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

ANNUAL COMPLIANCE REPORT, 2015	Docket No. ACR2015

COMMENTS OF
THE NATIONAL POSTAL POLICY COUNCIL
(February 2, 2016)

The National Postal Policy Council ("NPPC") respectfully submits these comments on the Postal Service's Annual Compliance Report for Fiscal Year 2015 ("*ACR*"), filed December 29, 2015. NPPC will address the following issues of interest to First-Class business mailer members:

- The Postal Service's pragmatic approach to pricing is the appropriate response to workshare discounts that exceed 100 percent due to reductions in the estimated costs avoided;
- The 69.4 percent pass-through at the Automation 5-Digit level sends inefficient signals that promote uneconomic mailer behavior, and means that the Postal Service does not charge a compensatory price for sorting to the 3-Digit/AADC level;
- The continued excessive cost coverage for First-Class Mail indicates a problem with the current system of using "top-down" pricing for First-Class Automation and Presort Letters and Cards; and
- The Commission should consider applying an incremental cost test in market-dominant mail in the future.

I. THE COMMISSION SHOULD CONTINUE TO ASSESS COMPLIANCE WITH SECTION 3622(e) OVER TIME

The Postal Service, the Commission, and mailers understand that estimates of costs avoided for the same worksharing activity vary from year to year. They also know that a mismatch inherently exists between (1) the costs avoided upon which a discount is set in a notice of rate adjustment (usually the prior fiscal year), and (2) the costs avoided during the time the discount is in effect. Those latter costs are not known until after the year is over and the discount subsequently is evaluated in the annual compliance review. FY2015 was no different. The Postal Service's longstanding pragmatic approach to adjusting worksharing discounts is an appropriate response to this timing problem.

In its FY2015 *Report*, the Postal Service identifies two First-Class Presort Letter, three Presort Cards, and one Automation Flats worksharing discounts in effect in FY15 that exceeded the costs that it recently estimated were avoided during that year. *ACR* at 11-13. Of those, only four -- the discounts for Automation Mixed AADC Letters, Mixed AADC Automation Cards, Automation AADC Cards, and 5-Digit Automation Flats -- exceeded the cost savings compared to index rates.

In the case of Automation Mixed AADC Letters, the pass-through exceeds 100 percent solely due to an unexplained decline in the avoided costs. The Postal Service set the discount at 4.6 cents in Docket No. R2015-4, matching the cost avoidance determined in the FY14 annual compliance review. However, in FY15 the costs avoided fell to 3.3 cents, resulting in a pass-through of 139.4 percent. *ACR* at 10. The Postal Service cannot be faulted for using the most current information available when setting the discount, and states that it will take prudent steps to adjust the discount going forward. The Commission should approve that plan.

A similar phenomenon occurred with Mixed AADC Automation Cards and with Automation AADC Cards. In both cases, the current discount was set in Docket No.

R2015-4 to match the cost avoidance calculated in FY14. See *ACR* at 11-12. In both cases, the Postal Service has now estimated that the cost avoidance declined by 0.1 cent in FY15. The Postal Service's plan to address these in the next price change should be approved.

Finally, in Docket No. R2015-4 the Commission approved a pass-through of more than 100 percent for the 5-Digit Automation Flats discount, accepting the rate shock justification. 39 U.S.C. §3622(e)(2)(B). The principal factor in this decision was the substantial volatility from year to year in the estimates of avoided costs. Using the FY14 figures upon which the Docket No. R2015-4 discount was based, the approved pass-through was 126.3 percent. Based on FY15 cost figures, the actual pass-through was 120.8 percent. *ACR* at 13. Given the Commission's approval of a larger pass-through than now appears to have been the case, the Commission should again accept the rate shock justification. Doing so is particularly important given the importance of the 5-Digit Automation Flats discount in the Presort discount tree.

Avoided costs change from year to year. For that reason, the Postal Service reasonably takes the position that "section 3622(e) applies over the long term, as a principle guiding pricing over a series of price adjustments." *ACR* at 7. And it merits pointing out that there is no evidence the current discounts exceed the cost avoided in the current (2016) Fiscal Year. Those avoided costs will not be known until late December 2016. For these reasons, the Commission should continue to recognize the Postal Service's need to engage in sound business practices when making determinations about discount levels.

II. THE FAILURE TO PASSTHROUGH 100 PERCENT OF THE COSTS AVOIDED AT THE AUTOMATION 5-DIGIT LETTER RATE MEANS THAT THE POSTAL SERVICE IS SENDING UNECONOMIC SIGNALS AND UNDERCHARGING FOR SORTATION TO THE 3-DIGIT/AADC LEVEL

First-Class Automation 5-Digit Letters save the Postal Service 3.633 cents compared to 3-Digit Letters. USPS-FY15-10 FCM Letter.xls (Tab Summary). Mailers of Automation 5-Digit Letters in FY15 received a discount of 2.5 cents off of the 3-Digit Letter rate, a pass-through of 69.4 percent.

There are several problems with this miserly pass-through. In economic terms, the failure to set the discount between the 5-Digit and the 3-Digit tiers at 100 percent of the costs avoided violates the principle of Efficient Component Pricing, which the Commission has long recognized best promotes efficiency. By not providing mailers with the correct economic pricing signal, the small pass-through provides an incentive for mailers to purchase more costly, less efficient processing by the Postal Service. This violates the Congressional objective of maximizing incentives to reduce costs and increase efficiency. 39 U.S.C. §3622(b)(2).

It also is a form of exclusionary pricing. When the Postal Service passes through substantially less than 100 percent of the calculated costs avoided, it underprices its own mail processing services (in this instance, the processing of mail from the 3-digit/AADC level to the 5-digit level). This is evident when viewed from the perspective of a mailer deciding whether to prepare a large mailing to the 3-digit or the 5-digit level.

The conventional way of looking at the matter is to say that in FY2015, the Postal Service offered a discount of 2.5 cents per piece for mailers to do work that costs the Service 3.633 cents to do. That has been viewed as a "cautious" approach, sharing only part of the cost savings with the mailers.

But from the mailer's perspective, the Postal Service offered to charge only 2.5 cents to do mail processing services, because the discount for 5-Digit Letters is 2.5 cents less than the rate for 3-Digit (or AADC) Letters. If it costs the mailer less than 2.5 cents per piece to take the additional step of preparing the mailing to the 5-digit level, it would save money by doing so and accepting the discount. If it cost the mailer 4 cents per piece to do so, the rational and efficient action would be to enter the mail at the 3-Digit rate, from which the Postal Service would sort the mail to the 5-digit level more efficiently.

But if the mailer's cost to prepare to the 5-digit level were 3 cents per piece, its rational decision would be to forego the additional step and enter the mail at the 3-Digit level, thereby saving 0.5 cents per piece because the mailer would pay only 2.5 cents to have to Postal Service sort to the 5-digit level. But although the Postal Service would be paid 2.5 cents per piece, its cost would be 3.633 cents per piece to process that mailing to the 5-digit level. Thus, in FY15 the Postal Service underpriced its service of sorting from the 3- to the 5-digit level by 1.133 cents per piece.

For the Postal Service to price below cost is generally poor economics. It can also be viewed as a form of exclusionary pricing taking work from more efficient private mail preparation firms that eke out their business from the margins between their costs and the discounts. The Postal Service should avoid this risk in the future by pricing all discounts at Efficient Component Pricing levels.

III. THE PERSISTENTLY HIGH COST COVERAGE OF FIRST-CLASS BULK LETTERS AND CARDS HIGHLIGHTS A FLAW IN THE CURRENT SYSTEM OF MARKET-DOMINANT RATE REGULATION

The *ACR* reports that the cost coverage paid by First-Class Presort Letters and Cards in FY2015 was 318.90 percent. This was, by a substantial margin, the highest of any market-dominant mail product.[1] For Presort Letters -- the most important product in the entire postal system – the cost coverage was 318.55 percent; for Cards, 328.44 percent. Both are nearly double the market-dominant system average of 183.41 percent.

As the Commission knows, the extraordinarily high cost coverage for First-Class Presort mail is not a one-year aberration. Instead, the cost coverage for this mail has remained persistently high for many years, harming business mailers and giving them reason to migrate away from the postal system to the long-term financial detriment of the Postal Service. Each annual compliance review proceeding under the PAEA has shown that First-Class Presort Mail has paid substantially above-average cost coverages and the highest per-piece contributions to institutional costs. This pattern is evident from the following table:

---

1 *ACR* at 8; USPS-FY15-2 Public-FY15CRA.xls (Tab Coversheet).

First-Class Presort Letters and Cards

	Attributable Cost (cents)	Average Price (cents)	Unit Contribution (cents)	Cost Coverage (%)	System Cost Coverage (%)
FY2008[2]	11.023	33.023	22.000	299.6	164.0
FY2009[3]	11.704	34.152	22.448	291.8	164.5
FY2010[4]	11.679	34.739	23.060	297.4	161.1
FY2011[5]	11.65	34.982	23.332	300.3	159.1
FY2012[6]	12.15	35.64	23.49	293.3	160.8
FY2013[7]	11.67	36.30	24.63	311.1	165.7
FY2014	11.8	37.848	26.04	320.6	184.31[8]
FY2015	12.1	38.7	26.6	318.9	183.41[9]

The trivial decline in cost coverage in FY15 notwithstanding (note there also was a non-trivial increase in unit contribution), the problem has worsened over time. FY2015

---

2 PRC, *Annual Compliance Determination, Fiscal Year 2008,* at Table III-2 (Mar. 30, 2009) (“*FY08 ACD*”).

3 PRC, *Annual Compliance Determination, Fiscal Year 2009,* at Tables IV-5 & B-1 (Mar. 29, 2010).

4 PRC *Annual Compliance Determination, Fiscal Year 2010,* at 84 Table VII-1 (Mar. 29, 2011, as corrected Apr. 8, 2011).

5 PRC, *Annual Compliance Determination, Fiscal Year 2011,* at 96 Table VII-1 (Mar. 28, 2012).

6 PRC, *Annual Compliance Determination Fiscal Year 2012*, at Tables VII-1 & D-1 (Mar. 28, 2013).

7 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. 20, 2014).

8 PRC, *Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2014*, at 77 (April 1, 2015).

9 USPS-LR15-1 (Public FY15CRS.xls) (Market-dominant products only).

marked the third consecutive year, and fourth in the last five, in which the cost coverage of First-Class Presort Letters and Cards exceeded 300 percent – that is, revenues more than tripled the costs of this efficiently-prepared mail.

The cause of the persistently high cost coverage is a pricing convention adopted more than 40 years ago when presortation discounts were first introduced into postal ratesetting. *See Opinion and Recommended Decision*, Docket No. R77-1 at 245-248 (May 12, 1978). That is the practice of “top-down” pricing of discounts. With top-down discounts, the starting point is a less or non-workshared (and thus higher cost) higher-priced rate category, with discounts for each step “down” the tier to a more refined presort level. For example, currently the benchmark rate is the Metered Mail category in Single-Piece, and the Presort and Automation discounts are taken “down” from that higher-priced rate.

A consequence of this top-down approach is that the most finely prepared mail receives no recognition in pricing for its many cost-saving characteristics that do not fit within the narrow definition of Section 3622(e). Presorted Mail has many low-cost characteristics – *e.g.*, “cleanliness,” local entry, traying and facing, accurate addressing, entry near the destination, lower cost sales channel – and these cost differentials are largely ignored by the calculations that underlie the discounts and are presented Library Reference USPS-FY15-3. However, those low-cost characteristics are captured in the CRA reports, which are prepared in a “bottom up” manner. As a result, First-Class Automation and Presort mail has significantly lower attributable costs than other mail even before taking worksharing into account.

This is shown yet again in the FY15 CRA. It reports a unit attributable cost for Presort Letters of 12.4 cents, 14.5 cents less than the average cost of 26.9 cents for Single-Piece letters. Public-FY15CRA.xls (Tab Cost 1). The 14.5 cent cost difference can be explained only partly by the worksharing costs avoided reported in USPS-FY15-3 (Worksharing Discount Tables). The remainder of the cost differential arises from the low-cost characteristics of Presort Mail that are not included in the worksharing discount calculations. This is the reason that Presort Mail has suffered from substantially above-average cost coverages for many years, because the distinctive low-cost characteristics of Presort Mail are real and permanent.

A better way to set Presort rates would be to set them from the "bottom up," starting with the lowest cost piece (in the case of Automation Letters, the 5-digit rate) and *adding* (instead of subtracting), the "discounts" up the tiers. This would enable each rate to be based on the unit costs of mail in that tier, with the difference between it and the next less finely presorted tier based on the costs avoided. That would more closely approximate the use of marginal costs for Presort Mail

Although this is not the proceeding to correct the Postal Service's anachronistic approach to setting rates, it is an appropriate occasion to identify the problem. Solving this problem will be a matter to consider in the upcoming review of the market-dominant ratesetting system currently required to begin in December 2016.

IV. THE COMMISSION SHOULD APPLY AN INCREMENTAL COST TEST TO MARKET-DOMINANT PRODUCTS

In its comments in Docket No. RM2016-2, NPPC explained that applying an incremental cost test in appropriate circumstances could potentially help identify problems in the pricing of market-dominant products.[10] In particular, an incremental cost test could determine whether any market-dominant products with cost coverages greater than 100 percent are, in fact, covering their costs. The Postal Service currently has no obligation to report the incremental costs of market-dominant products in its annual compliance filings, and does not in practice do so. The Commission should consider amending its regulations to require the Postal Service to do so in the future.

V. CONCLUSION

For the foregoing reasons, the National Postal Policy Council respectfully urges the Commission to consider these comments when making its determination pursuant

---

[10] *Comments of the National Postal Policy Council*, Docket No. RM2016-2 (January 25, 2016).

to 39 U.S.C. §3653, and also to take these comments into account in connection with its upcoming review of the ratemaking system required by 39 U.S.C. §3622(d)(3).

Respectfully submitted,

NATIONAL POSTAL POLICY COUNCIL

By: /s/ William B. Baker

William B. Baker
POTOMAC LAW GROUP, PLLC
1300 Pennsylvania Avenue, N.W.
Suite 700
Washington, DC 20004
(571) 317-1922

Arthur B. Sackler
Executive Director
NATIONAL POSTAL POLICY COUNCIL
1150 Connecticut Avenue, N.W.
Suite 900
Washington DC 20036
(202) 955-0097