Postal Service's legal monopoly.

steadily increasing diversion of messages to electronic mobile and broadband services. When the Commission deemed economic conditions “extraordinary or exceptional,“ the exigency “safety valve” allowed the Postal Service to exceed the cap temporarily, recoup its net losses, making it whole, and then – its task accomplished – the surcharge went away. The price cap system has led to greatly reduced Postal Service costs, streamlined operations, and provided sufficient cash flows to underwrite monopoly services on a universal basis.

These significant successes would tell an unqualified success story except for the consequences of the unrealistic and arbitrary retiree health benefit premium prefunding obligation that Congress tucked into the PAEA. That obligation bears no relationship to the actual provision of postal services in general or market-dominant services in particular but is responsible for liabilities on the Postal Service’s balance sheet. Those liabilities create a very misleading portrait of the Postal Service’s true financial condition. The Commission is well aware that the Postal Service has suffered no discernable consequences for not making that prepayment in recent years, other than on paper.

More accurately, if one takes into account both the Postal Service’s solid cash flows and a reasonable estimate of the market value (instead of the net depreciated value shown on GAAP-based balance sheets) of its enormous real property holdings throughout the United States, and the $338 billion in retirement assets at the end of FY2016, the Postal Service actually today enjoys very substantial financial strength.

The Commission has ample grounds for concluding that the system has proven to be a great success and achieved the goals and Objectives of the PAEA. As such, the Commission could rightly conclude this proceeding at Phase 1. At the same time, no system is perfect. Although the system has successfully accomplished the paramount goals of the PAEA, improvements at the micro level would better achieve some of the Objectives set forth in Section 3622(b). A few modifications, summarized in subsection B, would enable the price cap system to achieve the statutory Objectives, taking into account the Factors in Section 3622(c), in an improved manner.

A. NPPC/MMA/NAPM Members Account For Virtually All First-Class Presort Mail And A Substantial Share Of Single-Piece Mail, And That Volume Is At Risk

The First-Class Business Mailers represent essentially the entire First-Class Presort Mail product, encompassing Automation and Non-automation letters, cards, and flats. They also probably account for as much or more Single-Piece mail than households, typically mailed at Metered Mail or Residual Mail rates.[4] They also mail a substantial volume of USPS Marketing Mail letters.

MMA membership is comprised of companies that serve the communications, utilities, insurance, banking, financial services, healthcare, government, and cable/satellite industries. Despite diversion to electronic channels, these industries still rely primarily on the Postal Service for delivery of their statements, invoices, remittance payments, and other business communications. Their members constitute a substantial portion of the mailing industry employment and output in the United States.[5]

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[4] Approximately 40 percent of Single-Piece Letters were metered in FY 2016. United States Postal Service, *Annual Compliance Report Fiscal Year 2016,* USPS-FY16-4 FCM Billing Determinants workbook.xlsx, Tab A-1 Single-Piece Letters.

[5] *See generally EMA Foundation's US Mailing Industry Jobs and Revenue Study 2015,* Docket No. RM2017-3 (filed Feb. 24, 2017).

NAPM is a nonprofit organization that represents mailers, both mail owners and mailing service providers ("MSPs") who commingle, sort and prepare quality mailings inducted and compliant with work share requirements. Representing over 90 member companies mailing in 36 states, it collectively provides approximately 35 percent of the total First-Class mail volume and over 50 percent of the Full Service volume. NAPM member mail service provider companies interact with and perform mailing services for tens of thousands of clients and businesses nationally on a daily basis that use postal mailing products.

NPPC is an association of large business users of letter mail, primarily Commercial First-Class Mail using the Automation rate category, with member companies from the telecommunications, banking and financial services, insurance, and mail services industries. Comprised of 39 of the largest customers of the Postal Service with aggregated mailings of nearly 30 billion pieces and pivotal suppliers, NPPC supports a robust postal system as a key to its members' business success and to the health of the economy generally.

The First-Class Business Mailers' members are valued partners to the Postal Service, regularly preparing and entering large volumes of high quality, low-cost mail. They have invested many millions of dollars in capital equipment, software, processes, and extra labor that significantly assist in reducing postal costs[6] and improve service. They engage in many mail preparation actions including traying and facing, accurate addressing, placing high quality barcodes (including Full-Service Intelligent Mail

[6] Ignoring the substantial costs Presort mailers have incurred to meet ever-more stringent mailing requirements, the Postal Service fancies it has held costs down all by itself. *See Reply Comments of the United States Postal Service*, Docket No. ACR2016, at 4-5 (Feb. 13, 2017) (taking sole credit for reducing costs for Presort Mail).

barcodes and electronic mailing data) on mail pieces, high density preparation levels, and entry at times and destinations designated by the Postal Service. They often incur hefty transportation expenses to enter the mail at postal plants close to the ultimate destinations.

These efforts greatly benefit the Postal Service. First-Class Presort Letters and Cards continue to generate more revenue for the Postal Service than any other product, providing $15.417 billion in revenue in Fiscal Year 2016.[7] First-Class Business Mailers are also the primary mailers of First-Class Flats, which contributed an additional $671 million in FY 2016. They also mail a significant volume of Single-Piece mail at Metered Mail and residual rates. In addition, they are responsible for a substantial portion of USPS Marketing (formerly Standard) Letter volume, a product that generated more than $10 billion in postal revenues in FY2016.

First-Class Presort Mail has long paid, and continues to pay, rates that far exceed their attributable costs, whether measured by contribution per piece ($0.271 per piece) or by percentage markup (336.83 percent in FY2016). Both measures greatly exceed that of any other First-Class Mail or letter product.[8] In FY2016, First-Class Presort mail paid $10.840 billion in contribution, more than twice the contribution from either Single-Piece mail or Standard Mail Letters, the next largest contributors.[9] No other mail product bore anything close to so large a burden.

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[7] United States Postal Service, *Annual Compliance Report Fiscal Year 2016,* at Table 1 (Dec. 29, 2016) (*USPS ACR FY2016*).

[8] *Id.,* at 12.

[9] *Id*., at 12, Table 1 & 24, Table 2. In Fiscal Year 2015, First-Class Presort Mail paid $10.445 billion in contribution, also more than double the amount contributed by either First-Class Single-Piece or Standard Letters. *United States Postal Service FY2015 Annual Compliance Report*, at 7, Table 1 & 17,

Unquestionably the First-Class Business Mailers' members pay, by a large measure, the largest share of the institutional costs of the entire postal system.[10] Counting only Presort Mail, they pay almost 48 cents of every dollar of institutional cost contribution from market-dominant products, and almost 36 cents of every dollar of total institutional cost contribution.[11] Including their Metered Mail and residual letters in the Single-Piece product would increase their total contribution still more. And this does not even take into account their Marketing Letters, which likewise contribute the most per piece -- 10.5 cents -- of any USPS Marketing Mail product).

It must be acknowledged that the First-Class Business Mailers' mail volumes have declined since enactment of the PAEA. This decline has not been due to the price cap. On the contrary, the current price cap system has reduced postal costs, restrained postal prices, and retained volume while funding universal service six days a week.

But it is nonetheless true that First-Class business mailers have broadly and easily available, if imperfect, alternatives to hard-copy mail. The increasing availability and diminishing cost of already inexpensive mobile, broadband, and electronic distribution alternatives, and their expansive reach, has made them very attractive channels for communicating with utility, cable and telecommunications customers, financial account holders, insurance policy holders, investors, prospective customers, and more.

Table 2 ("*USPS ACR FY2015*"). Previous years were no different. *See Comments of National Postal Policy Council*, Docket No. ACR2014, at 3 (Feb. 2, 2015).

[10] This means that they also have borne the vastly largest share of common costs, any managerial errors, and rate increases throughout the PAEA era and before.

[11] *See USPS ACR FY2016*, USPS-FY16-1 (page 7 of 11) for total institutional cost contributions.

These attractive alternatives make it essential for the Postal Service to offer low and efficient postal prices. Today, postage accounts for 50-70 percent of the costs incurred by First-Class Business Mailers for a letter mailing.[12] The erstwhile rule of thumb that postage, paper, and production each cost one-third of the total cost of a letter mailing has receded into history as non-postal costs have fallen in the mailing industry. In addition to postage, mailers also often have had to invest substantially in hardware, software, and revised processes to comply with mailing rules changes. The sometimes-steep prices of doing so are indistinguishable, as a matter of budgets, by mailers (and their CFOs) from rates. They all are lumped together in one large pot of costs of doing business with the Postal Service, and are measured on that basis when comparing the cost of a mailing to that of alternatives.[13]

MMA, NAPM, and NPPC members would like to use the mail, but doing so must make business sense. If the price is too high or the service too slow, non-mail alternatives will offer more business value. If service is inconsistent or mail preparation and regulatory requirements too burdensome, the value of mail suffers.

While market conditions and emerging electronic alternatives have factored materially into the decline in business mail volume, it would be to bury one's head in the sand to ignore the contributing role of postal rates and compliance costs in the Postal Service's declining market share of business communications. Both absolute rate levels and incentives at the margins matter. As the First-Class Business Mailers have

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[12] The percentages may differ for other mail products that use more paper, more expensive paper, more printing or benefit from special advantages under the law.

[13] This is the case whether the costs are "capital" or "operational" in nature. When a CFO is asked to approve software acquisitions necessary to accommodate new Postal Service requirements, whether that cost is "capital" or "operational" is less important than the amount.

frequently pointed out, repeated rate increases, excessive price levels, and burdensome compliance costs for Presort Letters and Cards encourage mailers to move mail out of the system.

Discounts and other price incentives also have effects. Efficient discounts promote lowest combined cost and system-wide efficiency. Inefficiently priced worksharing discounts and price incentives that do not offer value achieve little. One reason for the slower-than-expected adoption of the Full-Service IMb was a sense among mailers that the price incentive, particularly for then-Standard Mail, offered insufficient value to offset the significant investments needed to prepare such barcodes.

The First-Class Business Mailers appreciate that the rate adjustments in Docket No. R2017-1 were a refreshing change from this history of unwise pricing. This proceeding gives the Commission an opportunity to ensure that the price cap system can reliably offer better business value, lower prices, and more efficient rates to First-Class Business Mailers.

To do this, the system must (1) preserve the lowest possible prices and (2) ensure that the prices are set efficiently by being properly aligned with costs. Doing so will benefit the Postal Service by retaining or increasing the volume of its most valuable mail, thereby providing the revenues needed for the system to provide postal services of the nature appropriate for the nation. Not doing so will simply lead to the continued fading away of business correspondence from the postal system.

B. Summary And Recommendations

As noted above, the price cap system has achieved, rather effectively, the Congress's paramount goals of encouraging the Postal Service to reduce costs, and to allow it greater pricing flexibility. Postal management has reduced annual costs by $14 billion thus far, and management continues to look for additional ways to drive costs out of the system.

At the same time, the price cap system has proven its effectiveness in securing sufficient revenue from market-dominant products to cover – easily – the costs of providing service and to pay by far the vast majority of institutional costs. Thus, there is no real need for any changes to the current price cap system.

However, there is room for improvement in the current system. Although the Commission, an administrative agency, may not change the specific requirements established in the PAEA, it may at any time modify its regulations "as necessary" consistent with the Objectives and Section 3622(c) Factors to improve how the system is applied at the class and product level. If the Commission chooses to use that authority in this proceeding, it should:

1. Amend its regulations to improve the accuracy and efficiency of market-dominant pricing signals by promoting incentives to maximize efficiency and cost reduction. As part of this, the Commission should establish a presumption that price incentives should reflect the full cost avoidances associated with the mailer preparation absent a compelling justification for not doing so. Doing so would increase system-wide efficiency and efficient mailer preparation as mandated by Objective 1, taking into account Factors 5, 7, and 12, by setting economically accurate and efficient pricing signals, thus reducing costs and leveraging the value of presorted mail to increase net revenue.

2. Modify its regulations to require the Postal Service to perform an analysis that assesses the costs and benefits of changes in mail preparation requirements. This would improve transparency in how prices are set and deter evasions of the price cap by shifting costs onto mailers, and thus would promote Objective 6 and Factors 3 and 5.

3. Place greater emphasis on the need to generate "just" rates as required by Objective 8, taking into account Factors 3, 4, 5, and 6,

to decrease the price incentive for First-Class Presort Mail and Marketing letters to migrate to electronic diversion.

4. Eliminate the anachronism by which First-Class Presort and Automation rates are linked to Single-Piece rates, a linkage that is not required by the statute, ignores the fundamentally distinct demands and costs of Single-Piece and Presort Mail, and leads to inefficient pricing in violation of Objectives 1 and 8, taking into account Factors 3, 4, 5, and 6.

5. Interpret the exigency provision in a manner consistent with its purpose.

6. Give greater weight to credible testimony by mailer executives regarding the effect of proposed market-dominant negotiated services agreements.

Similar improvements would also improve the reasonableness of the Marketing Mail Letter rate schedule as required by Objective 8. The system as implemented has not provided sufficient incentives to increase efficiency and efficient mailer preparation for Marketing Letters. This deficiency conflicts with Objective 1, taking into accounts Factors 5, 7, and 12, and Objective 8, and demands attention.

None of these modest improvements would affect the specific requirements and limitations established by Congress, but they would address the failure of the current system to "maximize efficiency" and create a "just" rate schedule while still accommodating the other Objectives.

II. THIS SECTION 3622(d)(3) REVIEW IS LIMITED TO MARKET-DOMINANT RATE REGULATION AND GIVES THE COMMISSION NO POWER BEYOND ITS NORMAL ADMINISTRATIVE AGENCY POWER TO REVISE ITS REGULATIONS

This proceeding fulfills the Congressional directive that the Commission, ten years after enactment of the PAEA "and as appropriate thereafter":

> shall review the system for regulating rates and classes for market-dominant products established under this section to

> determine if the system is achieving the objectives in subsection (b), taking into account the factors in subsection (c). If the Commission determines, after notice and opportunity for public comments, that the system is not achieving the objectives in subsection (b), taking into account the factors in subsection (c), the Commission may, by regulation, make such modification or adopt such alternative system for regulating rates and classes for market-dominant products as necessary to achieve the objectives.

39 U.S.C. §3622(d)(3). As an initial matter, it is important to focus on what Congress did and did not authorize the Commission to do when enacting this provision, because some in the postal community evidently misunderstand this provision and proceeding.

First, this proceeding is limited in scope. It concerns *only* whether the Commission's regulations implementing the price cap system for monopoly products -- a subset of Postal Service products that indisputably has shrunken since enactment of the PAEA both in absolute numbers and as a proportion of the Postal Service's overall business -- is achieving nine Objectives set forth in Section 3622(b) of the PAEA, taking into account the Section 3622(c) Factors. This regulatory system is designed to protect mailers of market-dominant products "from the 'unreasonable use of the Postal Service's statutorily-granted [and de facto] monopoly' power." *United States Postal Service v. Postal Regulatory Commission*, 785 F.3d 740, 745 (D.C. Cir. 2015) (quoting S. REP. NO. 108-318, at 19 (2004).

This narrow and specific focus means it cannot solve – and cannot be intended to address – *other* perceived Postal Service problems. Congress authorized the Commission to consider *only* the Section 3622 Objectives and Factors, which apply only to market-dominant products. The *ANPRM*'s exclusive focus on Section 3622 confirms the narrow scope of this proceeding. In contrast, Congress gave the Commission no criteria by which to review other matters such as cost attribution issues or the Postal Service's finances beyond its revenues and costs arising from market-dominant products. Making changes to address broader concerns is thus beyond the Commission's authority in this review, and would constitute precisely the type of exploitation of mailers subject to the monopoly that Congress forbade.

Second, Congress directed the Commission to review its regulations implementing "the system" established under Section 3622 of the PAEA to regulate rates charged to monopoly products, after ten years of experience. In Section 3622, Congress directed the Commission to adopt regulations that apply a price cap measured by the CPI-U, and also established certain additional "requirements" and "limitations" for the new system.[14] 39 U.S.C. §3622(a). The Commission duly adopted a system of regulations in rulemakings in 2007 and 2008 to implement the new price cap system created by Section 3622.[15] *See* 39 C.F.R. §§ 3010.1 *et seq*. (Part 3010) and, indirectly, Part 3020 (Product Lists).

It is that system of regulations implementing the price cap and related "requirements" for market-dominant postal products established by Section 3622 that the Commission is to review in this proceeding. As an administrative agency, the Commission already has inherent authority to revise regulations that it previously has promulgated, although it has seldom done so with respect to the market-dominant rate system it established in 2007 and 2008. The requirement that the Commission conduct

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[14] *See* 39 U.S.C. §3622(d)(1)(B)-(E); §3622(d)(2) & 39 U.S.C. §3622(e).

[15] *E.g.*, Order No. 43, Docket No. RM2007-1 (Oct. 29, 2007) (Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products); Order No. 26, Docket No. RM2007-1 (Aug. 15, 2007) (Order Proposing Regulations).

this proceeding can most naturally be read as Congress making sure that the Commission would, in fact, review its regulations implementing Section 3622 after 10 years. As such, it merely directs the Commission to use its normal administrative powers. The "and as appropriate thereafter" language is consistent with this interpretation, reminding the Commission that such a review is a continuing responsibility of an administrative agency.

Third, although the Commission plainly has authority to modify its regulations implementing the price cap, the Commission has no authority to change the fundamental "requirements" of the "system" by which monopoly product rates are regulated. The process of modifying its regulations does not grant the Commission authority to revise specific elements of the "modern system" specified by Congress, because administrative agencies lack the authority to rewrite statutes.[16] Nor, consistent with the Presentment Clause of the Constitution, could the Commission do so.

Despite the Commission's limited authority as an administrative agency, it has been suggested that the "adopt such alternative system" language in Section 3622(d)(3) delegates to the Commission authority to eliminate the price cap or fundamentally change the system in some other fundamental manner. That suggestion depends on a contention that the Objectives and Factors provide an "intelligible principle" that can guide such a purported delegation. One problem with this notion is that the Objectives conflict with one another, and thus give no clear guidance. Another is that, as the

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[16] The *ANPRM* does not discuss the Commission's view of its legal authority, despite having received two requests that it do so. *See* Letter from Matthew D. Field to Shoshana Grove (Oct. 28, 2014) & *Petition of the United States Postal Service for the Initiation of a Proceeding To Clarify The Scope of the Review of the System for Regulating Market-Dominant Rates and Classes*, Docket No. RM2016-9 (Apr. 7, 2016). If modifying "the system" is an Executive function, the only constitutionally permissible "modifications" are those that would implement the statutory price cap, not replace it with some other system.

Commission has recognized, Congress specified achieving those Objectives in the context of a price cap: "the objectives and factors, including those that can be regarded as quantitative operate within the context of the price cap; they are not on an equal footing with it." *Annual Compliance Determination Fiscal Year 2010*, at 19 (Mar. 29, 2011 ("*ACD FY2010*"). Because Congress established both the price cap system and the Objectives, a substantial burden faces anyone arguing that any fundamental different type of system could be consistent with the Objectives. This situation is not analogous to statutes that authorize regulation on a "public interest" or "just and reasonable" basis but establish no particular system; here, Congress established the contours of the basic system.[17]

Furthermore, if the Commission could abrogate the price cap or in some manner "gross up the revenue base," that would mean that the PAEA did not really impose a price cap. Instead, it would mean that the system in place for the past decade was merely some form of a deferred revenue collection system.

A final reason to doubt that the Commission has been delegated such sweeping authority is that this review is not a one-time event, as the unlimited "and as appropriate thereafter" language makes clear. If it could change the fundamental nature of the system willy-nilly anytime "appropriate thereafter," then it would have received an unprecedented grant to an Executive Branch agency of perpetual power to rewrite legislation. Not only would such putative power have substantial Constitutional issues,

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[17] *See Field v. Clark*, 143 U.S. 649, 693-94 (1892) (the "true distinction . . . is between the delegation of power to make the law, which necessarily involves a discretion as to what it shall be, and conferring authority or discretion as to its execution, to be exercised under and in pursuance of the law. The first cannot be done"); *Whitman v. American Trucking Associations, Inc.*, 531 U.S. 457, 472 (2001) (the constitutional question is whether the statute has delegated legislative power to the agency).

but it also would undermine the rate stability and predictability that Congress enacted the PAEA to create.

III. THE FRAMEWORK PROPOSED IN ORDER NO. 3673 IS GENERALLY REASONABLE, BUT INCOMPLETE

In this proceeding, the Commission is to review the "system" Congress established "by" Section 3622 "to determine if the system is achieving the objectives in subsection (b), taking into account the factors in subsection (c)." If it is, that is the end of the inquiry. If not, the Commission "may, by regulation, make such modification or adopt such alternative system . . ." The word "may" is discretionary; the Commission is not required to do so, and prudence may dictate that it not.

Order No. 3673 proposes a framework for this review. The First-Class Business Mailers recognize that a review of the Objectives is reasonable, and offer below specific comments on the proposed definitions and metrics. However, an initial concern is that the *ANPRM* is incomplete because it omits any discussion of how the Objectives are to be "applied in conjunction with one another" as required by Section 3622.

A. The *ANPRM* Does Not Address How The Commission Will Apply The Objectives In Conjunction With One Another

Section 3622(b) states that each of the nine Objectives "shall be applied in conjunction with the others." "Shall" is the language of command in a statute. *Boyden v. Comm'r of Patents*, 441 F.2d 1041, 1043 n.3 (D.C. Cir. 1971) (*citing Escoe v. Zerbst*, 295 U.S. 490, 493 (1935)). By prescribing that the Objectives are to work "in conjunction with one another," Congress placed them on a level footing. No one Objective is superior to or outweighs the others. Given the tension that exists between and among a number of the Objectives, how they shall be applied together is entirely unclear. The balancing and weighting of the Objectives, discerning whether the prescriptions of each may impact the interpretation of others, and so forth, are crucial to any assessment of the system, let alone an adjustment.

Accordingly, a review of the system must address how the different Objectives work "in conjunction with one another." Unfortunately, the *ANPRM* offers no hint as to how the Commission intends to apply them together. Nor does it offer any indication of how the Commission will take into account the statutory Factors applicable to market-dominant rate regulation.

An Advance Notice of Proposed Rulemaking invites comment but does not propose rules. And the Commission may very well determine that there is no need to modify the regulation of monopoly product rates in light of its success to date. Nonetheless, the Commission must explain how it applies the Objectives in conjunction with one another, and takes the Factors into account, when it concludes Phase 1 of this review, whether or not there will be a Phase 2.

B. Objective 1: To Maximize Incentives To Reduce Costs And Increase Efficiency

Objective 1 directs that the modern ratemaking system shall "maximize incentives to reduce costs and increase efficiency." The *ANPRM* preliminarily defines this Objective as a system that "uses available mechanisms, such as flexibility under the price cap, pricing differentials, and workshare discounts, to the fullest extent possible to incentivize the reduction of costs and increases in operational and pricing efficiency." *ANPRM*, at 4. It proposes three possible "measurable key concepts within this objective: (1) maximize incentives, (2) reduce costs, and (3) increase efficiency." *Id*.

The Commission's preliminary definition is reasonable. Although the Postal Service has been compelled "to reduce costs and increase efficiency in order to stay within the price cap,"[18] more can be done to maximize the incentives to reduce costs or increase efficiency through pricing. The inefficient pricing of Automation discounts is a clear case in point.

The capability to do better exists. The surest way to maximize efficiency and reduce costs would be to set workshare discounts consistent with the principle of Efficient Component Pricing ("ECP"). The Postal Service has not done so under the PAEA.[19] Nor do the Commission's regulations require it to do so. *See* 39 C.F.R. 30101.12(b)(5)&(6).

Instead, the Postal Service frequently sets important workshare discounts at levels that pass-through substantially less than 100 percent of the avoided costs, such as the 5-Digit Automation Letter rate in First-Class Mail – by far the largest volume in that class. This practice sends uneconomic pricing signals that conflict with the goal of lowest combined cost and Objective 1.

Relatedly, when the Postal Service passes through substantially less than 100 percent of the costs avoided, it underprices (by effectively selling below unbundled cost) its own services (mail processing and carrier sorting for presortation; transportation for

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[18] Postal Regulatory Commission, *Annual Report to the President and Congress Fiscal Year 2012*, at 5 (Jan. 3, 2013) ("*PRC 2012 Annual Report*").

[19] The Commission has repeatedly recognized that 100 percent passthroughs of cost differences promote efficiency. *E.g., Annual Compliance Determination*, Docket No. ACR2009 at 47, n.3 (Mar. 29, 2010) ("*ACR FY2009*"); *Annual Compliance Determination*, Docket No. ACR2007, at 66 (Mar. 27, 2008) (*ACR FY2007)* ("The PAEA does not impose a minimum passthrough of avoided costs for worksharing discounts, although 39 U.S.C. § 3622(b)(1) encourages maximization of incentives to increase efficiency. Full recognition of avoided costs is generally viewed as consistent with this objective.")

dropshipping).[20] Passing through less than 100 percent can be exclusionary if it precludes a more efficient provider from doing the work. Excluding a more efficient provider also harms the public by contravening the concept of lowest combined cost.[21]

Consider the FY2016 2.3 cent price difference (after the exigency surcharge was removed) between the 3-Digit/AADC and 5-Digit rates. If a mailer's cost to presort to the 5-Digit level were 3 cents per piece, its rational decision would have been to enter the mail at the 3-Digit/AADC level and pay the Postal Service the 2.3 cents to sort to the 5-Digit level, thus saving the mailer 0.7 cents per piece. But because it cost the Postal Service 3.4 cents to sort from the 3-Digit to the 5-Digit level, the net result would be to exclude the more efficient private provider of presorting services from doing the work. The same holds true for each discount for which the Postal Service passes through less than 100 percent of its cost savings.[22]

Nor has the Postal Service made optimal use of other opportunities to maximize incentives for cost reductions or pricing efficiency. A case in point is the Full Service IMb incentive. The First-Class Business Mailers believe that the Intelligent Mail

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[20] As explained in the First-Class Mailers' ACR Comments, a mailer deciding whether to prepare a large mailing to the 3-Digit/AADC or the 5-Digit level in FY2016 was offered a discount of 2.3 cents per piece to presort to the 5-Digit level. Looked at another way, the Postal Service was offering to charge mailers 2.3 cents to sort a 3-Digits/AADC mailing to 5-Digits itself. But because the Postal Service spent 3.4 cents to do that sort, it lost 1.1 cents on every 3-Digit/AADC letter that it sorted to the 5-Digit level. With about 4.528 billion 3-Digit/AADC pieces in FY2016, underpricing its mail processing service by 1.1 cents per piece cost the Postal Service nearly $50 million last year alone. *See Comments of the Major Mailers Association, National Association of Presort Mailers, and the National Postal Policy Council*, Docket No. ACR2016, at 10-12 (Feb. 2, 2017).

[21] In the example in the preceding footnote, if a private firm could sort to the 5-Digit at a cost of 3 cents (that is, more efficiently than the Postal Service), it would lose money by doing so because it would earn a discount of only 2.3 cents.

[22] For example, the most recent *ACR* reports that it cost the Postal Service 2.6 cents to sort a Standard Letter to the 5-Digit Level, but it charged 1.9 cents to do so. *ACR2016*, USPS-Y16-3, Tab Standard Mail Letters.

program has helped improve the Postal Service's operational efficiency. However, it has taken years for mailers to make general use of the Full Service IMb. A large factor in that delay was that the Postal Service did not use its pricing flexibility to maximize efficient participation. Instead, it offered an incentive that was simply too small to induce many business mailers to adopt the new barcode. The relatively slow adoption of the Full-Service IMb in Marketing Mail persists where, not coincidently, the Full Service IMb incentive is even smaller than the anemic incentive in First-Class.[23]

Finally, the Commission should recognize that maximizing the incentives for efficiency and cost reduction are fully consistent with the other Objectives, and do not appear to conflict with any other Objective. Objective 1 is complementary to Objectives 5 (because it promotes efficient pricing and thus financial stability), 6 (transparency), and 8 (just and reasonable schedule). Also, maximizing incentives for efficiency and cost reduction is fully consistent with Factors 3 (effect of rate increases), 5 (degree of mail preparation), and 6 (identifiable rate relationships). To the extent maximizing efficiency arguably reduces some pricing flexibility (Objective 4), that is offset by freeing the Postal Service to set base rates according to demand and cost factors. Even with ECP pricing of worksharing discounts, the Postal Service would be free to set prices for the six First-Class and seven Marketing Mail products as they wished so long as they remained under the cap. Accordingly, the Commission should strengthen its regulations to place more weight on effectuating Objective 1.

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[23] As early as 2010, the Postal Service Office of Inspector General urged management to try to encourage greater participation in the IMb program. Management believed the incentives then in effect were sufficient, but the slow uptake suggests that their belief was incorrect. Office of Inspector General, *Management Advisory – Full Service Intelligent Mail Program Customer Satisfaction*, Report Number DA-MA-11-001 (Nov. 22, 2010).

C. Objective 2: To Create Predictability And Stability In Rates

Objective 2 stipulates that the system shall "create predictability and stability in rates." 39 U.S.C. §3622(b)(2). The Commission proposes that a system satisfies Objective 2 if "prices for all market dominant products and promotions, [. . .] are capable of being consistently forecast with regards to timing and magnitude and that do not include sudden or extreme fluctuations." *ANPRM*, at 4. It further proposes, somewhat circularly, to measure Objective 2 by "(1) predictability, and (2) stability." *Id*.

As for predictability, the current price cap regulations have allowed predictable rate increases – but only in the sense that the *timing* of rate increases has been fairly predictable. The principal rule responsible for this is the requirement that the Postal Service maintain a schedule for regular and predictable price changes. 39 C.F.R. 3010.9. Credit also goes to the Postal Service for working proactively with mailers to help them anticipate the timing of upcoming rate adjustments beyond simply maintaining the schedule.

As for predictability in amount and stability, the current regulations generally have created predictability and stability at the *class* level. The cap has maintained rates at inflation levels on a class basis. We say "generally" because mailers operated from July 2010 until December 2016 under the cloud of either a request for or an actual exigent surcharge. For more than two years, mailers were forced to pay above-inflation exigent rates.[24] This undermined to a degree the greater predictability of rates that the price

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[24] *See Exigent Request of the United States Postal Service*, Docket No. R2010-4 (July 6, 2010). The Postal Service also had an opportunity – which it eschewed – to file a last cost-of-service rate case under the old rules for one year after enactment of the PAEA, or December 2007. 39 U.S.C. §3622(f). Thus, in reality mailers experienced only the period between January 2008 and July 2010 under a clean price cap with no overhanging cloud of an exigent increase.

cap was meant to assure.[25] In turn, this made mailers wary of committing to the mail, and has encouraged them to seek electronic alternatives more aggressively.

In contrast, rates *within* classes have generally been much less predictable and stable. Within First-Class Mail, the system has allowed the Postal Service to impose unpredictable rate increases for different products within Presort Mail that often have exceeded CPI-U. For example, in Docket No. R2012-2, the Postal Service singled out 5-Digit Automation Letters for an increase more than 40 percent above the class average. In Docket No. R2013-1, the rates for heavy 3-Digit and 5-Digit Automation flats rose by 10 to 15 percent depending upon weight – despite a class average increase of less than 2.5 percent.[26] In Docket No. R2015-4, the index rate increases ranged from a 0.6 percent increase for Mixed Automation AADC Letters to 4.53 percent for Automation Flats.

There are several explanations for the unpredictability and instability of rates within classes. One is that the Postal Service has generally failed to adopt a policy of setting workshare discounts at 100 percent of avoided costs, contrary to Objective 1. Its use of lesser passthroughs makes other rate increases less predictable.

A second reason is that the Commission has not enforced below the class level its regulation that the Schedule for Regular and Predictable Rate Adjustments "provide

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[25] It is worth noting that a "catch-up" or "reset the base" case would, by definition mean the recapturing of prior year losses. This would render the central premise of PAEA, the rate cap, an illusory retcon. It would mean, much like the return of the Bobby Ewing character to *Dallas*, that the last ten years of the rate cap did not happen.

[26] *See Comments of the National Postal Policy Council*, Docket No. R2013-1, at 12-13 (Nov. 1, 2012). Those increases targeted more than 70 percent of the extra ounces in Automation Flats at that time.

an explanation that allows mailers to predict with reasonable accuracy the amounts of future scheduled rate adjustments." 39 C.F.R. 30101.9(c).

A third is that the Commission has given excessive deference to the Postal Service's setting of rates within classes in the name of "pricing flexibility" pursuant to Objective 4, instead of applying that Objective in conjunction with Objective 1 and the Objective 8 requirement that the rate schedule be just and reasonable to the Postal Service's pricing flexibility.[27]

In practice, the Commission has invoked Objective 2 sparingly. For example, in approving the temporary exigent surcharge, the Commission cited it as militating "against differential pricing that would cause some mailers to experience wide fluctuations in price." Order No. 1926, n.144 (Dec. 24, 2013). But the Commission to date has placed far too little emphasis on it. This Objective deserves greater weight in the future.

D. Objective 3: To Maintain High Quality Service Standards

Objective 3 stipulates that the system should "maintain high quality service standards." 39 U.S.C. §3622(b)(3). The Commission proposes that a system satisfies Objective 3 if it is designed to allow the Postal Service to "consistently achieve, for each class of mail, stated days to delivery at a desired target rate." *ANPRM*, at 5. It also proposes to measure that by the Postal Service's actual service performance. *Id.*, at 6.

[27] Order No. 2365, Docket No. R2015-4, at 13 (Feb. 24, 2016) (stating "the PAEA gives the Postal Service pricing flexibility to distribute inflation-based increases within First-Class Mail"); *Annual Compliance Determination Fiscal Year 2011*, at 97 (Mar. 28, 2012) ("*ACD FY2011*") (applying "cap at the class level rather than the product level gives the Postal Service ability to apply non-uniform price adjustments within a class").

Since 2006, the Postal Service has reduced the service standards for mail subject to the monopoly, most notably in connection with its Network Rationalization initiative addressed in Docket No. N2012-1, but also in smaller-scale initiatives as well. This reduction in service was not matched by a corresponding reduction in prices. It therefore was tantamount to a rate increase that was not taken into account in the CPI-U measure.[28]

The First-Class Business Mailers accepted the reduced service standards as a necessary cost reduction, but it is important that the Service actually meet the new, reduced standards. Unfortunately, the Postal Service has struggled to meet even these lessened standards, even if the current standards could be considered "high quality." In general, to obtain acceptable delivery service today, business mailers typically must enter their mail at destination facilities and at narrow so-called "critical entry times," and those mailers have had to adjust their operations in order to meet the new operational demands.

To date, the Commission has largely mentioned Objective 3 in the context of justifying rate increases. *E.g.,* Order No. 1926, Docket No. R2013-11, at 158 (Dec. 24, 2013) ("The proposed increase is expected to maintain high quality service pursuant to 3622(b)(2) [sic] by providing the Postal Service with the revenue required to continue its obligations under section 3691"). This suggests that Objective 3 might be thought to be complementary to Objective 5. The *ANPRM* offers no evidence that this in fact is true. In particular, the First-Class Business Mailers are unaware of any effort to evaluate

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[28] *See United States Postal Service v. Postal Regulatory Commission,* 785 F.3d 740 (D.C. Cir. 2015) (paying more for same or less service equates to a rate increase); *accord Direct Testimony of Kevin Neels on Behalf of the Public Representative*, Docket No. N2012-1 (Apr. 23, 2012) (stating that a reduction in service standards is, in effect, a relaxation of the price cap).

whether rate increases have had any effect on service quality. All that occurs is a routine review of service performance in the annual compliance review.

Moreover, the Objectives to be "considered in conjunction" with Objective 3 are broader. In particular, Objective 1 should play a role. The Service's network rationalization initiative did not try to leverage or promote mailer preparation capabilities through the adroit use of discounts and other pricing tools. Instead, the Postal Service designed the program to optimize use of the remaining postal facilities. It thereby missed an opportunity to advance Objective 1 through maximizing cost reduction and to incentivize efficiency through the adroit use of discounts and other pricing tools.

E. Objective 4: To Allow The Postal Service Pricing Flexibility

Objective 4 provides that the system should "allow the Postal Service pricing flexibility." 39 U.S.C. §3622(b)(4). The *ANPRM* (at 6) offers that a system satisfies Objective 4 if it "allows for the Postal Service to exercise its discretion to set prices, the price structure, and the price schedule for market dominant products, subject to other requirements under the law." It suggests measuring this concept by comparing the current system to other systems, other utilities, the pre-PAEA postal ratesetting system, and private carriers. *Id*.

The First-Class Business Mailers submit that there are two aspects of pricing flexibility. The first is procedural--the ability to "to set its schedule of price adjustments and make revisions to the schedule at will." *Annual Compliance Determination*, *Fiscal Year 2015*, at 11 (Mar. 28, 2016) ("*ACD FY2015*"); *see also ACD FY2011*, at 19 ("The Postal Service has pricing flexibility under the PAEA, including deciding when to implement rate changes"). Here, the current system has succeeded exceptionally well;

rates for market-dominant products are changed far more swiftly than under the previous 10-month cost-of-service rate case system. As required by the statute, the Postal Service has the ability to adjust monopoly rates on 45-days notice, although in practice it provides longer notice due to the challenges of changing rates across the entire mailing industry. This practice has helpfully smoothed the implementation of new prices, reducing the inevitable imperfections in the process.

The second aspect of pricing flexibility is substantive—it "grants the Postal Service expanded pricing flexibility while providing mailers stability and predictability via an inflation-based price cap." *ACD FY2012*, at 77. In practice, under the Commission's current rules the Postal Service has exercised almost unlimited control over prices, because its noticed price adjustments have been allowed to take effect with rare exceptions. This has been a significant change from the regime under prior law, where the Postal Service merely proposed rates and the Commission had a greater role in establishing the rates.

The Postal Service's use of its substantive pricing flexibility has been a mixed bag. On the positive side, it has used its pricing flexibility under the current system to set prices that have collected revenues that more than recovered the attributable costs of market-dominant products and contributed substantially to institutional costs.

Second, to the Postal Service's credit, it has used its flexibility under the PAEA to introduce innovations in rate design. *See ACD FY2012*, at 24 ("The Commission rules related to application of the CPI-U price cap, introduction of new products, and implementation of promotional offerings, are designed to encourage the pricing flexibility envisioned in the PAEA"). Examples include the elimination of the extra ounce charges in First-Class Presort Mail up through 3.5 ounces and the introduction of the Metered Mail rate in the Single-Piece product. *Annual Compliance Determination, Fiscal Year 2014*, at 68 ("*ACD FY2014*") ("the Commission finds that the price differential between Stamped and Metered Letters is an appropriate exercise of the Postal Service's pricing flexibility").

Third, the Postal Service over the years also has exercised its flexibility to offer a variety of promotional incentives. Some of these it chose to repeat and some it did not. These all are examples of a degree of pricing flexibility that did not exist, for practical purposes, under the former cost-of-service regime.

On the other hand, the Postal Service has not always used its pricing flexibility to maximize efficiency and profitability. The Commission has observed that the "Postal Service has the pricing flexibility to increase contribution through worksharing incentives and rates charged for products within a class." *ACD FY2012,* at 8. For example, because the Postal Service receives a greater unit contribution from Presort Letters than from Single-Piece Letters, it could have improved its financial position by encouraging more Automation Letters through smaller rate increases.[29]

Nor has the Service necessarily applied its pricing flexibility in conjunction with the other Objectives. The Postal Service undoubtedly could have achieved more net revenue had it priced its products more optimally. For another, whenever the Postal Service has passed through less than 100 percent of the costs avoided in a workshare presort discount, it automatically has harmed its financial position by selling its sortation services below cost, as explained in Subsection B above.

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[29] The First-Class Business Mailers commend the Postal Service for taking this approach in Docket No. R2017-1, which was a sound first step toward correcting a problem long in the making.

To a greater extent than necessary under the statute, the Commission's deference to the Postal Service's pricing of monopoly products has frustrated the transparency demanded by Objective 6. This has happened when rates are changed without clear explanation or in unpredictable ways.

In other instances, the Commission's excessive deference to the Postal Service has largely ignored Objective 8, allowing the Service to price some products at non-compensatory rates for many years, with little intervention by the regulator. See *ACD FY2011*, at 30 ("the Postal Service is not taking full advantage of its pricing flexibility to address loss-making products"). This has resulted in other products having a higher cost coverage that would have been the case were all products properly priced.

Pricing flexibility has also been invoked to justify other Postal Service pricing decisions that have harmed its interests. A recent notable example is the failed Flats Sequencing System pricing initiative in Standard (now Marketing Mail). Introduced in Docket No. R2015-4, it was rescinded at the first opportunity in Docket No. R2017-1 after a disastrous experience.

These examples illustrate that in practice "pricing flexibility" has been treated as a paramount Objective while the "in conjunction with" statutory command has been minimized. After ten years, it remains unclear how the pricing flexibility Objective in practice has been affected by any other Objective.

Despite the strong (or excessive) deference to Postal Service pricing flexibility over the past decade, there is, oddly, one area in which the Commission has unduly and unnecessarily constricted the Postal Service's pricing flexibility. That is the Commission's decision to link First-Class Mail Presort and Automation discounts to

Single-Piece rates. *See* Order No. 536, Docket No. RM2009-3 (Sept. 14, 20010). This unnecessary and obsolete decision (discussed more fully in Section V(A) below) has significantly impaired the Postal Service's ability to price First-Class Mail products.

F. Objective 5: To Assure Adequate Revenues, Including Retained Earnings, To Maintain Financial Stability

Objective 5 provides that the system for regulating monopoly products should "assure adequate revenues, including retained earnings, to maintain financial stability." 39 U.S.C. §3622(b)(5). The *ANPRM* (at 7) proposes to define a system that satisfies Objective 5 as one under which "the Postal Service is financially solvent while able to respond to changes in its environment (*e.g*., volume erosion, legal or regulatory framework, demographic trends) and meet its statutory obligations (*e.g*., pricing and universal service)." The *ANPRM* suggests that the "key measureable concept" is "'financial stability,' which incorporates adequate revenues and retained earnings." It further suggests that "financial stability" could be measured by reviewing short-term, medium-term, and long-term financial stability (*id*.), but is unclear as to whether these would be alternative or cumulative measures, and how the three would be weighted.

Although Section 3622(b) does not define "financial stability" directly, the PAEA provides an appropriate definition in the Section 3622(d)(3) exigency provision. There, Congress effectively defined "financial stability" as that sufficient to allow the Postal Service: "under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States." There is no need for the Commission to invent a different definition lacking in a statutory basis.

Financial stability within the meaning of the PAEA should be evaluated by taking proper account of the Postal Service's cash flow and a review of the balance sheet that not only assesses the accounting principles but also notes the market value of the Postal Service's long-term property assets. This is addressed below in subsection 1.

As discussed in subsection 2, the Postal Service unquestionably obtains far more than sufficient revenues from market-dominant products to maintain its financial stability. Under the price cap regulations, market-dominant revenues have exceeded their attributable costs and contributed billions of dollars to institutional costs. Considered on an incremental cost basis, market-dominant products easily exceed their costs and contribute significantly to overhead. As a result, the Postal Service throughout the past decade consistently has had sufficient funds to operate, including positive operating income in several recent years. Most importantly, the Service has, in fact, provided uninterrupted service during the past ten years.

Against this history, speculation as to future trends in revenues and costs lacks concreteness. The Postal Service has been warning of dire financial dangers for most of the past decade, but these dire outcomes have never come to pass.

A principal reason why its dire warnings have not come true is that, as discussed under subsection 3, the Postal Service is under no serious risk of insolvency. The Postal Service was and is a government establishment in the Executive Branch. Notwithstanding that status, it has been fashionable to analyze its finances repeatedly *as if* it were a publicly traded, for-profit corporation. It is not. Financial ratios and Z-Scores used to analyze private firms provide little useful insights into the finances of a $70 billion Executive Branch agency which not only has substantial assets that do not appear on a balance sheet (omitting the market value of real estate gives a highly misleading picture of the Postal Service's true condition), but one that also by law can increase rates on mailers subject to its legal monopoly by more than the price cap in an exigent circumstance.[30]

As a government establishment, the Postal Service operates under different rules and prerogatives than private businesses. That Congress directed the Postal Service to operate in a business-like manner does not mean that its finances can be compared meaningfully to a private business. For example, unlike private firms, the Postal Service has access to taxpayer monies held by the Treasury Department, and its Forms 10-Q have stated its expectation that taxpayers would keep it functioning if necessary.[31] That the Postal Service also operates under different obligations, such as the universal service obligation, merely means that it has different costs than private firms and is an input to the analysis, not a conclusion. Basing conclusions about the Postal Service on the finances of much differently situated private firms would be to compare apples and oranges.

Most importantly, the Postal Service is financially stable. It has been and is able to maintain and develop market-dominant mail services of the nature appropriate to the

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[30] Chairman Taub acknowledged these differences in his recent testimony before the House Oversight and Government Reform Committee. *Testimony of Robert G. Taub, Chairman*, at 11 (Feb. 7, 2017) ("Financial analysis used in the private sector may not be directly relevant to government agencies because revenue streams, equity structures, and management incentives differ").

[31] *E.g., United States Postal Service Form 10-Q*, at 9 (Aug. 8, 2016) ("Disruption of the mail would cause undue hardship to businesses and consumers, and in the event of a cash shortfall, the U.S. government would likely prevent the Postal Service from significantly curtailing or ceasing operations "). In the event of cash shortfalls, private firms could not depend on the support of the Federal Government for any assistance at all.

nation. The current system of regulating monopoly postal products is achieving its Objective.

1. The PAEA defines "financial stability"

The term "financial stability" is not specifically defined in Section 3622(b), nor is it an accounting term of art. However, Section 3622 indicates what Congress meant by "financial stability." It does so in the exigency provision, which authorizes the Commission to approve above-cap rate adjustments due to extraordinary or exceptional circumstances where:

> Such adjustment is reasonable and equitable and necessary to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States.

39 U.S.C. §3622(d)(1)(E). Both the Commission and the Court of Appeals have called the exigency provision a "safety value" that allows the Postal Service to "compensate[s] for the net adverse financial impact of the exigent circumstances." Order No. 864, Docket No. R2010-4R, at 25 (Sept. 20, 2011); *Alliance of Nonprofit Mailers v. Postal Regulatory Commission*, 790 F.3d 186, 189 (D.C. Cir. 2015).[32] It follows that the standard defined in the exigency provision restates the normal, expected financial condition.

Thus, the definition of "financial stability" derived from the PAEA itself is that which allows the Postal Service: "under best practices of honest, efficient, and

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[32] *Accord* Order No. 1926, Docket No. R2013-11, at 17-19 (Dec. 24, 2013) (noting need to quantify the "net financial impact" of the exigent circumstance); *aff'd United States Postal Service v. Postal Regulatory Commission*, 640 F.3d 1263, 1268 (D.C. Cir. 2011) ("the adjustments must match the amount of the revenue lost as a result of the exigent circumstances"); *Alliance of Nonprofit Mailers v. Postal Regulatory Commission*, 790 F.3d 186 (D.C. Cir. 2015).

economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States." *See* Order No. 1926, Docket No. R2013-11, at 115 (Dec. 24, 2013) (an exigent rate adjustment must be "necessary to enable the Postal Service . . . to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States"). There is no need for the Commission to fashion a different definition of its own, untethered from any statutory basis.

Under the PAEA-based definition, the most appropriate metric is whether the system of rate regulation has generated sufficient funds to maintain and develop postal services, consistent with best practices of honest, efficient, and economical management and adapted to the needs of the nation. To the extent that a longer-term metric is desired, subsection 3 below sets forth the most appropriate way for the Commission to proceed.

2. The Postal Service has provided uninterrupted service for market-dominant products while their revenues easily have exceeded attributable costs

There is no question that the Postal Service has been able to "maintain and develop" postal services of the kind and quality adapted to the United States since enactment of the PAEA. This is the case for all postal services, but is particularly true for products subject to market-dominant rate regulation.

First, and most importantly, the Postal Service successfully has provided *uninterrupted* delivery services throughout the past decade. No service shutdowns have occurred for financial reasons; there were no missed payroll payments to letter carriers; no deployment of the National Guard to deliver the mail. The Postal Service has maintained its delivery of market-dominant mail six days a week, 52 weeks a year, without interruption, during a period in which its volumes have declined, demographics changed, a major recession occurred, and electronic alternatives flourished. That is an enormously significant accomplishment that should not be ignored.

One reason the Postal Service has provided service so successfully over the past decade is that its revenues from market-dominant products have easily exceeded costs by substantial amounts and made major contributions to institutional costs throughout those years. Neither the price cap nor the Commission's implementing regulations have hindered the Postal Service in the least from covering its costs of providing monopoly services throughout the past decade.[33] Furthermore, it is very likely that the Postal Service could have earned even more net operating cash flow (or "profit") from market-dominant products under the price cap had it: (1) done a better job of capturing cost savings from its network restructuring efforts; (2) not stumbled on the FSS investment; and/or (3) priced its monopoly products more optimally.[34]

Not only has the Postal Service successfully completed its daily delivery rounds without interruption, it has done so, despite overall volume declines, to more delivery points than ever before. *United States Postal Service FY2016 Annual Report to Congress*, at 6 & 28, *filed as* USPS-FY16-17 (Dec. 30, 2016) (more than 156 million delivery points in 2016, an increase of more than 1,000,000 from FY 2015). And,

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[33] To the extent that the 2007-2008 recession caused extraordinary losses, the Postal Service successfully recovered through the exigency surcharge the net financial losses that the Commission found were due to the recession. Even the fact that certain individual products and classes persistently have not recovering their costs has not prevented this from being true for market-dominant products as a whole.

[34] The First-Class Business Mailers do not challenge the honesty and integrity of postal management over the past decade. However, they do believe that postal products over the past decade have not always been priced in a manner consistent with best practices of a private firm

despite the increase in delivery points, delivery costs have fallen by about 1.5 percent annually since 2006. *Peeling the Onion*, at 3 (crediting falling delivery costs to the Postal Service's restructuring of delivery operations, eliminating 22,135 routes between 2008 and 2014).[35]

Second, the Postal Service has also introduced innovations in market-dominant products during the past decade in both pricing and technology. Examples of pricing innovations and new products include the no-incremental charge up to 3.5 ounces in First-Class Presort Mail, the Full-Service IMb incentive, Every Door Direct Mail, a non-worksharing price for Metered Mail, and others. The Postal Service has also experimented with a number of targeted promotional efforts in market-dominant mail. Technological innovations relate more directly to the physical mail piece, such as its efforts to advance the integration of digital advertising and Marketing Mail, and more recently, Informed Delivery and the MyUSPS mobile application.

Of course, the Postal Service has directed much of its innovative energy to its Package business, mostly to the benefit of Competitive Products.[36] The Postal Service's current and expected growth in competitive Package Services is improving its financial position and, with it, creating a healthy contribution to institutional costs. Nonetheless, given the growth of alternatives to the Postal Service in this category – ranging from Amazon's self-delivery network through the "Uberization" of packages deliveries to potential commercial drone options – it is reasonable to wonder whether this level of success and contribution in package services will continue in the longer run.

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[35] Although the number of routes has increased in the past two years, costs have still fallen. *USPS FY2016 Annual Report to Congress*, at 51.

[36] *Brennan Testimony*, at 6.

Hence, although Competitive Products are outside the scope of this review, maintaining market-dominant rates at CPI levels or below reduces the risk of cross-subsidization of Competitive Products, as required by PAEA.

3. The Postal Service is financially stable in all relevant measures

The *ANPRM* suggests that one could measure "financial stability" on a short-term, medium-term, and long-term basis, although it is unclear whether these would be applied together or it would use only one. I. *Id*., at 7. In particular, it states:

> Short-term financial stability could be measured by the Postal Service's operating profit (*i.e.*, operational revenue – operational expenses). Medium-term financial stability could be measured by economic profit (*i.e*,, total revenue – [variable cost + fixed cost]). Long-term financial stability could be measured by solvency (*i.e.*, total assets / total liabilities).

Id. The First-Class Business Mailers suggest that cash flow is the most appropriate measure, and by that measure the Postal Service currently is quite stable. The Postal Service's cash flow is certainly adequate to maintain and develop the postal services appropriate for the nation. And the Postal Service is quite well positioned for the longer run as well, when one properly analyzes its balance sheet to reflect its assets' true value rather than just accepting the GAAP recording of those assets.

a. The Postal Service's cash flow is strong

On an operational basis, the Postal Service continues to perform well and earn cash. The Postal Service reports cash flow in its Form 10-K. Its most recent Form 10-K reports a net increase in cash of $1.443 billion in FY2016. *USPS FY2016 10-K*, at 40.

Over the past three years, the Postal Service's net cash and cash equivalents at year-end have increased from $2.326 billion to $8.077 billion. *Id*., at 42.[37]

Furthermore, the Postal Service's operational revenue and expenses are highly predictable.[38] It has seasonal peaks and troughs, but over the years the Service has developed highly sophisticated volume forecasting and cost modes. This operational revenue and cost predictability allows the Postal Service readily to manage its cash flow. In addition, much Single-Piece postage is sold in advance and not used for some time, if at all. This means that the collection of cash – even if not recognized immediately on an accrual basis – and the corresponding eventual cost of handling the mail to which it is affixed occur in a sequence that benefits the Postal Service.

The Postal Service has not shown any inability to manage and develop postal services with that amount of cash in hand. Although the Postmaster General has stated that the Service has "insufficient cash reserves" (*Brennan Testimony*, at 7), she did not state what level would be "sufficient," and a monopoly provider can always find ways to spend additional money.

For a case in point, the Postal Service states that it "will require significant capital investment over the next few years to modernize and improve our processing and

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[37] The Postal Service has bewailed its "days cash on hand." This deserves little weight. Not only is its interpretation of that metric in dispute (*see* Office of Inspector General, *Measurement of Days of Operating Cash on Hand Audit Report*, Report Number FT-AR-17-001 (Oct. 20, 2016)), but it is also the case that few organizations have as steady and reliable day-to-day cash flow as does the Postal Service. Its cash is replenished daily. Even in severe economic conditions, the Postal Service can still expect to take in 80 to 90 percent of its usual revenue as people reset meters, mail with permits, and buy stamps.

[38] *E.g., USPS FY2016 Form 10-K*, at 4 ("Mail volume and revenue are historically greatest in the first quarter of our fiscal year, which includes the holiday mailing season, and lowest in the third and fourth quarters of our fiscal year during the spring and summer").

delivery infrastructure and update our delivery fleet." *USPS FY2016 Form 10-K*, at 31. While no one doubts that the Postal Service needs to continue to make capital investments in the years to come, assertions about such large spending "needs" require critical assessment. For example, the Postal Service may not sign a contract for new vehicles for at least two years, and the costs of such vehicles is not known.[39] And it would be naïve to think that the prospective vendors do not have an eye on this proceeding as they consider how to price their proposals. In short, the Commission should not accept at face value the Postal Service's estimated future spending needs, because those are subject to substantial change caused by both internal and external factors.

The Postal Service attributes its improved cash position in part to the revenues collected via the exigent surcharge, and blames the removal of the surcharge for reducing its cash flow by about $1 billion. *USPS FY2016 10-K*, at 2. It errs, however, in apparently believing that the surcharge revenue was somehow "additional" money. Instead, the surcharge simply restored the Postal Service to the net financial condition it would have enjoyed if the recession had not occurred, because it recovered the net loss due to the exigent circumstance (the recession). It had no entitlement to any additional amount. The surcharge simply allowed it to collect in 2014-2016 money that, but for the recession, it would have collected in 2009-2011. In fact, delaying the collection of that money probably benefitted the Postal Service by helping it to focus on the need to engage in serious cost reduction efforts to realign its services with changed demand.

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[39] The Postal Service's specifications for these vehicles anticipate a cost of about $35,000 each, with a goal of 140,000 vehicles and additional "off-the-shelf" vehicles. But these are only estimates; the prototypes have not undergone testing, and the ultimate cost simply is not known. It would be arbitrary to base any decisions in this proceeding on such unknown future controllable costs.

As the Commission said repeatedly, the surcharge was not a means to avoid the cap permanently.

Although the First-Class Business Mailers believe that cash flow is the superior metric to use, we note that the Postmaster General recently testified "Controllable income is more reflective of operating performance than net income, due to the outsized effects of these mandated and uncontrollable expenses." *Brennan Testimony*, at 6.[40] By this accrual measure, the Postal Service is doing well. In Fiscal Year 2016, the Postal Service had a "controllable income" of $610 million. *USPS FY2016 10-K* at 15. This followed strong performances by this metric in Fiscal Years 2015 and 2014, and its total controllable income over that period is $3.2 billion. *Brennan Testimony*, at 6. These are good results, not signs of distress.

As is known, under GAAP accounting the Postal Service incurred a net loss in FY 2016 primarily because of the $5.8 billion retiree health benefit premium prepayment. *Id*. While the *USPS FY2016 Annual Report to Congress* (at 25) notes a net loss from operations in FY2014, FY2015, and FY2016, those were due to the mandated retiree health benefit prepayments. Setting those aside, its GAAP net income from operations would be positive in each of those years. *USPS FY2016 Annual Report to Congress*, at 12. Finally, it is important to note that the Postal Service reports that it has incurred "no penalties or negative consequences resulting from our inability to make these payments." *USPS FY2016 10-K*, at 31. Therefore, relying on

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[40] Controllable income is a non-GAAP measure that excludes the Retiree Health Benefit prefunding requirement and non-cash actuarial adjustment for workers' compensation and Federal Employees Retirement System (FERS) liabilities over which management lacks control.

the GAAP accounting paints an inaccurate picture of the Postal Service's financial stability.

We submit that cash flow from operations is the best measure of operating performance.

b. Balance Sheet and Financial Ratios

The *ANPRM* appears to suggest equating long-term "financial stability" using concepts applicable to private firms that it has presented in its recent financial reports. *ANPRM*, at 7. The First-Class Business Mailers – all private businesses – submit that financial ratios used to analyze private firms are of dubious value in evaluating the Postal Service.

There are two fundamental problems with using univariate ratio analyses of sustainability, liquidity, activity and the like. The first is that their applicability to the Postal Service and its balance sheet has not been shown. The Commission has never even invited public comment on their use until now. The second is that, as Professor Altman has said, univariate ratio analysis presented in this fashion "is susceptible to faulty interpretation and is potentially confusing."[41] For example, a firm with a poor profitability record may be regarded as potentially bankrupt but, for other reasons, the situation might not be considered serious.

Although this proceeding is limited to a review of the performance of the system for regulating the rates of market-dominant products, the Postal Service does not report

[41] See Altman, E., *Corporate Financial Distress, A Complete Guide to Predicting, Avoiding and Dealing with Bankruptcy,"* page 101.

a balance sheet for market-dominant products. Instead, the Postal Service presents only a balance sheet on an entity-wide basis. This is problematic for several reasons.

First, it is unclear that an *entity-wide* balance sheet analysis bears material relevance to a review of whether any changes might be appropriate in the system that regulates the rates for *only market-dominant* products – which account for about three-quarters of the overall revenue. *USPS FY2016 Annual Report to Congress*, at 17.

Second, an entity-wide balance sheet introduces issues that are unrelated to the performance of the market-dominant rate regulation system. In particular, the Postal Service's defaulted prepayments of retiree health benefits affects a balance sheet prepared according to GAAP, but is unrelated to the performance of the price cap system.

Even assuming an entity-wide balance sheet were appropriate, an analysis of long-term financial sustainability based on balance sheets should use one that accurately counts assets and liabilities, not just a GAAP-reported ones. Such was not provided in the Postmaster General's recent Congressional testimony, which purported to show that the Postal Service's total liabilities, including its various retirement obligations, exceed its assets by $96 billion. *Brennan Testimony*, at 7. That table presents an incomplete picture of the Postal Service's true assets and liabilities, and should not be relied upon as a basis for drawing conclusions about its condition. Indeed, it would be arbitrary to rely on the GAAP balance sheet without also taking into account off-balance sheet assets that paint a much healthier picture.

Most importantly, the Postal Service's extensive land, buildings, and equipment are listed at net depreciated book value of $15.3 billion (rounded).[42] That understates the true value of the Postal Service's real estate by an enormous amount. The more relevant figure is the market value of the property, as that potentially could be used to satisfy liabilities or raise capital for investing in new equipment. Although the Postal Service has not provided such a number, its Inspector General has estimated that the market value of Postal Service real estate could be as high as $85 billion.[43] That value should be taken into account when considering the financial well being of the Postal Service. One might expect the Postal Service to challenge that adjustment on the grounds that it may need to use much of that real estate for operations, but that is unlikely to apply to all of the assets. In addition, private corporations have been able to convert substantial amounts of real estate into investable cash through sales and leaseback arrangements. There is no obvious reason why the Postal Service could not do so as well, as some of its real property sits in very valuable urban areas.

Second, the table in the Postmaster General's House testimony also shows that the Postal Service has some $338.4 billion in its CSRS, FERS, and RHB funds. It is well known that these funds do not earn a market-level interest rate, or even the assumed rate. In FY2016, the assumed rate of return for both the CSRS and FERS funds was 5.5 percent, but the actual rates were 4.04 percent and 3.04 percent,

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[42] *Accord USPS FY2016 10-K*, at 40.

[43] Office of the Inspector General, *Considerations in Structuring Estimated Liabilities*, Report Number FT-WP-15-003, at 3 (citing an estimate from June 2012) (Jan. 23, 2015).

respectively.[44] The RHBF assets are comprised entirely of long-term, special-issue U.S. Treasury securities bearing interest rates from 1.39 percent to 5.0 percent. If these plans earned market-level interest, the higher earnings would reduce the liability owed.[45]

It is also important to note that the Postal Service's CSRS and FERS' fund balances are both greater than 90 percent of their respective actuarial liability. *USPS FY2016 10-K*, at 24. This is true even without taking into account that the Postal Service also believes that its FERS obligations are not underfunded if its liability were based on postal-specific assumptions. It has asked the Office of Personal Management to reassess that liability. *Brennan Testimony*, at 10.

Third, consider further that the Postal Service's retiree health benefits' actuarial liability is funded at almost 50 percent. *Id.*, at 14. That is far more than the remainder the U.S. civilian federal government, much more than the Defense Department, and well-above the funding levels of Fortune 1000 companies. *Id*. This funding level is a sign of strength, not financial distress.

Finally, these numbers would likely change in a direction favorable to the Postal Service if H.R. 756 or similar postal reform legislation were to be enacted into law. Accordingly, the Commission should continue to monitor the status of that and similar legislation in the Congress.

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[44] Similarly, in FY2015, the assumed rates of return for both the CSRS and FERS funds was also 5.5 percent, and the actual rates were 411 percent and 3.47 percent, respectively.

[45] Alternatively, the Commission could adjust the liability calculated by OPM using a more appropriate discount rate to provide a more accurate perspective.

c. Multivariate Z-Scores

For several years, the Commission has calculated Altman Z-Scores for the Postal Service. The Altman Z-Score is a qualitative model developed in the 1960s that uses multivariate analyses (instead of the univariate analyses discussed above). It is used to assess the likelihood that a company could go bankrupt. A negative Altman Z-Score is regarded as an indication that the entity will go bankrupt within two years.

The Commission states that it uses the Z-Score to predict the possibility of the Postal Service becoming unable to pay its creditors. The Commission has calculated negative Z-Scores for each of the past three Fiscal Years, concluding: "there is a high probability that the Postal Service will go into financial distress." *Testimony of Robert G. Taub on Behalf of the Postal Regulatory Commission before the House Oversight and Government Reform Committee*, at 16 (Feb. 7, 2017). However, despite this pessimistic conclusion, the Commission concedes:

> the Altman Z-Score as a predictor of the entity's bankruptcy probability is only relative, the structure of the Postal Service's ratios may be atypical, and interpreting the significance of the Z-Score would require deeper analysis by Postal Service management.

Id. The Commission's use of the Altman Z-Score for the Postal Service has never been the subject of notice and comment until this year. And there are several important reasons to doubt that Z-Scores have any value in the case of the Postal Service.

First, if Z-Scores were accurate in this context, the Postal Service would have ceased operating years ago. It did not.[46] On the contrary, its operating income and

[46] In this, it is reminiscent of the humble bumblebee which, for decades, was believed to not be able to fly under relevant mathematical formulae only, of course, to be observed, in fact, continuously flying. It took more accurate understanding of how the bumblebee flies to adjust the formulae to that reality.

cash flow have improved over that period. That fact alone casts doubt on the usefulness of Altman Z-Scores in evaluating the Postal Service.

Second, the basis on which the Altman Z-Score model was derived on its face appears quite dissimilar from the Postal Service. Professor Altman derived his model from a sample of manufacturing firms from 1946 to 1965, none with more than $9 billion in assets, half of which went bankrupt and half of which did not. Even the modified version of the Z-Score calculation used by the Commission, which attempts to project for private and non-manufacturing firms, is still based on the original set of manufacturing firms.[47]

Third, all of the firms used to develop the Z-Scores were private firms subject to the risk of bankruptcy.[48] The Postal Service is neither. On the contrary, the Postal Service itself has stated that even in the event of a cash shortfall, "the U.S. government would likely prevent the Postal Service from significantly curtailing or ceasing operations." *United States Postal Service Form 10-Q For the Quarterly Period Ended June 30, 2016*, at 9. Using a model developed from a sample of firms, some more than 70 years ago, of much smaller size and nature, to predict the likelihood of an event that would not be allowed to happen, would be arbitrary in the extreme.

Finally, Objective 5 does not mandate any particular balance sheet. The best metric, as noted above, is cash flow. For longer run considerations, a balance sheet must be based on accurate estimates of the Postal Service's capital. The Z-Score

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47 Altman, Iwanicz-Drozdowdka, Laitinen, and Suvas, *Distress Firm and Bankruptcy prediction in an international context: a review and empirical analysis of Altman's Z-Score Model: Abstract*, at 7 (July 9, 2014) (Z-Score model for private and non-manufacturing firms was estimated using the same sample of firms that was used to develop the original Z-Score model). Professor Altman did not consider using cash flow ratios due to a lack of consistent depreciation data. *Id.*, at 4.

48 Half of the firms in Professor Altman's database did go bankrupt; half did not.

analyses used by the Commission to date have used net depreciated book value. Market value and actual funding levels of post-retirement benefits would provide a sounder basis for assessing the Postal Service's financial capabilities.

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The price cap system has proven remarkably successful in obtaining the revenue needed to maintain and develop market-dominant postal services in the national interest, including universal delivery six days a week. The Postal Service's cash flow has recovered from the recession and continues to fund operations and build a larger balance. Restraining prices has retained mail and improved the efficiency of the system. The easy availability of electronic alternatives means that the Postal Service must continue to lower its costs; continuing to raise prices and reduce service is not a formula for success.

The Postal Service's negative balance sheet is almost entirely due to the unrealistic statutory mandates of Congress to prefund its future retiree health benefit premiums, a matter for which market-dominant mailers are not responsible. There is no direct or indirect causal link between today's mailers and the health benefit premiums for retirees who have not yet been born. Indeed, the Postal Service's Cost and Revenue Analyses consistently have not accounted for the defaulted RHBF prepayments as either an attributable or an institutional cost.[49] Instead, it has presented it as a "Non-Controllable Expense" similar to the costs for annuitant health benefits or

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[49] *Accord Brennan Testimony*, at 6.

workers' compensation, divided into current year costs and a prior year cost.[50] Current year costs are distributed to the products on the basis of all labor costs; while the prior year cost is neither expressly deemed institutional nor classified in some other way.

Remember that market-dominant mailers already pay a surcharge for retiree health care benefits, in the form of the $3.1 billion rate increase embedded in the R2005-1 rate case to fund the former escrow obligation.[51] This increase remains embedded in the base, so the cumulative amount paid in this way by mailers for retiree health care benefits over the years now exceeds $30 billion. While less than the amount of the prepayment obligations, the $3.1 billion annually is approximately the size of the amortized payments going forward.

The price cap has achieved Objective 5 successful despite a recession, volume declines, and electronic diversion. Although it is but one Objective, and must be considered in conjunction with the others, the evidence shows that it has worked as Congress had intended. To the extent that the prepayment obligation distorts the success of the system, it should be remembered that the same law that enacted the prepayment obligation also established the price cap system for market-dominant products, and at no place stated that the price cap could be ignored in order to cover the prepayments.

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50 In Cost Segment 18, the component titled "Annuitant Health Benefits & CSRS Pension costs" (component no. 208 in the Cost Segments and Components report), the total accrued cost is the sum of the current year's pay-as-you-go premiums plus the statutory pre-funding payment. In Fiscal Year 2016, the total was $3.3 billion for the current year's premiums plus $5.8 billion for the pre-funding payment, a total of $9.1 billion.

51 The $3.1 billion per year added in Docket No. R2005-1 was, at that time, intended to fund an escrow related to the Postal Service CSRS. *See Opinion and Recommended Decision*, Docket No. R2005-1, at ¶3001 *et seq*. (Nov. 1, 2005). The PAEA redirected those escrowed funds to be a partial prepayment of the retiree health benefit premiums. PAEA, Section 801, 5 U.S.C. §8348(h); *see also 2011 Section 701 Report*, at 16. That increase became part of the base and has never been rescinded.

G. Objective 6: To Reduce The Administrative Burden And Increase The Transparency Of The Ratemaking Process

Objective 6 provides that the system should "reduce the administrative burden and increase the transparency of the ratemaking process." 39 U.S.C. §3622(b)(6). The *ANPRM* (at 8) states that a system achieves this Objective where it balances the goals of reducing the costs of rate proceedings and the availability of comprehensive understandable material relating to each rate proceeding." It suggests measuring this on the basis of reduction in the administrative burden and increased transparency, and identifies some possible metrics for both. *Id*.

The proposed definition and measures are reasonable. Applying them should result in a conclusion that the current ratemaking system has reduced the administrative burden on the Postal Service. In particular, rate changes occur far more swiftly than before, and on a much more slender record. Of course, many of the former rate case requirements were retained for purposes of the annual review process pursuant to Section 3652, a provision outside the scope of this proceeding. Congress determined that separating the costing proceedings from pricing proceedings would make better use of administrative resources, and this has largely held true.

Conversely, the current system is less transparent than the former cost-of-service regime. Under the former system, rates emerged from a thorough, on the record adversarial proceeding; under the current system, at least for First-Class Presort and Automation tiers, there often is no explanation why certain rates rise or fall by varying amounts. This loss of transparency is an unnecessary consequence of the pricing flexibility given the Postal Service under the price cap.

This loss of transparency might be more acceptable if the Postal Service had more effective communications with the industry. Unfortunately, the Postal Service has not always made effective use of industry feedback in forums such as MTAC and comments on Postal Service Federal *Register* notices. Nor has it always been receptive to insightful critiques from the Commission or its own OIG. Such breakdowns have manifested themselves in ineffective incentives or pricing mistakes. Better communications might have ameliorated some of the problems associated with the implementation of Full-Service Intelligent Mail barcode, PostalOne!, and the Flats Sequencing System.[52] The Postal Service did communicate in an improved manner before the Docket No. R2017-1 rate adjustments, and the First-Class Business Mailers encourage it to continue to do so in the future.

Third, transparency also suffers when the Postal Service imposes compliance costs on mailers that it never acknowledges or accounts for in pricing but which very much raise the real cost of mailing. The Postal Service's Inspector General concluded in a 2011 audit report on this subject that the Service "has not always fully considered how changes to mail compliance rules affect mailers."[53] For example, the Inspector General found that many mailers were not converting to Full-Service IMb because the Service had not taken into account the "costs of additional software, management of

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52 The FSS is a very expensive capital program that does not seem to have achieved its purpose. The problems were known for years. *E.g.,* Office of Inspector General*, Audit Report- - Flats Sequencing System: Production First Article Testing Readiness and Quality*, Report Number DA-AR-08-006 (June 4, 2008) (citing lower volumes than had been assumed in the Decision Analysis Report, delays, and production control problems).

53 Office of Inspector General, *Effects of Compliance Rules on Mailers: Audit Report,* Report Number MS-AR-11-006, at Highlights (Aug. 24, 2011).

electronic documentation, and unique barcodes"[54] which were not offset by the modest Full-Service IMb incentive. He also observed that the Service "did not estimate mailers' costs or complete a cost-benefit analysis for the proposed Move Update change related to Moved Left No Address/Box Closed No Order mail."[55]

According to that 2011 report, postal management "concurred with the findings and recommendations and stated that, where practicable, it will include mailers' costs in its cost-benefit analysis of new initiatives."[56] Unfortunately, the First-Class Business Mailers have not observed much improvement in the ensuing six and one-half years.

Instead, in Docket No. R2013-10, the Postal Service sought to require Full-Service IMb as a condition for obtaining First-Class Automation rates. The Commission denied that proposal, holding that the mailing regulation change constituted a rate change with price cap implications. Order No. 1890, Docket No. R2013-10 (Nov. 21, 2013). Although that case remains in litigation, the Court of Appeals affirmed the central holding that the Commission has authority to regulate mail preparation changes that implicate the price cap. *United States Postal Service v. Postal Regulatory Commission*, 785 F.3d at 743; *see also* 30 C.F.R. §3010.23(d)(2).

In its reply comments in the FY2016 ACR proceeding, the Postal Service stated that it has "had more success in reducing costs and slowing cost growth for Presort Letters/Cards than for the Single-Piece Mail product."[57] What it did not explain,

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[54] *Id*., at 3.

[55] *Id*.

[56] *Id*., at Highlights.

[57] *Reply Comments of the United States Postal Service*, Docket No. ACR FY2016, at 4 (citing changes in costs per piece since FY 2008).

however, is how much of that cost restraint has been due to improved efficiency, and how much can be attributed to shifting costs onto mailers. Is it merely a coincidence that the "success" the Postal Service claims pertains to a product with numerous mailing preparation requirements, which have become more onerous over the years, compared to a product for which it has little ability to shift costs onto mailers?

The answer to this is literally unknown. That is because when the Postal Service shifts or imposes costs onto mailers that raise the cost of mailing, it does not acknowledge or account for that shift. That failure in transparency also implicates Factors 3 (effect of rate increases upon businesses), 5 (degree of preparation), and 6 (simplicity of rate structure). It also has an adverse effect on mailers, both large and small, and their willingness to use the mail. The impact can be particularly significant on small businesses (60 percent of NAPM's members are small businesses, as are many of their customers).

H. Objective 7: To Enhance Mail Security And Deter Terrorism

Objective 7 provides that the system should "enhance mail security and deter terrorism." 39 U.S.C. §3622(b)(7). The *ANPRM* suggest that a system achieves Objective 7 if it "encourages methods of safeguarding the mail system from illegal or dangerous use, or terrorism." *ANPRM*, at 8. It suggests that achievement of Objective 7 might be measured by "a review of available safeguards" intended to enhance security, and "a review of the availability of an exigent-like provision to ensure funds are available to respond to specific threats." *Id*., at 9.

The current ratemaking system has had no noticeable effect on enhancing mail security and deterring terrorism and the Postal Service has never claimed otherwise for the past ten years. The First-Class Business Mailers support the Commission's proposed definition, but disagrees with the proposed metrics.

The Full-Service Intelligent Mail barcode initiatives (unique ID and eDoc) should increase the security of the mail. The current system allows room for the Postal Service to provide greater incentives, particularly in USPS Marketing Mail, to encourage more mailers to apply Full-Service IMbs to their mailings. No change to the current system is required to enable this to happen; it requires only that the Postal Service use its pricing flexibility (Objective 4) in conjunction with this Objective and Factor 13 (the value to the Postal Service and users of promoting Intelligent Mail and of secure, sender-identified mail) to do so.

No new "exigency-like" provision to ensure funds for security is necessary. The current exigency provision already is available for such a need. This is evident from the Senate Report on S. 2468 in the 108th Congress, which was the precursor to the PAEA in the next Congress. That Report explicitly tied the exigency language to a national emergency such as terrorism:

> [T]he terrorist attacks of September 11, 2001 and the subsequent use of the mail to transmit anthrax highlight the need to address unexpected and extraordinary circumstances and their effect on the Postal Service and its financial requires. Therefore, the Postal Regulatory Commission shall establish procedures under which the Postal Service can adjust rates on an expedited basis due to unexpected and extraordinary circumstances.

S. REP. NO. 108-318 at 11-12. There is no need to create a new exigency provision.

I. Objective 8: To Establish And Maintain A Just And Reasonable Schedule For Rates And Classifications

Objective 8 provides that the system should "establish and maintain a just and reasonable schedule for rates and classifications" while allowing the Postal Service to make changes of unequal magnitude within, between or among mail classes. 39 U.S.C. §3622(b)(8). The concept of "just and reasonable" rates appears frequently in regulatory statutes as the benchmark for protecting the customers of the regulated entity. *E.g.*, 47 U.S.C. §101(b) (Communications Act of 1934). Where the service provider has a legal monopoly, as is the case with First-Class Mail, the "just and reasonable" standard requires regulation because there is no competition that can be relied upon to keep rates at competitive levels.

The *ANPRM* (at 8) offers a preliminary definition of such a system as one in which "rates and classifications are linked to distinct cost or market characteristics, and the amount charged for each service is neither excessive to the mailer nor threatened the financial integrity of the Postal Service. It tentatively proposes to measure the two concepts of justness and reasonableness, and suggest a variety of ways to assess achievement of each concept. *Id*.

Considering the "reasonableness" prong first, the *ANPRM* suggests examining the relationship between price and cost to ensure that "prices and costs do not threaten the Postal Service's financial integrity." *ANPRM*, at 9. As another option, it proposes considering the total compensation provided by products or classes. *Id*. These definitions are unnecessarily broad. Instead, it would be more useful simply to adhere to the generally accepted regulatory definition of "reasonable," which is that rates for a product are reasonable when they cover its costs and make a modest contribution above that. Using that definition, First-Class Presort Mail rates are “reasonable” – with the important exception that where the Postal Service passes through less than 100 percent of costs avoided for sortation services it by definition is providing its sortation service below cost.

As to the “just” prong, using the Commission’s suggested metrics of a review of excessive price increases, of price and cost relationships, or of the cost or market characteristics that define a price category or product, it is clear that the current system has allowed the Postal Service to charge unjust rates for First-Class Presort Mail despite limiting class-wide increases to the CPI-U cap. The extraordinarily high cost coverage of First-Class Presort Mail compared to any other market-dominant product, combined with reduced service, has lessened the value of the mail and thus accelerated the move of business correspondence to electronic alternatives. The unsurprising result is a decline in the Postal Service’s market share and revenues.

The Postal Service also has maintained unjust prices for USPS Marketing Letters, coupled with pricing certain other products within the same class below cost. The effect has been to make Marketing Letters a less attractive option than it should be.

1. Historical unit contributions and cost coverages of First-Class Presort Mail demonstrate that Presort Mail has been charged unjust prices for a decade

Even a cursory review of the price and cost relationships of Presort Letters and Cards (the largest product within First-Class Mail) compared to that of Single-Piece (the second largest) shows that the Postal Service has charged prices for Presort Letters far above cost. This unjust situation could be ameliorated if the Commission simply were to construe Objective 8 in conjunction with other Objectives, instead of in isolation.

The table below compares the institutional cost contributions of First-Class Presort and Single-Piece Letters and Cards over the history of the PAEA:

	Presort Attrib Cost (cents)	Presort Unit Contrib (cents)	Presort Cost Coverage (%)	System Cost Coverage (%)	SP Attrib Cost (cents)	SP Unit Contrib (cents)	SP Cost Coverag e (%)
FY07[58]	11.820	21.206	279.4	163.9	30.948	18.335	159.2
FY08[59]	11.023	22.000	299.6	164.0	25.146	17.107	168.0
FY09[60]	11.704	22.448	291.8	158.2	26.371	17.318	165.7
FY10[61]	11.679	23.060	297.4	161.1	27.201	17.633	164.8
FY11[62]	11.650	23.332	300.3	159.1	27.797	17.251	162.1
FY12[63]	12.15	23.49	293.3	160.8	27.49	18.36	166.8
FY13[64]	11.67	24.63	311.1	165.7	27.54	19.67	170.7
FY14[65]	11.804	26.043	320.6	172.8	27.768	21.374	177.0
FY15[66]	12.138	26.712	320.1	1711	26.800	23.447	187.5
FY16[67]	11.5	27.1	336.83	181.4	28.2	21.2	175.39

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58 *ACD FY2007*, at Table IV-A-1 & Table VII-B-1. The 2007 ACD reviewed rates set in the R2006-1 omnibus rate case conducted under the prior cost-of-service system.

59 *Annual Compliance Determination, Fiscal Year 2008,* at Table III-2 (Mar. 30, 2009) ("*ACD FY2008*").

60 *ACD FY2009,* at Tables IV-5 & B-1.

61 *ACD FY2010,* at Tables VII-1 & B-1 (as corrected Apr. 8, 2011).

62 *ACD FY2011,* at Tables VII-1 & A-1.

63 *Annual Compliance Determination Fiscal Year 2012*, at Tables VII-1 & D-1 (revised May 7, 2013).

64 PRC, *Financial Analysis 2013: Analysis of United States Postal Service Financial Results and 10-K Statement for Fiscal Year 2013*, at 43-44 App. A (revised Apr. 10, 2014).

65 PRC, *Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2014*, at 73-75 Appendix A (Apr. 1, 2015).

66 PRC, *Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2015*, at 88-89 Appendix A (Mar. 29, 2016).

67 USPS-LR16-1 (Public FY16CRAReport.xls) (Market-dominant mail only).

First-Class business mailers have brought this unfair burden to the Commission's attention repeatedly for most of the past decade. Each time, the Commission has allowed this situation to persist, with no explanation other than to recite that "one objective of the PAEA is to allow the Postal Service pricing flexibility, subject to the inflation-based cap and that this flexibility can be used to apply non-uniform price adjustments within a class." *ACD FY2015*, at 76; *accord Annual Compliance Determination, Fiscal Year 2013*, at 70 (Mar. 27, 2014); *ACD FY2012*, at 82; *ACD FY2011*, at 97 (because Section 3622(d)(2)(A) applies "the CPI cap at the class level rather than the product level gives the Postal Service the ability to apply non-uniform price adjustments within a class"); *accord Order No 2365*, Docket No. R2015-4 (Feb. 24, 2015) ("Subject to certain limitations, most prominently the price cap, the PAEA gives the Postal Service pricing flexibility to distribute inflation-based increases within First-Class Mail").

By focusing solely on year-to-year price changes, the Commission has missed the forest for the trees. The problem does not arise from a rate change that is unequal within a class in any given year. It arises from a consistent pattern over many years that produced essentially the same results every single year. As an example, six years ago the Commission declined to rectify the fact that Presort Mail contributed 5.5 cents more per piece than did Single-Piece: "At this time the Commission does not find that the cost coverage for Presort First-Class letters violates section 3622(b)(8)."[68] After six years of regulatory inaction, that disparity has risen to 5.9 cents per piece.[69]

Fiscal Year 2016 marked the fourth consecutive year, and the fifth in the last six, in which the cost coverage of First-Class Presort Letters and Cards exceeded 300 percent. That means that the Postal Service is pricing this mail at more than *triple* its cost. And this has occurred, year after year, under a system meant to *protect* mailers held captive by the monopoly. The persistence of this high cost coverage indicates that the price cap system as implemented to date has failed to prevent the Postal Service from exploiting these mailers held captive to the monopoly.

Small wonder that the volume of Presort Letters and Cards has fallen by 36 percent since 2007.[70] Unjustly high First-Class Presort prices have accelerated electronic diversion in a manner inconsistent with Factor (4) (the available alternative means of sending and receiving letters and other mail matter at reasonable costs) and are a primary cause of the Service's declining share of business communications.[71]

The decline in volume and revenue cannot be in the best interest of either the Postal Service or First-Class business mailers. And, while economic factors and the appeal of electronic alternatives have played roles in the decline in First-Class business volumes, these extraordinarily high prices unquestionably have had a significant detrimental impact as well. The PAEA gives the Commission ample authority to correct

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68 *ACD FY2010*, at 85.

69 *ACR FY2016*, USPS-FY16-1 (Public FY16CRAReport.xls) (Market-dominant mail only).

70 *Brennan Testimony*, at 3.

71 In contrast, Marketing Mail may become relatively more attractive as marketers shift to hybrid digital/mail campaigns.

the deficiencies that have led to the unfair pricing. In this instance, it has occurred due to an interpretation of Objective 8 that tolerates unequal perennial price changes and that subordinates Objective 8 to Objective 4.

That misapplication of Objective 8 is made even more evident when the continued unjust pricing of Presort Mail is considered in conjunction with Objectives 1 (maximizing incentives to reduce cost and increase efficiency) and 5 (financial stability), taking into account Factors 1 (value of actual mail service), 3 (effect of rate increases on business mail users), 4 (availability of alternatives), 5 (degree of preparation), 12 (need for the Postal Service to increase efficiency and reduce its costs), and 13 (intelligent mail). In contrast, pricing flexibility (Objective 4) should be considered in conjunction with these other Objectives; it is not predominant over them.

2. The current system has enabled the Postal Service to charge unreasonable below cost rates for its sortation services

As discussed above, a discount set at less than avoided cost is a price below cost. It is also a price that excludes more efficient upstream competitors. Whenever the Postal Service's cost to perform the task (which is precisely what the "cost avoided" is) exceeds the price it offers to do so (the discount, which is seen as a surcharge when viewed from the mailer's perspective), it loses money when a mailer chooses to have it do the work. That means the Postal Service effectively loses money each time a mailer purchases the Service's sortation services.

A rate schedule is not "reasonable" if a discount/incremental charge is less than the Postal Service's cost of performing a given task. Setting discounts below avoided costs also conflicts with Objective 1 and implicates Factors 6 and 12, which require the

Commission to take into account both mailer preparation and the need for the Postal Service to increase its efficiency and reduce its costs.

The surest way to avoid such noncompensatory and exclusionary pricing in the future would be for the Postal Service to set discounts at Efficient Component Pricing levels. Doing so would apply Objective 8 in conjunction with Objective 1 (maximize incentives to reduce costs and increase efficiency), Objective 2 (rate stability), Objective 5 (adequate revenues, by avoiding money-losing pricing), and Objective 6 (transparency in rates). These would outweigh any diminishment in pricing flexibility, although the Service would continue to have ample flexibility to offer new rate incentives to achieve the Objectives and improve its efficiency.

J. Objective 9: To Allocate The Total Institutional Costs Of The Postal Service Appropriately Between Market Dominant And Competitive Products

Objective 9 provides that the system should "allocate the total institutional costs of the Postal Service appropriately between mark-dominant and competitive products." 39 U.S.C. §3622(b)(9). The *ANPRM* says comparatively little about this Objective, positing merely a review of historical cost allocations – an exercise that would shed little light on whether past shares were "appropriate" – or a review of Commission decisions setting minimum contributions. *ANPRM*, at 10.

The Commission also has said little about Objective 9 in the past. Neither the Postal Service nor the Commission has attempted to "allocate" institutional costs as a costing matter, nor could they do so under the definition of attributable costs.

The Commission already is required to set a minimum contribution for Competitive Products as a group, which is the subject of a separate proceeding. *See*

Docket No. RM2017-1. Setting a minimum requirement at a non-zero level that can increase the contribution from Competitive Products if they continue to grow, and at a level that does not distort Competitive Product pricing should be all that is necessary to "allocate" the institutional costs appropriately. Indeed, it would appear difficult for the Commission to do anything else.

IV. IMPROVING THE CURRENT PRICE CAP REGIME TO BETTER ENABLE PRICES TO ACHIEVE THE STATUTORY OBJECTIVES AND FACTORS IS VITAL TO THE CONTINUED SUCCESS OF THE POSTAL SERVICE

Notwithstanding the existence of an exigent surcharge for more than two years, the statutory CPI-U price cap has allowed the Postal Service to operate successfully, provide universal service, and maintain and develop postal service for a decade while simultaneously reducing its costs. Furthermore, the price cap has played an indispensable role in keeping mailers in the postal system by causing Postal Service management to make necessary cost-cutting and mail flow optimization decisions. It has also helped to promote managerial "best practices" by preventing postal management from simply raising prices. Despite the decline in First-Class Presort Mail volume, the price cap has helped to keep hardcopy an option for business mailers.

The Commission, therefore, has sound reason for concluding that the price cap has worked well and that no change is necessary. Within the cap, however, there is room for improvement. The current system has not always achieved all of the Objectives as well as it could, and the Objectives have not always been well applied in conjunction with one another. The perpetuation of inefficient and overpricing of Presort and Automation letters is of paramount concern. This ultimately harms the Postal Service, as postal prices significantly affect business mailers' decisions whether to use the mail to deliver a particular communication, or if so, at what category to prepare and enter what they decide to mail.

In First-Class Mail, these decisions are as micro as the degree of presortation to which to prepare a mailing. And they are as macro as how aggressively to encourage customers to elect electronic delivery of invoices, bills, and other standard business communications. When Presort and Automation Letters continue to pay, by far, the largest unit contributions of any letter mail in the mailstream and inefficiently priced discounts, there is a strong incentive to migrate those communications out of the mailstream.

As for USPS Marketing Mail, the number of available distribution channels is even greater, meaning that many alternatives exist if the Postal Service charges excessive prices for Marketing Mail products. In addition to broadcast and cable media, and in newspapers and magazines, marketing matter can be placed on email, web advertising, and a large and growing variety of social media. The price, to the decimal, and the service quality can determine what channel is used. For the Postal Service to remain viable in the delivery of advertising mail, its prices need to make economic sense for the business mailer.

The Commission should exercise its authority to modify its regulations, and its interpretations of those regulations, to better achieve the Objectives, taking into account the Factors, by improving the efficiency, transparency, and justness of monopoly rates.

A. The Commission Should Require The Postal Service To Use Efficient Component Pricing To Maximize The Incentive To Reduce Cost And Promote Efficiency

ECP is an economic approach to pricing that holds that rate differences should equal cost differences. Professor John Panzar presented a thorough discussion of ECP in Docket No. R2006-1.[72] His testimony defined ECP as "the principle that worksharing discounts should be set equal to the per unit avoided costs of the Postal Service." *Id.*, at 19. ECP induces mailers to perform work "if and only if they can do it more cheaply than the Postal Service." *Id.*

In the Commission's words:

> Efficient Component Pricing rates are those where the difference between the rates of any two worksharing categories will equal the difference in avoidable worksharing cost between the categories assuming 100 percent passthrough of avoidable cost savings. Similarly, the ECP rate between a non-workshare category and a workshare category will equal the difference in costs due to the specific workshare activity to be recognized in the rate.

Opinion and Recommended Decision, Docket No. R2006-1, at 84 (Feb. 26, 2007).[73]

The Commission has long endorsed ECP, stating that the "virtue of ECP or an ECP approach beyond worksharing is that it continues to promote productive efficiency". *Opinion and Recommended Decision*, Docket No. R2006-1, at 87; *see also*

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[72] *Direct Testimony of John C. Panzar on Behalf of Pitney Bowes Inc.* (revised), Docket No. R2006-1 (Oct.31, 2006).

[73] The principles supporting ECP apply to other cost differences for mail within a subclass (using the former terminology). *Id.*, at 44. Professor Panzar noted that the "basic economic argument in support of cost-based rate differentials is the same as that for avoided cost worksharing discounts. Mailers can act to minimize end-to-end costs only if the difference in rates for mail with differing characteristics reflects differences in the costs incurred by the Postal Service." *Id.*, 44-45.

Op. and Rec. Dec., Docket No. R2006-1, 81-90; *ACD FY2008*, at 62; *Opinion and Recommended Decision*, Docket No. MC95-1, IV-116-117 (1996). Congress effectively endorsed ECP principles when it enacted Section 3622(e), which generally prohibits worksharing discounts that exceed 100 percent of the costs avoided.

Although Congress did not specifically prohibit passthroughs of less than 100 percent, it did enact Objective 1 to "maximize incentives to reduce costs and increase efficiency." Setting rate differences at 100 percent of cost differences would fulfill this Objective.

Despite Objective 1 and its endorsement of ECP, the Commission has not required the Postal Service to adhere to ECP principles when setting rates for monopoly products under the PAEA. In particular, as noted above, the Commission has not required the Postal Service to set rate differences equal to the avoided costs for a number of workshare discounts in both First-Class and Standard (now USPS Marketing) Mail, and between Presort and Single-Piece First-Class Mail. Often this has occurred because the Commission allowed the "pricing flexibility" Objective to outweigh the clear direction to "maximize" incentives to increase efficiency, Factor 5 (effect of mailer preparation on reducing Postal Service costs), and Factor 12 (the need for the Postal Service to increase its efficiency and reduce its costs).

The Commission has ample authority to rectify this situation. For example, in its recent Section 701 Report, it noted that establishing a "soft floor" for worksharing discounts could eliminate inefficiencies caused by the Postal Service performing work that mailers may perform at lower cost. *Section 701 Report* at 64 (Nov. 14, 2016). Nothing in the statute prevents the Commission from establishing such a soft floor under its own authority. The Commission could simply make an appropriate amendment to Rule 3010.12(b)(6). Doing so would constitute an improvement over the current regulations, and would better balance pricing flexibility with the need to maximize incentives for efficiency and cost reduction.

B. To Improve Transparency, The Postal Service Should Be Required To Conduct A Cost-Benefit Analysis Before Changing Mailing Requirements Or Shifting Or Imposing Additional Costs On Mailers

Section III(G) above discussed the lack of transparency arising when the Postal Service shifts costs to mailers through changes in mailing preparation, or by introducing costly, and occasionally buggy, software systems. The Commission could address this lack of transparency by requiring the Postal Service to conduct a cost-benefit analysis before changing mailing requirements or shifting (or imposing) additional costs on mailers.

Executive Order 13563, which reaffirmed and supplemented Executive Order 12866, directs regulatory agencies to perform cost-benefit analyses before issuing proposed or final rules.[74] While not subject to this Executive Order, the Postal Service should nonetheless observe the important public policy and regulatory principles it embodies and regard it as a sound model for any change in mailing requirements. Accordingly, the Commission should amend its regulations to require the Postal Service to conduct a cost-benefit analysis when changing mailing regulations, in order to evaluate whether the changed regulation would have the effect of shifting costs onto

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[74] *Executive Order 13563 – Improving Regulation and Regulatory Review* (Jan. 18, 2011), 76 *Fed. Reg*. 3821 (Jan. 21, 2011) (stating agencies must "(1) propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs [recognizing that some benefits and costs are difficult to quantify]; (2) tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations").

mailers, or imposing additional costs, in violation of the price cap rule.[75] Such an analysis could also consider whether the change would affect the lowest combined cost of mailing.

V. WORKSHARE DISCOUNTS SHOULD BE APPLIED SOLELY WITHIN A PRODUCT AND, ABSENT A COMPELLING JUSTIFICATION, SHOULD PASSTHROUGH 100 PERCENT OF THE ESTIMATED COSTS AVOIDED

Workshare discounts for First-Class Presort Mail today are taken from a Metered Mail "benchmark" in the separate and distinct Single-Piece product. Using a Single-Piece benchmark is an historical anachronism dating from the 1970s, when worksharing was first introduced, and when workshared mail was in the same "subclass" as non-workshared mail. The Commission extended this interpretation to Section 3622(e) in Docket No. RM2009-3,[76] despite its previous determination that Presort and Single-Piece Mail are separate products with much different cost and demand characteristics, as well as substantially different preparation requirements (handwritten, stamped envelopes compared to IMb and electronic mailing information).

That is an administrative interpretation not required by the statute. The Commission indisputably has legal authority to change its interpretation.

Indeed, this review provides an ideal occasion in which to recognize that this anachronistic linking does not serve any of the Objectives. It frustrates achieving of Objective 1 (by hindering the Postal Service from pricing Presort Mail to maximize

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[75] Either or both of the two prongs in EO 13563 could be helpful in mitigating cost shifting that could cause the price cap to be exceeded.

[76] Order No. 536, Docket No. 2009-3 (Sept. 14, 2010), *petition for review dismissed sub nom. United States Postal Service v. Postal Regulatory Commission*. The Commission set Metered Mail as the new benchmark in Docket No. RM2010-13. Order No. 1320 (Apr. 20, 2012), *aff'd United States Postal Service v. Postal Regulatory Commission*, 717 F.3d 209 (D.C. Cir. 2013).

efficiency and recognize cost reductions), Objective 2 (by reducing predictability of Presort rates because they ultimately are not based on Presort costs or demand elasticity), Objective 4 (by prohibiting the Postal Service from pricing Presort Mail on the basis of its distinct cost and demand characteristics, but instead artificially linking its rates to Single-Piece rates), Objective 5 (by preventing the Postal Service from pricing Presort Mail in light of its demand elasticity), Objective 6 (basing rates on those of a separate and distinct product is burdensome and hinders transparency), and Objective 8 (the linkage contributes to Presort Mail's paying an unjust cost coverage because it prevents Presort prices from being based on the product's own distinct costs and demand). In contrast, not one Objective is advanced by the current interpretation.

Basing workshare discounts in Presort Mail on a benchmark in a different product having different cost and demand characteristics prevents the Postal Service from pricing its largest and most profitable First-Class Mail Presort Mail product on the basis of its own distinct costs and demands. Instead, the interpretation set forth in Order No. 536 harms the Postal Service and the mailing industry on a daily basis by subsuming all other pricing criteria so that the postage rates paid by large, sophisticated bulk mailers depends, ultimately, on the rate of a one-ounce Single-Piece letter.[77] It is time to abandon the obsolete and harmful policy of "linking" Presort workshare discounts to Single-Piece mail.

A. Discounts Should Be Set Solely With Reference To Within A Product

Applying workshare discounts only within a product would promote sound pricing by allowing Presort rates to be based on the costs and demand of Presort Mail, not

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[77] The current Metered Mail "benchmark" is based on the Single-Piece one-ounce letter rate.

Single-Piece mail. In practice, this would mean that the Postal Service would set Presort Mail rates on the basis of the distinct cost and demand for that product, and Automation discounts would be taken from the Nonautomation Presort Letter rate.

The historical grounds for basing Presort and Automation discounts on Single-Piece rates no longer apply. When worksharing discounts were introduced in Docket No. R77-1, they were discussed solely in terms of aligning costs, and the Rate Commission expressly did not consider intrinsic cost and demand factors. Over the years, of course, Presort Mail grew substantially, eventually maturing into the largest product and contributor to institutional costs in the system.

The Commission recognized the distinct cost and demand characteristics of Presort and Single-Piece Mail when it approved the Postal Service's classification of the Presort mail product (then named "Bulk"). Order No. 43, Docket No. RM2007-1, at 103 (Aug. 15, 2007).[78] Whatever merit this practice may have had in years past, it no longer serves any useful purpose. On the contrary, it continues to prevent the Postal Service from taking the distinct cost and demand characteristics of Presort Mail into account in its pricing decisions – the very opposite of pricing flexibility.

There can be no dispute that Presort Mail and Single-Piece Mail have distinct cost and demand characteristics. The Postal Service recently compared the unit costs of Presort and Single-Piece Mail in FY2008 to those in FY2016:

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[78] The Commission did so over an objection that recognizing bulk letters as a separate product could cause Presort rates to differ from Single-Piece rates by more than the costs avoided by worksharing – in other words, it necessarily contemplated that the Postal Service would price the Product according to its distinct costs and demand, instead of being treated as a dependency of Single-Piece.

	FY2008 Cost Per Piece	FY2016 Cost Per Piece
Single-Piece Letters	$0.252	$0.281
Single-Piece Cards	$0.242	$0.292
Total SP Letters & Cards	$0.251	$0.282
Presort Letters	$0.112	$0.117
Presort Cards	$0.079	$0.079
Total Presort Letters & Cards	$0.110	$0.115

Reply Comments of the United States Postal Service, Docket No. ACR2016, at 4 (Feb. 13, 2017). Presort Mail has substantially lower unit attributable costs than Single-Piece. This cost difference is more than the costs avoided due to worksharing. Not only is the absolute magnitude of the costs strikingly different, but so is the rate of change. As the Postal Service observed, Presort Mail unit costs grew by only 4.5 percent between FY 2008 and FY 2016, while the unit costs for Single-Piece Mail grew by 12.4 percent over the same period. *Id*.

The two products likewise have very different demand characteristics. This is shown by the Postal Service's demand equations. *See Market Dominant Demand Analyses, FY 2016*, *Volume Forecasting Methodology of the United States Postal Service* (Jan. 23, 2017). The Service's most recent calculation of the own-price elasticity of Single-Piece Letters is -0.100. *Id*., at 9. For Presort, the own-price elasticity is -0.306. *Id*. at 39. That these calculated elasticities differ is unsurprising, because mailers of the two products have different motivations and purposes. These differences are also reflected in the fact that the demand equations for Single-Piece and Presort

Mail use different approaches and different factors.[79] For example, the Postal Service has found it necessary to take into account electronic bill presentment in its forecasting model for Presort Mail.[80]

Setting workshare discounts on the basis of a benchmark sharing the same cost and demand characteristics promotes efficiency and comports with other statutory provisions, including Section 3642 (governing the classification of products). In particular, by allowing the Postal Service the flexibility to set the price of Presort Mail on the basis of the distinct inherent cost and demand of that product – rather than derivatively from the different cost and demand of Single-Piece Letters – the Commission would improve the ability to achieve Objectives 1, 4, 5, and 8.

B. Workshare Discounts Should Pass Through 100 Percent Of The Costs Avoided, Absent A Compelling Justification

The Commission should modify its current regulations to add a provision that the Postal Service should passthrough 100 percent of the costs avoided due to worksharing, unless a sound justification exists for not doing so. The Commission has long interpreted Section 3622(e) as constituting a ceiling on workshare discount passthroughs, but not a floor. However, there is no statutory obstacle to setting a floor by regulation.

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79 For Single-Piece, the explanatory variables are Employment, Postal Prices, a linear time trend, a nonlinear intervention variable starting in 2008Q4, a variable for Postage in the Hands of the Public, and three other dummy variables and seasonal variables. For Presort Mail, the Postal Service first estimates a single “trunk equation” from which it estimates separate individual equations by shape. Elasticities associated with employment and postage prices from the trunk equation are used as stochastic restriction in the individual demand equations. The explanatory variables in the Presort equation are: Employment, Postal Prices, Time Trends (staring in 1992Q1, 2002O3, 2010Q4, and 2014Q1, a non-linear intervention variable starting in 2008Q1, a dummy variable, and seasonal variables.

80 *Market Dominant Demand Analyses, FY 2016,* at 5.

Establishing a presumption that worksharing passthroughs should be set at or near 100 percent of avoided costs would advance several Objectives. First, it would promote Objective 1, because setting accurate cost signals would maximize the incentives to reduce costs and increase efficiency. As the Commission said only last year:

> Although passthroughs below 100 percent are lawful, they send inefficient pricing signals to mailers. Passthroughs set as close as possible to 100 percent would promote efficiency, lower the total combined costs for mailers, and encourage the retention and growth of the Postal Service's most profitable products.

ACD FY2015, at 10; *see also ACD FY2009,* at 73. Similarly, it takes account of Factor 5, which instructs the Commission to take into account the degree of mail preparation. It also advances Objective 8, because it is not just for the Postal Service to squeeze out more efficient competitors by selling sorting services below the price of performing them.

Second, setting passthroughs at 100 percent would effectuate Efficient Component Pricing, which the Commission has long endorsed. ECP is discussed at greater length in Section IV(A), *supra*.

The Commission's recent Section 701 Report noted that establishing a "soft floor" for worksharing discounts may eliminate inefficiencies caused by the Postal Service performing work that mailers may perform at lower cost." *Section 701 Report,* at 10. Although that Report suggested that Congress enact such a floor, nothing in the statute prevents the Commission from doing so using its own authority. Doing so would balance pricing flexibility with the need to maximize incentives for cost reduction, and provide a constraint that would lead to more stable and predictable rates. Finally, any negative effect on the Postal Service's pricing flexibility attributable to setting a floor on worksharing passthroughs would be outweighed by the increased pricing flexibility it would receive by removing the link to Single-Piece rates and by the gains in efficiency that would accrue from more accurate pricing signals.

Accordingly, the Commission should modify section 3010.2(b)(6) of its regulations to require the Postal Service to passthrough 100 percent of costs avoided in worksharing discounts, or provide a compelling justification for any proposed workshare discount set at less than 100 percent of avoided costs.

VI. THE COMMISSION SHOULD INTERPRET THE EXIGENCY PROVISION CONSISTENT WITH ITS PURPOSE

Congress intended the exigency provision to apply to extraordinary or exceptional circumstances such as terrorism or natural disasters. It was never intended to guarantee the Postal Service a certain level of revenue during economic downturns, especially when postal customers do not have pricing power due to the same circumstances. *See Letter from Sen. Susan Collins to Shoshana Grove, Re: Docket No. R2013-11* (October 18, 2013) (stating that the exigency provision was intended to apply only If "terrorist attacks, natural disasters, and other events . . . cause significant and substantial declines in mail volume or increase in operating costs that the Postal Service cannot reasonably be expected to adjust to in the normal course of business." The exigency provision "does not authorize rate increases to recover losses caused by electronic diversion of communications from mail to the Internet"); *see also* S. REP. NO. 108-318, at 11-12 (reporting on earlier version of legislation, stating that the September 11, 2001, and anthrax attacks "highlight the need to address unexpected and extraordinary circumstances and their effect on the Postal Service and its financial requirements").

As noted above, the Postal Service states, in its Form 10-Q filings, that, in the event of a cash shortfall, the U.S. government would likely prevent the Postal Service from significantly curtailing or ceasing operations. In applying the exigency provision in the future, the Commission should recognize that even the Postal Service itself has the unique expectation that the federal government would provide an ultimate backstop.

VII. THE COMMISSION SHOULD REVISE ITS RULES FOR NEGOTIATED SERVICE AGREEMENTS TO MAKE VOLUME RETENTION AND EXPANSION AGREEMENTS LESS DIFFICULT TO APPROVE

Although the Commission's rules state a policy objective "to allow implementation of negotiated service agreements that satisfy the statutory requirements of 39 U.S.C. 3622(c)(10),"[81] very few NSAs have been approved for domestic market-dominant products. This has underplayed the potential of the category, given the volume of market-dominant domestic mail. While there may be numerous reasons for this, one issue that has presented problems is determining what price elasticity should be used. Much time has been devoted fruitlessly in attempts to quantify "anyhow" volumes as the Commission strives to ascertain whether a particular proposal offers a "net financial benefit" to the Service.

The Commission's rules currently require the Postal Service to submit estimated "mailer-specific costs, volumes, and revenues" with and without the NSA. 39 C.F.R. §3010.42(f)(1) & (2). Company-specific price elasticities would facilitate this calculation,

[81] 39 C.F.R. §3010.40(a).

but the Postal Service is as yet unable to measure elasticities to that degree of precision.

One action the Commission could take, however, would be to accept more willingly evidence of the effect of an NSA on a business from suitably qualified testimony from corporate executives. The current approach amounts to a Catch-22; the Commission deems it essential that evidence of the impact of the agreement be on the record before taking it into account, but such evidence cannot be produced without first approving the NSA and having it take effect. For example, in Docket No. MC2015-3, which considered an NSA for Discover Financial Services, the record contained specific testimony from a Discover executive detailing the effects of a grant or a denial of that NSA. The Commission gave no credence to that testimony, yet events have proven it to be accurate. Objectively better results would likely occur if the Commission were to place greater reliance on similar testimony in the future.[82]

VIII. CONCLUSION

For the foregoing reasons, the Major Mailers Association, the National Association of Presort Mailers, and the National Postal Policy Council respectfully submit that the current price cap system has achieved the goals of the PAEA

[82] One possibility would be to approve an NSA conditionally with a “hard” look-back in the Annual Compliance Review after a full year of operation.

remarkably well and, with the improvements suggested herein, should continue to serve the public, the Postal Service, and mailers well in the years to come.

Respectfully submitted,

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