

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. 3

(Issued July 26, 2006)

Participants are requested to consider the Postal Service's approaches to developing First-Class Mail and Standard Mail rates in this omnibus rate case. The approaches exhibit significant differences from the accepted rate design practices established in previous omnibus rate cases. This Notice of Inquiry concerns issues specific to the First-Class Letters and Sealed Parcels subclass. Notice of Inquiry No. 2 issued July 21, 2006, concerns issues specific to Standard Mail.

These inquiries are intended to initiate discussion with a goal of developing a record that thoroughly examines rate design practices in these classes of mail. The Commission encourages participants to develop and submit testimony responsive to the issues presented in either or both of these Notices of Inquiry. Testimony on the theoretical and practical issues associated with designing rates for these classes should thoroughly develop the record and facilitate consideration of alternatives. Additionally, submissions responding to the Commission's specific questions, discussing the legal or policy ramifications of the Postal Service proposals, or identifying attendant issues not highlighted in the Notices of Inquiry will help assure that a balanced record is available to inform the Commission's consideration.

Comments addressing Notice of Inquiry No. 2 were to be filed by August 4, 2006. Comments on that Notice of Inquiry and this one may be combined, and submitted on or

before August 10, 2006. Participants are encouraged also to include testimony on these issues in their direct cases. The Postal Service may provide additional testimony on rate design as supplemental direct testimony or in response to the presentations of other participants.

*Introduction.* The Postal Service's Request includes a proposal to "de-link" the design of single-piece mail and workshared mail within the First-Class Letters subclass. Under accepted rate design practice, a revenue target is set for the subclass and then the design of rates within the subclass is directly related to the avoidable cost differences between mail in each rate category. The proposed rates were developed by establishing distinct revenue targets for single-piece and workshared mail, and then developing individual rates independently within each group. Postal Service witness Taufique (USPS-T-32) does not indicate any consideration given to the relationships between specific single-piece and workshare rates. In this respect, the proposal implicitly treats single-piece mail and workshared mail as separate subclasses.

Under the Postal Service's proposal, workshare rates would no longer be designed as discounts from the first-ounce single-piece rate. Consequently, the differences between the proposed workshare rates and the first-ounce single-piece rate would reflect "more than simply the costs avoided by performing worksharing activities which the Postal Service and the Postal Rate Commission have determined are appropriately reflected in rate differences." USPS-T-32 at 14. This is a significant departure from the rationale used to justify First-Class Mail worksharing discounts since their inception.

To date, worksharing discounts have been, to the extent practicable, set equal to the costs avoided by worksharing. This practice is intended to send price signals that encourage worksharing by mailers only if the mailer's cost of preparing mail to meet worksharing specifications is less than or equal to the resulting reduction in USPS costs. By de-linking worksharing rates from single-piece rates, the proposal implicitly downplays the importance of the price signals sent to mailers by the difference between the first-ounce single-piece rate and rates for comparable mail that is workshared. This

further suggests a substantially different relationship between the markets for single-piece and workshared First-Class Mail than that which underlies the historically accepted approach to rate design.

*Background.* From the introduction of the first presort discount for First-Class Letters, the justification for reduced rates for workshared mail has rested substantially on a firm link between the rate differential and the costs avoided by the Postal Service when worksharing is performed by mailers. In recommending the establishment of a presort discount, the Commission relied on this principle. “Although the Service admits to lack of experience with presorting, their best information suggests that the one-cent discount will, on the average, be the equivalent of the clearly capturable cost avoidance.” PRC Op. MC73-1 at 16. (Footnote omitted.)

In later cases, the Commission addressed issues related to the effect of the heterogeneous nature of single-piece mail on cost avoidance estimates. “In First Class, single-piece cost-driving characteristics range along a spectrum from very hard-to-handle (illegible addresses with incorrect ZIP codes) to mailings that resemble presort mail in every respect except for the presorting itself.” PRC Op. R84-1, ¶ 5129. This reasoning led to the adoption of a benchmark consisting of a subset of single-piece mail that could more readily (and would be more likely to) convert to workshare. At the same time, in order to isolate the cost effects of worksharing activities, the Commission excluded “associated worksharing” costs from the basis for discounts because “[i]t is not equitable to reflect the lower costs in the presort mailings’ rates, but not in those for mailings similar except for presorting.” *Id.* at ¶ 5132.

The Docket No. R90-1 Opinion contains a comparison of two predominant approaches to calculate the discount levels, “cost difference” and “cost avoidance.” “The cost difference methodology generally compares the average costs for letter-shaped nonpresort First-Class Mail to the average costs for letter-shaped presorted First-Class Mail. The cost avoidance methodology excludes the effects of extraneous factors in calculating mailer worksharing cost savings because it...compares the cost of a piece of mail without the worksharing characteristic (but a candidate for conversion to

the worksharing program) with a piece identical in every respect except that it does reflect the mailer worksharing effort[.]” PRC Op. R90-1, ¶ 5066. Ultimately, the Commission recommended rates for the automation presort categories using a cost avoidance approach. “[C]ost savings due to automation are calculated by comparing unit costs between bulk metered mail and the relevant automation discount category.” *Id.* at ¶ 5088.

In Docket No. MC95-1, the Commission rejected a Postal Service proposal to de-link the development of single-piece and automation presort First-Class Letter rates by placing them in separate subclasses. The opinion in that case includes an extensive discussion of cost avoidance issues, including the importance of selecting an appropriate benchmark. “Where benchmarks for calculating costs avoided by worksharing are not well defined, traditional ‘passthrough’ analysis tends to lose its economic meaning. This is especially true of First-Class Mail[.]” PRC Op. MC95-1, ¶ 4291. Consistent with this analysis, the Commission reaffirmed its reliance on bulk metered mail as the benchmark for worksharing cost avoidance. *Id.* at ¶ 4302.

As recently as Docket No. R2005-1, the Postal Service advocated the use of costs avoided by the worksharing of bulk metered mail (BMM) as the basis for worksharing discounts. “...BMM letters is the mail most likely to convert to worksharing.” USPS-T-21 at 11. The Postal Service calculated cost avoidances and passthroughs by comparing each automation presort category to BMM (the “cumulative” approach), as opposed to comparing each to the next-least presorted category (the “incremental” approach).

In response to Presiding Officer’s Information Request No. 6, Question 7 in that case, witness Taufique explained that the Postal Service took the incremental price signals into consideration, but believed that the cumulative (or total) passthrough approach better reflected the price signals most relevant to the choices made by mailers. The response explains that “[w]hat matters is that mailers are provided appropriate signals based on the workshare savings accruing to the Postal Service[.]” Docket No. R2005-1, Tr. 3/616. It supports the comparison of each presort category to

BMM by explaining that mailers “may make a ‘yes or no’ decision to workshare or not[.]” *Id.* at 618. The response also discusses how the existence of third-party presort consolidators might influence the appropriate basis for cost comparisons. “[O]ther customers present unsorted mail to presort businesses which combine their mail with mail from other customers to gain finer presort and to upgrade the mail by applying barcodes. ... In addition, it appears that the business strategy for some large presort bureaus is the conversion of single-piece mail or other less workshared mail to 5-Digit workshared mail, if at all possible.” *Id.* at 620-21.

This position is consistent with the notion that there is overlap in the markets for single-piece and workshared First-Class letters. The potential for mail to be entered as either single-piece or workshared makes the price signal to mailers an important driver of efficiency. When the difference in rates for workshared and non-workshared mail that is otherwise comparable is equal to the difference in the Postal Service’s cost of handling such mail, the resulting price signal creates an incentive for mailers to make efficient decisions about whether or not to workshare.

In contrast, the Postal Service’s instant proposal to de-link the design of rates for single-piece and workshared First-Class Letters is inconsistent with the concept of overlapping markets. The effect of the price signal on mailer behavior and the subsequent effects on Postal Service contribution and efficiency in the postal sector are not taken into consideration. If the historically accepted concept of overlapping markets is invalid, then the differential between rates for workshared and non-workshared mail that is otherwise similar might have little or no influence on mailers’ decisions to workshare or not. In such an environment, there could be merit in adopting the proposed approach. However, the Postal Service’s testimony does not address the issue of the composition of the market(s) for single-piece and workshared First-Class Letters directly.

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. What does the market for First-Class letters look like today?
  - a. Do any single-piece letters have the potential to convert to worksharing? If so, is the candidate mail likely to have cost-driving characteristics similar to the average for single-piece letters?
  - b. Do any workshared letters have the potential to revert to single-piece? If so, is the candidate mail likely to have cost-driving characteristics similar to the average for workshared letters?
  - c. What is the significance of the rate differentials between the first-ounce rates of single-piece and workshared letters in creating an incentive for mailers and/or presort bureaus to perform worksharing that results in productive efficiency?
  - d. In the First-Class Mail Letters subclass, is the price signal from the difference between the first-ounce rates for single-piece letters and workshared letters still relevant? If so, should the rate differences be developed using the traditional benchmark approach, or some other method? If not, why not, and is the proposed approach to designing rates for First-Class Letters appropriate, or is some other method more appropriate?
2. 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? 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.<sup>1</sup>

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<sup>1</sup> This definition embodies a bottom-up approach, but it appears to suggest that the top-down 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.

- a. How does ECP apply to worksharing?
- b. How does ECP apply to shape?
- c. How does ECP apply to other cost causing characteristics?

By the Commission

(S E A L)

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Secretary