Postal Rate Commission
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UNITED STATES OF AMERICA
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners: George Omas, Chairman;
Dawn A. Tisdale, Vice Chairman;
Ruth Y. Goldway; and
Tony Hammond

Postal Rate and Fee Changes Docket No. R2006-1

NOTICE OF INQUIRY NO. 2

(Issued July 21, 2006)

The purpose of this Notice of Inquiry is to solicit comments on the method that should be used to design rates for the Standard mail subclasses. Comments are requested within 14 days of the issuance of this Notice. Additional responses in the form of testimony may be appropriate as well.

Introduction. Historically, a basic premise underlying rate design has been that mail within a subclass shares basic cost and demand characteristics (even though subclasses generally include various shapes of mail). Therefore, a cost coverage is appropriately evaluated and applied to the subclass as a whole. Under the traditional approach, each rate within a subclass is evaluated in relation to all other rates within the subclass to assure that they are fair and equitable.

The Postal Service's rate proposals in this docket draw attention to two aspects of this evaluation process. The first relates to worksharing. It is well established that cost-saving characteristics that are the result of worksharing should be specifically reflected in rates. The Commission has adhered to the principle that within a subclass, worksharing rate differences should fully reflect the costs that the Postal Service would avoid (or incur) if the mailer were to move from one workshared category of mail to another.

Rates that fully reflect avoidable costs (rates that pass 100 percent of the differences in avoidable cost through to the mailer) satisfy the cost recovery and fairness policies of the Postal Reorganization Act. Occasionally, subordinate statutory policies have justified worksharing rate differences that fail to pass through 100 percent of avoidable costs. In such circumstances, the Commission has explained variations from 100 percent passthroughs with reference to the non-cost rate setting criteria of section 3622(b).

The second aspect of rate design highlighted by the Postal Service's proposed rates involves cost-causing characteristics that do not result from worksharing, such as weight and shape. Here, too, there is a presumption that rates within a subclass should fully reflect cost differences that are caused by such differences. This process is less exact, as it is often difficult to separate the cost effects of shape from weight. However, to the extent feasible, cost-causing characteristics are evaluated and rate distinctions are implemented to recognize those characteristics. Here, too, policies such as rate simplification, the need for rational rate relationships, and avoidance of rate shock have often caused the Commission to recommend rates that did not perfectly reflect cost differences.

The Commission believes it is important that its application of the various statutory ratemaking criteria be done in a transparent manner. Previous rate decisions have attempted to explain how specific rate levels have been determined. In Standard mail, the organizing tool that the Commission has used to evaluate proposed rates within a subclass is a "presort tree." This device starts with a single benchmark rate that allows each rate to be compared with all other rates in the subclass in terms of the percent of avoided costs (the passthrough) that the rate reflects.[1]

In this docket, the Postal Service proposes to depart from the established method of designing Standard mail rates by proposing a multitude of free-standing rate

[1] The term "avoided cost" is used generically here and includes the Postal Service costs that are avoided as the mailer selects among different shapes within the subclass, as well as Postal Service costs avoided as a result of worksharing.

categories, each with its own benchmark rate. It notes that pieces of different shapes are processed in separate paths by different machines, and, consequently, have different make-up requirements. It suggests that because mail of one shape can not be processed in a flow dedicated to another shape, it may not be correct to treat differences costs between those distinct flows as "avoidable" costs.

Nonetheless, in order to evaluate whether rates relationships within a subclass are fair, and whether rates send economically efficient price signals to mailers, it is necessary to be able to compare the avoided costs associated with each rate category to all other rate categories within the subclass. Without this information, it is difficult to evaluate whether rates within a subclass are fair or efficient.

Participants are requested to discuss the advantages and disadvantages of departing from the established approach, as the Postal Service proposes. For ease of presentation, the discussion below only refers to Standard Regular piece rates, but is relevant to Standard mail as a whole.

Background. Prior to Docket No. R90-1, rate design for Standard mail was based on an algebraic formula that used avoidable costs for presorting and barcoding to develop rate differences. This process was modified in Docket No. R90-1 to accommodate the introduction of shape-related rate differentials, additional barcode discounts, a discount for saturation mail, and dropship discounts. An essential feature of the Docket No. R90-1 approach to rate design was a device referred to as a "presort tree." This device helped the rate designer detect and correct rate anomalies[2] and allowed those evaluating rates to explicitly and systematically consider all shape-related, presort, and automation cost differences in reconciling rates with the policy and pricing factors of the Act. In so doing, the rate designer selected passthrough

[2] The introduction of separate rates for letters and flats created two sets of discounts by which the rate for a nonautomated 3/5-digit letter could be calculated. One set consisted of the letter-flat discount at the basic level plus the presort discount for a 3/5-digit letter. The other set consisted of the presort discount for a 3/5-digit flat plus the letter-flat differential at the 3/5-digit presort level. The sum of the discounts in each set had to be equal, otherwise subtracting each set of discounts from the benchmark rate would have produced a different rate for a nonautomated 3/5-digit letter, i.e., a rate anomaly.

percentages to apply to the avoided cost differences to develop rate differentials. Each passthrough selection was evaluated for consistency with the rate setting criteria of the Act. The fact that the R90-1 approach used a single benchmark was consistent with recommended rates in previous rate cases, which also relied on a single benchmark.

Prior to R90-1, the benchmark was the Basic nonauto presort rate. This was the least workshared mail and, accordingly, the most costly. From R90-1 through R2005-1, the benchmark was the Basic Nonauto Nonletter rate with no dropshipping. Similarly, in those dockets, this was the most costly type of mail in Standard Regular.

In the instant docket, the Postal Service uses the following eight benchmarks: (1) MAADC Automated letter; (2) MAADC Machinable letter; (3) MADC Nonmachinable letter; (4) MAADC Automated flat; (5) MADC Nonautomated flat; (6) MADC nonmachinable flat (Hybrid flat/parcel); (7) MADC Nonmachinable parcel, and (8) Machinable parcel. The Postal Service has provided evidence supporting the presort discounts for each benchmark, but not for the rate differentials between benchmarks. In Presiding Officer's Request No. 5, Question 3.b., the Postal Service was asked to provide a rationale for each discount in terms of a single benchmark. In response, the Postal Service provided a presort tree with calculated passthroughs, but no rationale justifying specific passthroughs.

Discussion. If rates were designed to fully reflect differences in avoided cost (i.e., 100 percent passthroughs), the organization of a presort tree would not matter, because the difference in rates between any two categories would equal the difference in avoidable cost between the two categories. Any presort tree scheme would produce the same discounts and rates. Such rates would be fair and non-discriminatory because rate differences would reflect only cost differences. They would be consistent with the principle of Efficient Component Pricing (ECP) because they would fully reflect the costs that the Postal Service avoids or incurs as the customer shifts mail from one workshare category to another. This would promote productive efficiency. Rates would provide incentives for the low cost producer to provide presorting, barcoding, and dropshipping, which would minimize the cost of the mailing to society.

When passthroughs deviate from 100 percent, rate differences do not fully reflect cost differences. Without some analytical framework by which the relationship of rate differences and cost differences can be evaluated, there can be no assurance that rates within a subclass are cost-based or that any departures are consistent with the other policies of the Act. A presort tree provides the analytical framework for evaluating current rates.

In its response to Presiding Officer's Information Request No. 5, Question 3.a., the Postal Service argued that the value of a presort tree that links parcels to flats is questionable because they are subject to different mail preparation requirements. Another view is that if a presort tree reflects shape differences, it enables rates to reflect the fact that letters, flats, and parcels are handled in different processing streams, and that different processing streams give rise to most shape-related costs. That letters, flats, and parcels are processed on different equipment, but are transported on the same vehicles and delivered by one carrier to one route lends support to this argument.

The presort tree underlying current rates contains three branches, one for letters, one for flats, and one for residual shape pieces.[3] Organizing rates in this manner clarifies that rates do not fully reflect cost differences where the passthrough of shape-related cost differences is less than 100 percent. In the instant docket, as noted, the Postal Service uses eight benchmarks. One effect of organizing rates in this manner is that it obscures the degree to which shape-related cost differences might be reflected in rates. The relationship of one shape of mail to another is an issue that the Postal Service's presentation does not address.

Under the established subclass concept, as passthroughs deviate from 100 percent, price discrimination results because rate differences do not equal avoided cost differences.[4] The more rate differentials deviate from 100 percent passthroughs, the

[3] Under current rates, there is one residual shape surcharge applicable to each presort level.

[4] A generic definition of price discrimination in the economic literature is P_1-$MC_1 \neq P_2$-MC_2. *See* Stigler, George J., *The Theory of Price*, 3rd ed. (1966), at 209, fn. 10. This inequality can be restated as P_2-$P_1 \neq MC_2$-MC_1. This equates to 100 percent passthrough of the cost differential.

greater the degree of price discrimination. The proponent of rates that depart significantly from 100 percent passthroughs has the burden of showing that the resulting discrimination is justified. It in order to justify price discrimination, one must first determine its nature and degree. The organizing technique of the presort tree has been a valuable tool for doing that. Care must be taken in constructing a presort tree, however. Apparent passthrough percentages will vary, implying different degrees of price discrimination, depending on the benchmark selected and the resulting alignment of rate categories.

In its response to Presiding Officer's Information Request No. 5, Question 3.a., the Postal Service stated that a presort tree works reasonably well, among other things, when the benchmark represents substantial volume within the subclass. The established practice, however, is to select benchmarks that are suitable for capturing relevant cost differences, and that non-cost characteristics of the mail, such as volume level, are irrelevant. The algebra applied in the established method for designing rates is such that if one holds constant (1) the structure of the presort tree; (2) the avoided costs; and (3) the passthrough percentages, and varies only the benchmark, the same set of rates will be produced regardless of the rate category that is chosen to serve as the benchmark.[5]

This point can be illustrated by considering three alternative approaches. If the most-costly rate category were selected as the benchmark, the avoided costs would be used to develop discounts for all rate categories, and the algebraic rate design formula would produce a set of rates that reflect deeper discounts for mailers whose mail avoids more costs than the most-costly category. If the least-costly rate category were selected as the benchmark, the avoidable costs would be used to develop surcharges. The same amounts that represent discounts in the first case now would represent surcharges. The rate design formula would produce a set of rates using the least-cost category as the benchmark rate. All other rates would consist of progressively larger

[5] All other inputs to the formula would also have to remain unchanged, e.g., the breakpoint and test year volumes.

surcharges in proportion to the additional cost incurred by the Postal Service as less worksharing is performed. If a benchmark somewhere between the least-costly and most-costly rate categories were selected, some avoided costs would be used to develop discounts and others would be used to develop surcharges. The rate design formula would produce a set of rates consisting of both discounts and surcharges. In all three scenarios, the same set of rates would be produced.

Participants are invited to comment on the preceding observations. In their comments, they may wish to address one or more of these specific issues.

1. Does the principle of Efficient Component Pricing (ECP) require that the difference between any two rates within a subclass equal the difference in avoidable cost between the two rate categories? Consider that Baumol and Sidak define the efficient component price as the input's direct per-unit incremental cost plus the opportunity cost to the input supplier of the sale of a unit of output.[6]
    a. How does ECP apply to worksharing?
    b. How does ECP apply to shape?
    c. How does ECP apply to other cost causing characteristics?
2. Is some organizing technique, such as a presort tree, needed to provide a systematic way of analyzing each rate differential within a subclass in terms of the rate-setting criteria of the Act?
    a. Is it needed to avoid rate anomalies?
    b. What should the preferred organizing technique be?
    c. What criteria should be used to evaluate the merits of one presort tree versus another? For example,
        i) Are one or many benchmarks preferable?

[6] This definition embodies a bottom-up approach, but it appears to suggest that the topdown equivalent approach would entail a 100 percent passthrough of avoided costs for all cost-causing characteristics. *See* William J. Baumol and J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, Yale Journal of Regulation, Volume II, Number 1, Winter 1994, pp. 171-202.

ii) Should benchmarks be chosen on the basis of mailpiece characteristics that cannot be readily converted to alternative characteristics (like parcels converting to flats)?

iii) Should there be a unique benchmark for letters? For flats? For parcels?

iv) Should a benchmark category be selected based on how typical that category is of the subclass?

v) Should a benchmark category be the least-cost, most-cost, or median-cost category in the subclass?

By the Commission

(S E A L)

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