

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

REGULATIONS ESTABLISHING SYSTEM
OF RATEMAKING

Docket No. RM2007-1

REPLY COMMENTS OF THE UNITED STATES
POSTAL SERVICE IN RESPONSE TO ORDER NO. 26
(October 9, 2007)

On August 15, 2007, the Commission issued Order No. 26, setting forth its proposed rules for the regulation of market-dominant and competitive product pricing under the Postal Accountability and Enhancement Act (Act). The Commission solicited comments on its proposed rules, and also asked the Postal Service to submit an initial version of the new Mail Classification Schedule (MCS) required by the rules. On September 24, 2007, the Postal Service, along with close to thirty other parties, filed initial comments. In addition, the Postal Service submitted a proposed MCS for the Commission's consideration. The Postal Service hereby files its Reply Comments.

I. Market-Dominant Rate Adjustment Rules

A. The Commission's basic approach towards the review of market-dominant rate adjustments is consistent with the framework of the Act

Several parties criticize the Commission's rules for providing too little pre-implementation review of market-dominant rate adjustments. Valpak presses this issue most strongly, arguing that the proposed rules for the pre-implementation review of Type 1 (price cap) rate adjustments are faulty because, among other things, the review period contemplated by the rules is too short, will only examine whether the proposed

rates comply with the cap, and will not allow discovery.¹ Valpak asserts that the annual compliance review and complaint procedures of §§3653 and 3662 , respectively, are not adequate substitutes for “pre-implementation comment and review.”² McGraw-Hill, meanwhile, also suggests that the Commission’s rate adjustment review procedures are too limited,³ while NAA argues that the proposed rules for market-dominant customized agreements do not provide adequate prior review.⁴

Finding fault with these rules on the basis that they do not rely primarily on pre-implementation review of rate adjustments is not a criticism of the rules themselves, but of the framework of the Act to which the rules must conform. The Act sets forth a detailed regulatory framework for market-dominant products that contains three carefully-delineated mechanisms through which the Commission can review the prices set by the Postal Service in the normal course of business.⁵ Each of these provisions has a different scope of review, with corresponding remedial provisions tailored to that review:⁶ the prior review provision of § 3622(d) ensures that the Postal Service’s rate adjustments comply with the price cap; the annual compliance review process of §§ 3652 and 3653 ensures that the Postal Service’s prices conform with the broader standards of chapter 36; and the complaint process of § 3662 allows the Commission to hear mailer complaints predicated on chapter 36 as well as other specified provisions of the Act. Thus, the Act replaces the extensive pre-implementation processes of the

¹ See Valpak Comments at 3-7.

² See *id.* at 5-7.

³ See McGraw-Hill Comments at 6-8.

⁴ See NAA Comments at 2-12.

⁵ The Commission can also review prices pursuant to § 3622(d)(1)(E), but that only applies in “extraordinary or exceptional” circumstances.

⁶ See, e.g., Postal Service Reply Comments on Second Advance Notice at 12-13; Time Warner Reply Comments on First Advance Notice at 14 (noting that “Congress was careful in delineating the Commission’s enforcement authority under different provisions.”).

Postal Reorganization Act (PRA) with a regulatory structure characterized instead by a short prior review and a greater emphasis on procedures for monitoring and oversight.

This framework is designed to achieve the policy objectives of § 3622. Congress saw a short prior review period as important for according the Postal Service increased flexibility over its pricing and product decisions.⁷ A short prior review period was also consistent with Congress' decision to increase incentives for efficiency and ensure the predictability and stability of rates through the imposition of a price cap. At the same time, the Act's requirement for the annual reporting of cost, volume, revenue, workshare discount, service performance, market test, and similar data through § 3652, and SEC-like financial data through § 3654, achieve the statutory goal of increasing the Postal Service's transparency, and enable the Commission and stakeholders to track data trends on an ongoing, year-to-year basis.

This framework also illustrates the Commission's changed role under the Act, and the Act's conferral of greater flexibility on the Postal Service. The Commission's former responsibility for recommending specific prices for postal services based on its judgment as to which among a spectrum of potential, lawful prices was most consistent with the statutory criteria has now become one of ensuring that the prices established by the Postal Service in the exercise of its business judgment are compliant with the requirements of title 39. Furthermore, the substantive standards have changed from a cost-focused regulatory structure that required rates meeting a "fairness and equity" standard to a regime that focuses on compliance with a price cap applied at the class level and the establishment of rates that are just and reasonable (*i.e.*, fall within a "zone

⁷ See, *e.g.*, S. REP. NO. 108-318, at 11 (2004). A short prior review period also reduces the administrative burden of the ratemaking process, in compliance with § 3622(b)(6).

of reasonableness”). These aspects lend themselves to Commission procedures that are based on continued monitoring and the resolution of disputes as they arise, rather than through extensive pre-implementation review and litigation.

The Commission’s proposed rules seem consistent with the framework established by the Act. The Postal Service understands proposed Subpart B of Part 3010 as enabling a system of prior review whose sole substantive outcome will be a determination of whether the rates noticed by the Postal Service comply with the price cap, though the Postal Service must address, and other parties can comment on, other aspects of the statute for transparency purposes.⁸ This suggests that the Commission will rely instead on the annual compliance review and complaint processes to ensure that the Postal Service complies with the other relevant portions of title 39. In addition, the Commission’s proposed rules for market-dominant customized agreements in Subpart D of Part 3010 provide a short prior notice period, with continued monitoring through annual data reports that verify whether the Postal Service’s expectations are met and that the statutory criteria are satisfied. This approach also comports well with the overall statutory scheme.

1. Valpak Comments

Valpak’s comments on the proposed Type 1 review procedures seem to reflect a belief that the Commission’s decision not to adopt extensive pre-implementation procedures like those that existed under the PRA is inappropriate. Valpak asserts that the procedures set forth by the Commission “fail to ensure that the objectives, factors, and other limitations of the PAEA that Congress expressly made part of the modern

⁸ See 39 C.F.R. §§ 3010.13, 3010.14 (as proposed); Order No. 26 at 23-24.

system of regulating rates [are] met.”⁹ By this Valpak implies that the *only* way to achieve the policy objectives of the Act is through an extensive pre-implementation process in which all of those policies can be litigated. It was Congress, however, that set forth a statutory scheme based on a price cap and limited prior review.

Valpak recognizes that “it could be permissible for the Commission to have different types of proceedings addressing different topics,” but faults the Commission for not saying “when, if ever, such comments would be entertained and/or addressed.”¹⁰ Valpak seems to ignore, however, the Commission’s specific statement that this proceeding is simply the first step in the implementation of the Act, and will be followed by proceedings applicable to complaints and the annual compliance review.¹¹ The Commission accurately describes these provisions as “complementary to the proposed regulations.”¹²

Valpak particularly criticizes the Commission’s proposed procedures for ignoring the statutory objective of increased transparency, based on the observation that the pre-implementation review of rate changes would be less comprehensive than under the PRA.¹³ However, only by ignoring the rest of the statute, and the fact that complaint and annual compliance review regulations are on their way, can Valpak assert that the new regulatory system will be less transparent because the notice of rate changes will be less extensive than before. Section 3652, for example, requires the annual

⁹ Valpak Comments at 4. Valpak also asserts that there is “an absence of due process protection” in the ratesetting process because of the limited prior review period set forth by the Commission. See *id.* at 6. Valpak cites to nothing, however, to indicate that the principles of “due process” compel the pre-implementation litigation and review on any statutory issue that can be conceived by an interested party. The presence of a complaint process and the annual compliance review process protects any “due process” concerns that mailers may have.

¹⁰ *Id.* at 5.

¹¹ See Order No. 26 at 3.

¹² *Id.*

¹³ See Valpak Comments at 7-12.

submission of extensive data underlying pricing, which will be reviewed in a public proceeding, in contrast to the prior regime whereby similar data were provided and reviewed in the context of periodic “rate cases.” As the Postal Service has noted previously, the Commission properly applies principles of statutory construction in recognizing that there are sections of the law outside of § 3622, such as § 3652 and § 3654, which relate directly to market-dominant pricing and to the achievement of the policy objectives of § 3622.¹⁴

Valpak similarly argues that the Commission’s decision not to allow discovery during the prior review period is inconsistent with the Act’s attempt to increase transparency, claiming that “[i]t is not clear how the Commission will achieve the statutorily-mandated ‘increase’ in ‘transparency’ if the Postal Service is not required to respond to mailer requests for information, and if the Commission’s PRA-era information-gathering techniques are abandoned.”¹⁵ The decision by the Commission not to allow discovery is, however, wholly in keeping with the nature of the prior review procedure. Consistent with the framework of the Act, the review period is short and is limited to the resolution of a single issue: whether the Postal Service’s rate adjustments are consistent with the price cap. In light of this, allowing formal discovery would seem to needlessly complicate the Commission’s review.

2. APWU Comments

APWU asserts that because “it is impossible to separate issues of postal cost determination and allocation from the issue of rate compliance,” and because “a 45-day notice period will not permit adequate inquiry into these issues by the Commission or by

¹⁴ See Postal Service Initial Comments on First Advance Notice at 9, 18.

¹⁵ Valpak Comments at 11.

other interested parties,” the Commission should “make a rule to establish public comment and discovery procedures that will permit interested parties to determine whether proposed rates comply with statutory requirements and policies of the Act beyond the rate cap.”¹⁶ APWU appears to be proposing that the Commission establish a pre-implementation review procedure of unspecified duration that examines whether the proposed rates comply with the requirements of the Act beyond the price cap. As discussed in connection with Valpak’s comments above, this would be inconsistent with the framework of the Act.

3. McGraw-Hill Comments

McGraw-Hill suggests that the Commission’s rules should provide for the “possibility that a serious non-rate-cap issue may be raised within the initial 45-day review period and the Commission may have time to resolve it within that period, or may be able to do so within an appropriate extension of that period, and may deem the issue sufficiently serious to warrant such an extension.”¹⁷ Most fundamentally, this approach seems inconsistent with the statutory framework, in which “non-rate-cap” issues are to be considered in either the annual compliance report or complaint procedures, as discussed above.

McGraw-Hill’s proposal would also seem to inhibit the predictability of the Type 1 rate adjustment procedures. “Predictability” is an important objective of the Act, as manifested most concretely by proposed § 3010.7. One important aspect of the contemplated Type 1 review process for the annual general price change is that its timeframes will be predictable: the Postal Service will, as discussed previously in this

¹⁶ See APWU Comments at 1-4.

¹⁷ McGraw Hill Comments at 7.

proceeding, provide 90 days notice of the price change,¹⁸ and the Commission will, pursuant to the timeframes set forth in its rules, make a determination of whether those changes comply with the price cap within 34 days of that notice.¹⁹ This will provide assurance that the implementation date as set forth in the Postal Service's notice pursuant to § 3010.7 will be achievable.

On the other hand, the prospect of delaying, for an unspecified period of time, a determination of compliance on the basis of a non-rate-cap issue would seem to defeat the intended predictability of the process and could hinder the Postal Service's and mailer's abilities to meet the implementation date. A delayed implementation would also cause the Postal Service to lose revenue that could never be recovered.²⁰ Finally, it would be administratively difficult for the Commission to handle, within the short timeframes contemplated by the Act, requests from interested parties to delay the compliance determination for some specified reason, requests that could only serve to make the process more complex and litigious. Overall, it is far preferable to have a consistent, predictable process that allows the Postal Service to adhere to a regular and predictable series of implementation dates for the annual general price change, rather than the more ill-defined and open-ended process proposed by McGraw-Hill.²¹

¹⁸ See Postal Service Reply Comments on First Advance Notice at 5-6.

¹⁹ See 39 C.F.R. § 3010.13(a), (c) (as proposed).

²⁰ Two factors cause implementation slippage to equate to permanent income loss. First, once compliant rates are designed and noticed based on the applicable cap, no mechanism exists for immediate adjustment of those rates even if the intended implementation date slips. Second, unlike the provision for the recovery of prior years' losses in the old breakeven rate environment, for purposes of developing *subsequent* rate changes, the new inflation-based rate cap operates independently of previous positive or negative variances in net revenue, including those relating to delayed implementation of earlier rate changes.

²¹ Similarly, NNA urges the Commission to amend its rules to provide that a Type 1 rate adjustment will be reviewed for a period between 45 and 90 days, depending on the complexity of the rate change. See NNA Comments at 5. This suggestion should be rejected for the same reasons that the Commission should reject the McGraw-Hill proposal.

4. NAA Comments

NAA presents an argument similar to McGraw-Hill, but with respect to the proposed Type 2 (customized agreement) rate adjustment review procedures. NAA asserts that the Commission's proposed rules do not allow for "an effective prior review in practice," and that after-the-fact review is an insufficient substitute for prior review as a means of ensuring adherence to the statutory criteria.²² Because of this, NAA asserts that the Commission's proposed rules should expressly contemplate delaying the implementation of any agreement if there is a "genuine issue regarding statutory compliance."²³

The Postal Service respectfully submits that amending the rules in such a way would be inconsistent with the Act. Moreover, NAA fails to address with any specificity how the Commission's rules are inadequate to the task of determining whether an agreement complies with the statutory criteria. The data required to be filed in the notice of agreement should provide a sufficient level of detail to assess compliance that would later be tested in light of subsequent data reports. Clearly, the Act allows the Commission to adopt such an approach.

The Postal Service agrees with Amazon and MMA that the best way to address customized agreements' compliance with the statutory criteria is through continuing review rather than "ad hoc pre-implementation assessments."²⁴ In particular, this will allow the Commission to assess statutory compliance using actual, concrete results. Furthermore, relying on pre-implementation review in the manner suggested by NAA would also introduce the same uncertainties concerning customized agreements that

²² See NAA Comments at 9.

²³ See *id.* at 10.

²⁴ See Amazon Comments at 2; MMA Comments at 6.

characterized the prior regime. As Discover notes, “the fear of...indeterminate pre-implementation NSA review procedures has been one of the primary factors that has scared off mailers from entering into NSA negotiations over the last several years.”²⁵ If negotiated pricing is to work in the long term, then the primary emphasis should not be on before-the-fact regulation. Instead, the Commission and the Postal Service should look to post hoc evaluation that fosters continued and ongoing improvement in the quality of negotiated prices. Costly up-front litigation makes this effort more difficult by reducing the number of customers otherwise ready and able to negotiate terms, and thus reducing the number of pricing events that the Postal Service can experience and use to improve.

B. The Postal Service sees no need for modifications at this time to the Commission’s Type 1 price cap review procedures

In addition to the more fundamental criticisms of the Commission’s proposed Type 1 rate adjustment review procedures discussed above, a number of parties have proposed modifications to those rules. Several of those proposals are discussed in this section.

1. Communications between the Commission and the Postal Service

Valpak and OCA suggest that the Commission issue a rule requiring all communications between the Commission and the Postal Service during the prior review period be public, and that any meetings or briefings that are held also be public.²⁶ While as a general matter this seems reasonable, it is also important to recognize that informal contacts between the Commission and the Postal Service may

²⁵ Discover Comments at 2-3.

²⁶ See Valpak Comments at 12; OCA Comments at 9-10.

facilitate the Commission completing its review within the contemplated timeframes. Thus, the Commission should not promulgate a rule that would restrict its ability to engage in such communications. In such instances, subsequent disclosure of the communication may be appropriate.

More generally, the Commission should avoid establishing procedures that could be used by parties to inhibit its ability to expeditiously conduct the cap compliance review. In particular, the Postal Service is concerned that any public meetings or briefings might lend themselves to becoming *de facto* hearings on issues beyond the price cap. The Postal Service firmly supports the Commission's intent to keep the Type 1 review proceedings simple, streamlined, and focused.²⁷ Past experience already suggests that the Commission will carefully consider the interests of interested parties when it decides whether to make communications public. As such, the need for an actual rule in 39 C.F.R. addressing this issue seems unnecessary.

2. Notice Period

Valpak proposes that the Commission's rules expressly require the Postal Service to notice its Type 1 price changes 90 days in advance.²⁸ The Postal Service has previously indicated its understanding that the Act gives it the discretion to determine how much prior notice of rate changes to provide, and therefore opposes Valpak's proposal as being inconsistent with the statute.²⁹ Recognizing, however, the Commission's disagreement with the Postal Service in this regard,³⁰ the Postal Service also opposes Valpak's proposal because it would insert unnecessary rigidity into the

²⁷ See Order No. 26 at 17.

²⁸ See Valpak Comments at 8-9.

²⁹ See Postal Service Reply Comments on First Advance Notice at 5; Postal Service Reply Comments on Second Advance Notice at 17-18.

³⁰ See Order No. 26 at 14-15.

rules. While the Postal Service has committed to providing 90 days notice for the annual general price change, given current levels of technology, such a period may be unnecessary for smaller changes, such as the introduction of a new option within an existing product.³¹ The Postal Service therefore urges the Commission not to adopt Valpak's suggestion.

3. Postal Service Filing Requirements

A number of parties suggest that proposed § 3010.14 be amended to require that the Postal Service accompany its rate adjustment notice with a wider variety of commentary. Specifically, parties suggest that the Postal Service should explain 1) how its proposed rates conform with § 403(c) of title 39;³² 2) how it plans to eliminate any greater-than-100-percent-passthrough workshare discounts over time, where required by § 3622(e);³³ 3) how far, in circumstances where a class has failed to cover its attributable costs in the prior fiscal year, its rates go towards eliminating the cross-subsidy being received by that class;³⁴ and 4) how a rate adjustment for a product that significantly exceeds the rate of inflation is consistent with the statutory objectives and factors.³⁵

Though some of these proposals do not seem unreasonable when considered in isolation, viewed collectively they would seem to add appreciably to the administrative burden of the Type 1 prior review process. In addition, any benefit that they might have seems small, since none would add any insight relevant to the determination of whether the noticed rates satisfy the price cap. Expansive requirements for Postal Service

³¹ See Postal Service Reply Comments on First Advance Notice at 6 n.13.

³² NAA Comments at 13-15.

³³ APWU Comments at 5-6.

³⁴ Valpak Comments at 20.

³⁵ DMA Comments at 4-6; NNA Comments at 9.

exposition on a wide variety of issues unrelated to the cap would seem to make “the process burdensome,” and “would be contrary to the goals of a simpler, more flexible process.”³⁶ Thus, the Postal Service recommends that the Commission implement § 3010.14 as proposed.

In particular, the Postal Service urges the Commission not to adopt the “soft band” proposal of DMA and NNA. While DMA claims that a written explanation of how a rate adjustment for a product that significantly exceeds the rate of inflation is consistent with the statutory objectives and factors would not impose a “significant burden on the Postal Service,” since it could occur in a “few paragraphs,” the Postal Service views this proposal as inconsistent with the framework of the statute, for the reasons discussed previously in this proceeding.³⁷

Finally, NNA suggests that § 3010.14 be amended so as to require the Postal Service to provide with its rate change notice a “basic Cost and Revenue Analysis” for each product, and “the most recent Billing Determinants by class.”³⁸ With respect to the latter proposal, the Postal Service notes that the rules already require it to provide billing determinant data for purposes of applying the cap.³⁹ The former proposal, meanwhile, is inconsistent with the framework of the Act, as discussed above: data currently found in the CRA will be filed each year as part of the annual compliance review process.

³⁶ C.f. Order No. 26 at 20-21.

³⁷ See Postal Service Reply Comments on First Advance Notice at 17-19.

³⁸ NNA Comments at 9.

³⁹ See 39 C.F.R. § 3010.23(d) (as proposed).

4. Comment Period

NNA argues that the comment period should not be hardwired at 20 days.⁴⁰ The Postal Service considers hard deadlines such as these very useful to ensure the prompt and predictable handling of rate adjustment reviews by the Commission. It therefore urges the Commission to retain the rule as proposed.

C. The Commission's procedures for the review of Type 1 increases do not violate the APA

Medco Health Solutions argues that the Commission's proposed Type 1 rate adjustment procedures violate the Administrative Procedure Act (APA). As Medco admits, the manner by which the Commission has formulated those procedures is not at issue, since the Commission has been following the strictures of notice-and-comment rulemaking.⁴¹ Instead, Medco argues that proposed procedures themselves violate the APA because the Commission has stated that it will not entertain comments concerning matters such as costing or the compliance of any amended notice by the Postal Service with the relevant requirements, and because the Commission has set a 20-day time period for the receipt of those comments.⁴²

In order to evaluate Medco's claims, it is first necessary to understand what the Commission's task is under the Act. Congress has required that the Commission "by regulation establish...a modern system for regulating rates and classes for market-dominant products," that achieves the enumerated statutory "objectives" (and takes into account the "factors"), and adheres to the procedural and substantive framework set

⁴⁰ NNA Comments at 6.

⁴¹ Medco Comments at 3.

⁴² *Id.* at 6-8. Medco also asserts that that the notice contemplated by proposed 39 C.F.R. § 3010.13 does not satisfy the APA. *Id.* at 6. However, to the extent the APA applies to these proceedings, the formalistic criticisms advanced by Medco reflect simply the future contents of the notice that the Commission will provide, and can thus be easily accommodated by the Commission.

forth by Congress in the “requirements” of § 3622(d). Certainly, when the Commission “by regulation” establishes or revises the contours of the ratemaking system, it must adhere to the requirements of the APA. In terms of the actual procedures that will occur within that regulatory scheme, however, the Commission must adhere to the intent of Congress, as expressed in the Act. In terms of prior review, Congress has mandated a specific procedure whereby the Commission must notify the Postal Service if a rate adjustment that the Postal Service is planning to put into effect satisfies the price cap. The Commission is not “approving” or “prescribing” any individual rate during its Type 1 review, but is simply allowing the rates noticed by the Postal Service to go into effect after verifying that the average percentage increase for each class of mail is in compliance with the applicable price cap limitations. The Commission can still entertain complaints that a rate or rates violate some non-rate-cap standard of title 39, such as § 403(c). The rules issued by the Commission thus appropriately implement the statutory process set forth by Congress.

Medco’s arguments that the Commission’s prior review procedures violate the requirements of the APA are without merit, since those procedures accord fully with the applicable principles of notice-and-comment rulemaking. With respect to Medco’s criticisms concerning the scope of the Commission’s comment period, nothing in the APA’s requirement that “interested persons [be given] an opportunity to participate” in a rulemaking suggests that an agency does not have the discretion to limit the scope of the comments that it will entertain, based on the purpose of the proceeding. Even Medco recognizes that agencies have the discretion to “weed out the irrelevant,” but

suggests that this should occur after parties have submitted their comments.⁴³ Medco cites to no authority (other than “standard agency practice”) that suggests, however, that it is inappropriate for an agency to decide that it should exercise that discretion before parties submit their comments.

Indeed, such an approach seems much more administratively efficient, and more consistent with the clear emphasis in the Act for a simpler, more streamlined prior review proceeding.⁴⁴ Moreover, the Commission’s determination that it will review an amended notice of rate adjustment (*i.e.*, a notice submitted by the Postal Service subsequent to an initial determination that the first notice did not comply with the price cap limitations) expeditiously and without further public comment is fully supportable under the Act, and does not seem to run afoul of the APA, since parties will already have had an opportunity to comment earlier in the proceeding.

Medco also admits that the APA gives an agency the discretion to determine how much time it will give parties to submit comments.⁴⁵ This is correct, since, as courts have noted, one must look to the specific statute being administered, not the APA, to determine how much time to comment is appropriate, and “[w]hether still more time might have been beneficial to some parties is not the issue.”⁴⁶ Instead, the relevant question is the provision of a meaningful opportunity to participate. In this case, a 20-day comment period seems clearly appropriate, due to the limited focus of the proceeding and the statutory emphasis on streamlined, predictable proceedings. In addition, there are also other statutory provisions in place to protect parties who discern

⁴³ See Medco Comments at 7.

⁴⁴ See Order No. 26 at 17.

⁴⁵ See Medco Comments at 8.

⁴⁶ See *Kootenai Tribe of Idaho v. Veneman*, 313 F.3d 1094, 1118 (9th Cir. 2002).

a non-rate-cap issue after the conclusion of the 20-day period, which further makes the proposed comment period acceptable.

Overall, it seems clear that the Commission has the broad discretion, under the APA, to note at the outset that it will not entertain certain matters in a Type 1 proceeding, and to set forth a limited period of time for the submission of comments, in order to effectuate the purposes of the Act. Here, the Commission's inquiry is essentially limited to mathematically determining whether the Postal Service's notice of rate adjustment averages out to CPI-U. The Commission has logically shifted some matters that it considers extraneous to that inquiry to the annual compliance review period or the complaint process, which allow for a greater opportunity for in-depth consideration of the issue, to the benefit of both the Commission and interested parties.⁴⁷

D. The Commission's proposed rules for customized agreements should be reassessed in only one limited way

A number of parties have proposed modifications to the Commission's proposed rules for market-dominant customized agreements. This section discusses some of those proposals.

1. OCA Comments

OCA proposes that the Commission incorporate into its rules aspects of the "Suggested Framework" from the J.P Morgan Chase (Bank One) case, and require that there be "clear and convincing evidence" that a customized agreement will satisfy the

⁴⁷ The Commission has also invited, for transparency purposes, comments on whether the noticed rate adjustment complies with the policies of § 3622. See 39 C.F.R. § 3010.13(b)(2) (as proposed). Medco glosses over that fact.

criteria of § 3622(c)(10) before it can take effect.⁴⁸ OCA states that these modifications are necessary because the standard for allowing a customized agreement to be implemented has been made “significantly more stringent” under the Act and the Commission’s proposed rules.⁴⁹

OCA’s claim that a higher burden of proof now applies to the Commission’s pre-implementation review of customized agreements finds no support in the Act or the Commission’s rules. OCA seizes on the word “must” in proposed § 3010.40 and acts as if the Commission has, by its use of that word, thereby decided that the Postal Service has to show, with apparently much greater certainty than before, that a customized agreement will achieve the requirements of the Act, or else it cannot be implemented. However, the OCA points to nothing to support a conclusion that the Act was designed to make it more difficult for the Postal Service to enter into customized agreements.

In addition, OCA is not accurately reading the Commission’s proposed rules. As the Commission notes, the Act “seeks to provide the Postal Service with added flexibility to enhance producer and consumer surplus through negotiated service agreements. The proposed rules will decrease the administrative and economic burden in implementing such agreements.”⁵⁰ Instead of relying on the extensive pre-implementation procedures of the PRA regime, the Commission states that it will rely on “periodic reviews” in order to verify that these agreements meet the Postal Service’s expectations and satisfy the statutory criteria.⁵¹ Proposed § 3010.40, which figures

⁴⁸ See OCA Comments at 3-9.

⁴⁹ *Id.* at 4.

⁵⁰ Order No. 26 at 39.

⁵¹ *Id.* at 40.

prominently in OCA's argument, simply "expresses the Commission's objective in administering the implementation of negotiated service agreements" based on the procedures then specified in the rest of Subpart D.⁵²

In particular, the Commission's rules should not, as suggested by OCA, prescribe specific terms that must be included in a customized agreement.⁵³ As proposed, rule 3010.42 simply requires that the Postal Service provide, among other items, "details regarding the expected improvements in the net financial position or operations of the Postal Service." OCA would modify the rule to require that each agreement provide "rewards" to a mailer within a set range and contain liquidated damages should the mailer's reward exceed the upper bound of the range. Specifically, the OCA seeks to require that the agreements identify the "change" in mailer behavior that would be "rewarded," and that a "unit of measure of cost, volume, etc." be estimated for each change in mailer behavior. The modifications also would require the agreement to identify minimums and maximums at which rewards commence and are forfeited. If the upper bound is reached, then the agreement would mandate liquidated damages.⁵⁴

The proposal is inconsistent with the Act. Section 3622(c)(10) recognizes the desirability of customized agreements and accords the Postal Service broad authority to enter such into agreements. Rule 3010.42, as proposed, strikes an appropriate balance of providing transparency about the financial effects and other key attributes of the agreement without mandating its specific terms. The OCA's proposal should be rejected.

⁵² *Id.* at 39.

⁵³ OCA comments at 3-8.

⁵⁴ OCA Comments at 8.

Moreover, it is unclear as to how the OCA's proposal would in fact accomplish its stated goal of increasing the confidence that a customized agreement will improve the financial position of the Postal Service beyond what the Commission-proposed rules already require. The financial effects of the agreement must already be provided, and this would include the effect of any mailer "reward" or "change" in behavior. It is hard to see how imposing structural requirements on the Postal Service's ability to negotiate, with upper and lower bounds and liquidated damages for exceeding the upper bounds, would enhance customized agreements or further any statutory purpose.

2. Public Availability of Market-Dominant Customized Agreements

A few parties propose that the Commission state expressly in its rules that the "notice of agreement" filed by the Postal Service pursuant to proposed § 3010.42, including the terms of the customized agreement itself, will be publicly available.⁵⁵ The Postal Service suggests, however, that it makes more sense to defer this issue to the confidentiality proceeding that the Commission has said will be conducted in the near future. None of the other parts of the proposed rules include provisions dealing specifically with confidentiality issues. Waiting until the upcoming confidentiality rulemaking will allow the Commission to approach modifications to 39 CFR in a comprehensive and consistent manner. Before then, confidentiality issues can be considered on a case-by-case basis.

Should the Commission wish to address this issue now, it is important to note that the Postal Service may have confidentiality concerns with respect to market-dominant customized agreements, and mailers may need confidentiality with regard to

⁵⁵ See NAA Comments at 5; Valpak Comments at 20-21.

their business data, as evident from past Commission proceedings concerning customized agreements. Thus, elements of a market-dominant agreement, or the broader notice of agreement, may contain confidential information that should be protected in order for the Postal Service and customers to feel comfortable entering into customized agreements. As such, a rule specifying that the notice of agreement will be publicly available, without also recognizing that some portion may be identified and treated as confidential, does not seem appropriate.

3. NAA Suggestion on Maintaining Distinction Between Functionally Equivalent and Baseline Agreements

NAA suggests that the Commission may wish to continue distinguishing between “baseline” and “functionally equivalent” customized agreements in its rules.⁵⁶ At this time, and assuming that the Commission accepts the Postal Service’s position on whether customized agreements are “products” for purposes of the Act, the Postal Service sees no need for such a distinction.⁵⁷ The Act applies the same substantive and procedural standards to all customized agreements, and distinguishing between agreements on the basis of “functional equivalence” would seem to add a procedural issue that has little or no relevance to whether an agreement satisfies the standards of § 3622(c)(10).

4. Advo and Time Warner Proposal

Advo recommends that the Commission delete its proposed rule requiring the Postal Service to file, in its notice of agreement, an “analysis of the effects of the [NSA]

⁵⁶ NAA Comments at 12.

⁵⁷ If the Commission decides that it is best to continue treating market-dominant customized agreements as being separate “products,” then distinguishing between baseline and functionally-equivalent agreements would probably be important. *C.f.* Order No. 26 at 82 n.77.

on the contribution to institutional costs from mailers not party to the agreement.”⁵⁸ Advo views this provision as an unnecessary carry-over from the cost-of-service regime of the PRA, noting that pricing under the CPI-U cap is no longer a zero sum game. Time Warner also criticizes the Commission’s rule as being inconsistent with the statutory criteria.⁵⁹ The Postal Service agrees that the Commission should re-assess whether this rule is appropriate. With a price cap governing the size of overall price increases by class, the basic rationale for the old approach under the PRA is no longer apparent.

5. Discovery

APWU suggests that the Commission should expressly allow interested parties to request information from the Postal Service during the pre-implementation review of customized agreements.⁶⁰ APWU asserts that discovery is necessary so that interested parties can ensure for themselves that a customized agreement satisfies the requirements of the statute. As discussed previously in the context of the Type 1 rate adjustment procedures, however, the Postal Service views formal discovery mechanisms as impractical and inconsistent with the streamlined prior review contemplated by the Act.

II. Classification Rules

The Commission has proposed a framework for classification changes that distinguishes between changes that rise to the level of adding, deleting, or transferring a “product,” and changes that simply modify the provision of an existing “product.” For the

⁵⁸ Advo Comments at 3-4.

⁵⁹ Time Warner Comments at 11-13.

⁶⁰ APWU Comments at 6-8.

former, the Commission proposes procedures based on the requirements of § 3642.⁶¹ For the latter, the Commission proposes procedures whereby the Postal Service will submit, on at least 15 days notice, revisions to the MCS so that the MCS conforms with the Domestic Mail Manual (DMM); the Commission, meanwhile, will only review those revisions for formatting purposes.⁶²

A. Medco Health Solution’s APA argument seems to be inconsistent with the regulatory scheme contemplated by the Commission

Medco Health Solutions argues that the Commission’s proposed classification procedures are inconsistent with the APA because they do not include an opportunity for public comment on changes to the MCS below the level of adding, deleting, or transferring a product.⁶³ Its argument that modifications to the product descriptions within the MCS are an “exercise of the Commission’s rulemaking process” seems to be inconsistent, however, with the regulatory structure contemplated by the Commission in its rules.

The Commission describes the MCS as being the “appropriate vehicle” through which it will fulfill its statutory responsibility to maintain the “lists” of competitive and market-dominant products under § 3642. As the Commission states:

The Commission is charged with maintaining accurate product lists. 39 U.S.C. § 3642. The Commission views the Mail Classification Schedule as the vehicle for presenting the product lists with necessary descriptive content. The explanatory information included with the product lists will inform participants in Commission proceedings of the nature and scope of Postal Service products and must be sufficiently detailed to allow the Commission to verify that the rates and categorization of products are in compliance with the PAEA. Thus, the Mail Classification Schedule is

⁶¹ See Part 3020, Subparts B, C, and D.

⁶² See Part 3020, Subpart E; Order No. 26 at 98. The Commission has proposed separate procedures for changes to the size and weight limitations for mail matter. See Part 3020, Subpart F.

⁶³ Medco Comments at 9-10.

important in that it will provide for the transparent and accurate maintenance of the product lists.

The Commission finds the Mail Classification Schedule to be the appropriate vehicle for maintaining the market-dominant and competitive product lists that the Commission is charged with overseeing. This does not impose constraints on the Postal Service's flexibility to develop new products or modify products consistent with the policies of title 39. The Commission's primary role under 39 U.S.C. § 3642, as evident from the proposed rules, is the proper categorization of Postal Service products. The rules proposed for updating product descriptions and features in the Mail Classification Schedule will not inhibit Postal Service flexibility.⁶⁴

Therefore, the fundamental purpose of the MCS within the new regulatory system is to identify the "products" for purposes of the Act, and to categorize those "products" as market-dominant or competitive. The "product lists" within the MCS serve this purpose. Below the product lists, however, the "product descriptions" within the MCS do not serve to restrict the ability of the Postal Service to make business decisions concerning the provision of its existing products without first going to the Commission, as the DMCS did.⁶⁵ Instead, the product descriptions within the MCS simply summarize what is within the Postal Service's broader tariff (the DMM), and are structured so as to accord with the product lists also appearing in the MCS. This distinction between the MCS and the DMCS reflects the fact that the Commission's function under the Act has changed from designing classifications pursuant to a set of statutory criteria to ensuring that the Postal Service stays within the bounds of the statute.

The Commission's proposed rules regarding changes to the MCS reflect the changed regulatory landscape mandated by the Act, conferring on the Postal Service

⁶⁴ Order No. 26 at 85-86.

⁶⁵ In Subpart F of Part 3020, however, the Commission has restricted the ability of the Postal Service to make changes in the size and weight limits for market-dominant products. Why it has decided to do so is not immediately apparent, and the Postal Service suggests that the Commission simply handle all classification changes below the § 3642 level in accordance with the provisions of Subpart E.

the flexibility to manage its existing products. The Commission's rules contemplate a real difference between revising the "list of products" in the MCS and revising the descriptions of those products in the MCS. The Act requires the Commission to review any proposed new "product" pursuant to § 3642, and Subparts B, C, and D of Part 3020 of the proposed rules therefore apply to proposals to modify "the market-dominant product list or the competitive product list appearing in the MCS" by adding, deleting, or transferring a product.⁶⁶ Subpart E, meanwhile, applies to changes in the "product descriptions," rather than to the "list of products."⁶⁷ These are changes to the operational terms and conditions concerning the provision of an existing product, which do not constitute a change so profound so as to essentially create a new product.⁶⁸

The Commission describes the procedures of Subpart E as "provid[ing] a simplified path for the Postal Service to provide necessary updates to the [MCS]," in order to ensure "that the product descriptions (i.e., all information about a product appearing in the [MCS]) accurately reflect the current offerings of the Postal Service."⁶⁹ The Commission will not review such classification changes on their substantive merits, but will simply review the changes for formatting purposes, and will update the MCS to coincide with the effective date of the DMM change as specified by the Postal Service.⁷⁰ This "preserv[es] the Commission's editorial rights in the [MCS]," while giving the Postal Service the flexibility to manage its product structure.⁷¹

⁶⁶ See, e.g., 39 C.F.R. § 3020.30 (as proposed).

⁶⁷ See 39 C.F.R. § 3020.90 (as proposed).

⁶⁸ See Order No. 26 at 97.

⁶⁹ *Id.*

⁷⁰ *Id.* at 97-98.

⁷¹ *Id.* at 98.

Thus, the substantive decision to change the product descriptions in the MCS will be made by the Postal Service when it decides to update the DMM, with the Commission simply updating the MCS in order to ensure that it conforms with the newly revised DMM. The Commission will not determine or consider the substantive lawfulness of the change when it updates the MCS. The Commission is therefore not exercising its “rulemaking authority” when it changes the MCS, and the “notice and comment” requirements of the APA do not apply.

In this regard, however, it seems prudent for the Commission to revise its tentative decision to incorporate the entirety of the MCS into 39 CFR. Since changes to the provision of an existing product are in substance made by the Postal Service in the DMM, with the Commission simply revising the MCS under Subpart E so that it accords with the DMM, it seems confusing for the Commission to designate the “product descriptions” within the MCS as being part of its regulations. The Postal Service notes, for example, that § 503 of title 39 states that the regulations of the Commission “shall not be subject to any change...by the Postal Service.” In addition, placing the “product descriptions” of competitive products into the Commission’s regulations raises serious questions as to whether such treatment would conform with § 3632, which gives the Governors the ability to enact classification changes for competitive products, below the § 3642 level. On the other hand, it does seem appropriate for the Commission to incorporate the “product lists” within the MCS into its regulations; thus, the Postal Service recommends a revision to proposed § 3020.12(a) to state that only the “product lists” appearing in the MCS are incorporated into 39 CFR.

These Commission’s proposed rules reflect the practical working relationship between the Postal Service and its customers, and the fact that it is fundamentally the duty of the Postal Service to manage its product structure so as to maintain a healthy Postal Service and a healthy mailing community. In light of the challenges of the current marketplace, the Postal Service has strong incentives to work closely with its customers to ensure that they understand the directions and purposes behind any proposed classification change. The Postal Service will thus, as discussed earlier in this proceeding, ensure that important and complex changes to prices and products will be communicated to, and discussed with, customers well in advance of their implementation, including through notices in the *Federal Register* and an opportunity for formal comment.⁷² This will, in turn, ensure that interested parties are able to fully engage with the Postal Service prior to the classification change being noticed pursuant to Subpart E. The Commission, meanwhile, should step in only if a mailer challenges the Postal Service’s business decision for not complying with title 39.⁷³

B. Valpak and McGraw-Hill’s suggestions that “major” classification changes be subject to prior review should not be adopted

Valpak and McGraw-Hill both argue that the Commission should conduct pre-implementation review of “major” classification changes, since relying on after-the-fact review is in their view neither fair nor efficient.⁷⁴ Valpak, in arguments that are similar to its arguments concerning the review of Type 1 market-dominant rate adjustments, discussed earlier, states that such review of major classification changes should include

⁷² See Postal Service Initial Comments on First Advance Notice at 15; Postal Service Supplemental Comments on the Classification Process at 12.

⁷³ As the Commission notes, “other checks and balances always are available such as the complaint process. This is consistent with both allowing the Postal Service flexibility and providing after-the-fact review where appropriate.” See Order No. 26 at 97.

⁷⁴ Valpak Comments at 12-16; McGraw-Hill Comments at 2-5.

the opportunity for public comment, and should be *completed* prior to the notice of rate adjustment that is associated with the classification change.⁷⁵ McGraw-Hill suggests that, at the very least, the Commission should handle “major classification changes” under Subpart E of Part 3020 the same way it handles size and weight limit changes under Subpart F, which sets forth a 45-day review period for such changes.⁷⁶ In addition, it suggests that the Commission should promulgate a rule allowing it to extend the 45-day period upon its own initiative or at the request of an interested party, for good cause shown.⁷⁷

Congress clearly intended that the Postal Service be able to act more like a business.⁷⁸ In this regard, as discussed above, the Commission’s proposed rules accord with the understanding of the need for flexibility in order for the Postal Service to operate within the current market environment. The Commission has appropriately concluded that it should review the substance of a classification change only if a mailer can claim that it is unlawful. This construction reflects not only the Commission’s adjudicatory role under the Act, but also the fact that the substantive standards specified by the Act give the Postal Service increased flexibility to act according to its business judgment.⁷⁹

In addition, mailers will also have the ability to engage fully with the Postal Service on the substantive merits of a classification change before it is noticed to the Commission pursuant to Subpart E. As discussed in detail above, the Postal Service

⁷⁵ See Valpak Comments at 16.

⁷⁶ See McGraw-Hill Comments at 4-5.

⁷⁷ *Id.* at 5.

⁷⁸ See, e.g., H.R. REP. NO. 109-66, part 1 at 43 (2005) (“The objective of the bill is to position the Postal Service to operate in a more business-like manner.”).

⁷⁹ In addition, it would also seem difficult for the Commission to attempt to draw a line between “major” and non-major classification changes.

has a strong incentive to ensure that its customers understand the directions and purposes behind any proposed classification change, especially when it comes to major and likely controversial classification changes, like those identified by Valpak and McGraw-Hill. Major changes such as these will include the opportunity for consultation and comment. The Postal Service therefore urges the Commission to maintain its rules as proposed.

C. There is no need for rules addressing the timing of a classification change notice associated with a price change

MMA argues that the Commission should preclude the Postal Service from changing mail preparation requirements at the same time that it changes rates pursuant to § 3622(d)(1)(C).⁸⁰ This is impractical, however, since classification changes are often closely associated with rate changes. It is also unnecessary, since the Postal Service, as discussed previously, plans to provide as much, or more, notice of a classification change as it provides notice of the associated price change, which will be 90 days in the case of the annual general price change for market-dominant products.⁸¹

Valpak suggests that the Commission should require in its rules that the Postal Service provide notice to the Commission of a classification change accompanying a price change at the same time it provides notice of the price change.⁸² This conforms to the Postal Service's intentions for the future, so there is no need to include it in a rule.

⁸⁰ MMA Comments at 6.

⁸¹ See Postal Service Supplemental Comments on the Classification Process at 13.

⁸² Valpak Comments at 15.

III. The Price Cap Compliance Calculation

Several parties filed comments addressing price cap compliance issues, raising various questions. Their discussions of the matter, however, are based largely on a misapprehension of the fundamental operation of a price cap regime. With one possible minor exception, the actual changes they suggest in the methodology proposed by the Commission for cap compliance calculations should not be adopted.

Before responding directly to the parties' comments, it is constructive to clarify exactly what the inflation-based cap on rates is intended to achieve. First and foremost, the cap operates on "the percentage change in rates."⁸³ It therefore starts with current rates and, at the class level, limits the allowed percentage change in those rates to the measured rate of inflation. Conversely, it is not a cap on average revenue per piece over some specified time period. Thus, in the most simplified example, if there were only one rate for an entire class to which the cap were being applied, for purposes of the cap calculation it would be irrelevant whether that rate had been constant over the previous year, or had changed once or even twice over the course of the previous year, although any of those circumstances would likely affect the average revenue per piece reported for that time period. For purposes of determining the base rate to which the cap would be applied in this simplified hypothetical, the Postal Service would simply use the current rate for the class at the time the notice of price change was filed.

How did average revenue per piece even enter into the discussion? In reality, unlike in the simplified example discussed above, there are multiple rates in each class, and some weighting mechanism must be applied to ensure that a weighted, overall

⁸³ 39 U.S.C. § 3622(d)(1)(A).

average change in rates for the class does not exceed the cap. To control for differing seasonal variations in mail volumes, the most obvious weights to apply are billing determinants for the most recent four quarters. Intuitively, the Postal Service should multiply each element in its set of rates by the applicable billing determinant, sum the products, and get a total that, by construction, looks on the surface like total class revenue. In reality, of course, how that sum gets characterized is irrelevant in the cap compliance context, as it is simply a comparison of two sums—the sum obtained using the set of current rates versus the sum obtained using the proposed rates (using the exact same fixed set of volume weights for each set of rates)—and a determination of the percentage difference between the two sums. In the proposed rules, this process is laid out in §§ 3010.23(b)-(c). The Commission, however, prudently does not characterize the sums obtained from this process in any way, and neither the term “revenue” nor the term “revenue per piece” appears anywhere in proposed § 3010.23.

Nonetheless, in theory, one could further divide each sum by total volume, thus purporting to derive average revenue per piece. But that further complicating step would do nothing to alter the calculation of the percentage difference. Moreover, if rates for the class changed over the course of the previous year, total class revenue constructed from the above process using current rates would differ from actual class revenue reported for the historical year. Likewise, constructed average revenue per piece would differ from historical revenue per piece. Neither circumstance, however, has any bearing on the validity of the cap compliance calculation.

To reinforce this point, it might be useful to re-examine the necessity of using billing determinants for the most recent four quarters as volume weights. As suggested

above, using such a set of billing determinants allows control for seasonal mailing patterns which may differ by rate element within the class. But once that control has been achieved by focusing initially on those figures, a variety of weights corresponding to average values for time periods other than an entire year can easily be derived. For example, each four-quarter billing determinant could be divided by 12 to identify the average monthly billing determinant. Average monthly values thus derived could be substituted for the yearly billing determinants in the overall computation process, and the ultimately resulting percentage differences would be every bit as valid as those derived using the set from four quarters. Of course, they would also be computationally identical, as the 1/12th appearing in both the numerator and denominator would cancel out. The point is, however, that no material significance should be associated with the time interval to which the volume weights relate and the “revenue” or “average revenue per piece” figures which might be calculated, because the purpose of the exercise is to identify percentage differences between sets of rates, and not to generate estimates of total revenue or revenue per piece for particular time periods.

Pitney Bowes seems to have fallen into the exact trap which the Commission so meticulously avoided in its drafting of § 3010.23. In its comments, Pitney Bowes argues that:

The proposed rules must be clarified, however, to make clear that the Commission will assess compliance with the annual limitation on the basis of the average revenue per piece within a particular class, and not on the basis of the actual “current rate.” The proposed regulations may be read to require an assessment on the basis of average revenue per piece derived from historical billing determinants information. This is an appropriate approach and one that will provide mailers with the assurance inherent in the PAEA that from year to year postage rates within a given class of mail, on average, will not increase at a rate greater than inflation. Nevertheless,

the proposed rules could be clearer and the explanatory narrative and the proposed rules should be further clarified to make this point explicit.⁸⁴

Pitney Bowes is incorrect in asserting that the cap should be applied to average revenue per piece rather than actual “current rates.” It would be equally incorrect to suggest that observed year-to-year changes in average revenue per piece should play any role in the evaluation of cap compliance, although it is not clear whether Pitney Bowes is actually making that suggestion. Pitney Bowes is advocating clarification in the proposed rules and the accompanying narrative, but since it offers no specifics (at least with respect to the rules), and the principles it appears to be espousing are clearly misdirected, the Commission should decline to alter its course in response to its comments.

Time Warner, on the other hand, endorses the approach chosen in the Commission’s proposed rule, and criticizes earlier comments that variously advocate reliance on changes in total revenue or changes in average revenue per piece to measure cap compliance.⁸⁵ In particular, Time Warner challenges the unnecessary prospect of post hoc review and adjustments associated with methodologies that would focus the operation of the cap on changes in total revenue or changes in average revenue per piece, rather than on changes in rates, as the Act intends.⁸⁶ Time Warner also presents a strong case as to why before-rates billing determinants are the appropriate volume weights to use. The only concrete suggestion made by Time

⁸⁴ Pitney Bowes Comments at 10-11.

⁸⁵ See Time Warner Comments at 6-10.

⁸⁶ By focusing on overall revenue, for example, the comments of James I. Campbell, Jr. (dated Aug. 3, 2007, posted Aug. 9, 2007), cited by Time Warner, would allow adjustment in the rate cap for one year based on volume “shortfalls or overshoots” from a previous year. The cap, in other words, would no longer be tied directly to inflation, and this procedure could in fact be used to justify rate increases greater than the cumulative rate of inflation. While such a course of action could certainly at some point in the future be advantageous to the Postal Service, it does not adhere to the price cap regime which Congress intended.

Warner regarding such billing determinants, however, seems to overlook the provisions of § 3100.23(d), which was initially and inadvertently omitted from Order No. 26, but noticed by errata the next day. Given the plain language of that provision, it would appear that the concerns of Time Warner have already been adequately addressed within the Commission's proposed rules.

DMA and Advo raise concerns that also relate to the underlying core intent of the price cap.⁸⁷ Specifically, they question whether the partial year adjustment provision violates the principle of "rate increases no greater than the rate of inflation,"⁸⁸ alternatively stated as the principle that "cumulative average rate increases can not exceed the cumulative corresponding change in the CPI-U index"⁸⁹ The Postal Service submits that, in fact, the partial year adjustment provision proposed by the Commission fully complies with this objective.

To support its position, Advo attached a relatively lengthy and complicated statement from two technical experts, Antoinette Crowder and William C. Miller. It appears, however, that the essence of the Crowder/Miller statement can more fruitfully be discussed in the context of DMA's much shorter and more direct statement of what appears to be the identical concern:

We are further concerned that the proposed regulations allow the Postal Service to accrue and use Cap authority on a monthly basis. While we are certain that the Postal Service would not actually raise rates monthly and we are not troubled by their ability to have different rates in effect at different times of the year, there is one aspect that does concern us. If the Postal Service raises rates part way through the year, we are concerned that Cap mechanics (as defined in the Proposed Regulations) actually could allow the Postal Service to increase their revenues above the CPI Cap. Consider an example where the average rate for a class is a dollar

⁸⁷ See DMA Comments at 6-8; Advo Comments at 5-6.

⁸⁸ DMA Comments at 6.

⁸⁹ Advo Comments at 6.

for the first year of the new system. But halfway through the year the Service uses its six months of Cap authority – assumed for this example at 3 percent per year – and raises the rate to \$1.015. Then, at the end of the year, the Service raises rates again to \$1.03. If the regulations allow this, the Service will have collected excess revenue (at constant volumes and mix) even though the rate at the end of the year will be only higher than that at the end of the previous year by the amount of inflation in the CPI.⁹⁰

Fundamentally, DMA (and Advo) seem to be conflating two distinct questions.

One question is, would a mid-year rate change of the type hypothesized above by DMA, if implemented pursuant to the partial year adjustment provision, represent allowance of a rate increase greater than the rate of inflation? The second question is, could such a hypothetical rate change legitimately raise other concerns? The Postal Service submits that the correct answer to the first question is an emphatic “no,” while the correct answer to the second question is merely “perhaps.”

To address the first question, it is useful to restate the logic behind the approach that the Commission has adopted for both full year and partial years adjustments.⁹¹ According to those provisions, the final average CPI-U value (call it C) is an average of the last 12 months (whenever that occurs). The initial value (call it A) is an average over the base period. Any intermediate values, whether full or partial year, are the average of the most recent 12-month period divided by the previous “most recent 12-month period” (call it B). Fortunately,

$$B/A * C/B = C/A$$

So, regardless of the magnitude of the increase or decrease in the CPI-U, under the approach embodied within the proposed rules, one always comes back to C/A, which is

⁹⁰ DMA Comments at 7-8.

⁹¹ See 39 C.F.R. §§ 3010.21, 3010.22, and 3010.26 (as proposed).

consistent with the CPI-U increase for the entire period, from the start of the base period to the end of the final period.

For additional price increases, one can just add letters in sequence:

$$B/A * C/B * D/C * E/D = E/A$$

Note that the above formula does not have any months in it. That is because, properly constructed, it does not matter whether the increase is for 1 month or 24 months. Any perceived gain (or loss) incurred in one period (say, the D/C increase) is offset in the very next period (by using D in the denominator of E/D). The rule works because the current period's denominator is always the previous period's numerator.

By construction, therefore, the methodology proposed by the Commission *cannot* result in a cumulative rate increase that is higher than the correctly measured rate of inflation between the starting point and ending point of the analysis. That would be true whether the Postal Service raised rates every year, every half-year, or (as DMA posits hypothetically) every month. There is no time dimension to a change in rates, because the change occurs in the instant the new rates become effective and the old rates become obsolete.⁹² The Commission has proposed a sound methodology that unambiguously achieves the objective of a cap on rates, as distinguished, for example, from a cap on revenue, or a cap on average revenue per piece.

Thus, even when DMA questions whether the Postal Service would, under its hypothetical, “have collected *excess revenue*,” DMA must itself concede that the actual rate would have grown by no more than the amount of inflation.⁹³ Similarly, although it

⁹² A rate change from 10 cents to 15 cents is a 50 percent rate increase, whether the 10-cent rate was actually in effect 2 weeks, 2 months, or 2 years, or whether the 15-cent rate is expected to be in effect 2 weeks, 2 months, or 2 years.

⁹³ See DMA Comments at 8 (emphasis added).

explicitly makes no similar concession, the analysis submitted on behalf of Advo is grounded not on the change in rates, but rather on the change in “the average postal price for Year (t).”⁹⁴ The concept of changes in “average postal price” between years very clearly involves a time dimension, and is therefore beyond the scope of what a rate cap compliance calculation is intended to measure. As stated earlier, the Postal Service concludes that a mid-year rate adjustment of the type hypothesized by DMA would not result in rates higher than the cumulative rate of inflation.

That conclusion, however, leads to further examination of the second underlying question raised by DMA and Advo, regarding the potential *revenue* consequences of such potential mid-year rate adjustments. Clearly, as DMA suggests with respect to its hypothetical, if a relatively constant amount of inflation is recaptured via two smaller increases (one halfway through the year and one at the end) versus one larger increase at the end of the year, the Postal Service will end up with more revenue under the first scenario than under the second.

But this is not always the effect on revenue of a mid-year rate adjustment. Consider instead an alternative set of circumstances. Assume that the Postal Service has been routinely making annual rate adjustments on a January implementation cycle. Under the DMA alternative, rate changes in January of Years 0 and 1 are followed by an additional rate change in July of Year 1. But in another alternative, after raising rates in January of Year 0, the Postal Service for some reason cannot raise rates in January of Year 1, and must postpone until July of Year 1. Under this set of circumstances, the Postal Service could use the partial year adjustment provision (plus the unused authority provision) to capture all of the inflation between January of Year 0 and July of

⁹⁴ See Crowder/Miller Statement at 6.

Year 1. Moreover, using the partial year adjustment provision, it could get back on the January cycle at the beginning of Year 2. In this way, the inflation between January of Year 1 and July of Year 1 is not lost. Compared with the hypothetical posed by DMA, in this alternative, the Postal Service ends up with less revenue during Year 1 (than it would have obtained if it had been able to maintain the January cycle), but the ending rate is the same.

A baseline and these potential alternatives can be summarized as follows, all predicated on an established January-January cycle.

Baseline: JaY0 JaY1 JaY2 JaY3

Scenario One (DMA): JaY0 JaY1 JuY1 JaY2 JaY3

Scenario Two: JaY0 JuY1 JaY2 JaY3

Hopefully, the discussion above has established that, regardless of the scenario, each successive rate increase can be (and, applying the Commission's methodology, would be) calibrated such that the resulting cumulative rate increase would match cumulative inflation over the applicable interval. Thus, the allowable cumulative increase through JaY3 will be at the same level in the Baseline, Scenario One, and Scenario Two, despite varying numbers of, or schedules for, intermediate rate changes. In that sense, compliance with the rate cap is not the issue.

Compared with the Baseline, however, each of the scenarios would have consequences for cumulative revenue. The Postal Service picks up revenue in Scenario One, but loses revenue in Scenario Two. In essence, DMA and Advo are concerned about the revenue consequences of Scenario One, but neither party purports to address Scenario Two. It seems fair to assume, though, that because the Postal

Service comes out with less revenue in this instance, any level of concern on their part would be reduced correspondingly.

At this point, the salient question becomes, is there any material basis for DMA and Advo to be concerned? The Postal Service submits that, given the totality of the Commission's proposed rules, there is not. What both DMA and Advo appear to be overlooking is proposed § 3010.7, which requires the Postal Service to file with the Commission a schedule of rate changes that are anticipated to occur at specified regular intervals. More importantly for purposes of this discussion, the Postal Service would also be required to explain any revisions to or variations from that schedule.

Consider, therefore, the consequences of this proposed rule for Scenario One. If the Postal Service were to wish to add a mid-year rate adjustment into what would otherwise be an annual cycle, it would have to explain that change in the schedule. In other words, contrary to the implications of DMA and Advo, and notwithstanding the methodology by which cap compliance is evaluated, the Postal Service could not interject an additional mid-cycle rate increase without some articulated rationale.

Equally importantly, consider Scenario Two, in which the anticipated January increase in Year 1 for some reasons slips to a later time, July in our hypothetical. The Commission's proposed cap compliance methodology beneficially allows the late implementation to capture (albeit with the standard one-year lag) the additional amount of inflation accruing between January and July. This avoids implications for subsequent downstream inflation-based adjustments. Unfortunately, it does not restore to the Postal Service the higher revenue that would have been generated by an on-cycle rate increase six months earlier. Once again, in order for Scenario Two to occur, the Postal

Service would, under proposed § 3010.7, need to explain the circumstances leading to the revised timing of the rate change. But the flexibility afforded by the proposed cap compliance rule in this instance would seem to be viewed as beneficial from all perspectives. Specifically, DMA and Advo offer no criticism which would suggest that operation of the proposed rules would be to their detriment under a Scenario Two hypothetical.

In conclusion, DMA argues that the rules should protect against rate changes made more frequently than annually which could have detrimental consequences on the overall level of postal revenues that mailers must generate.⁹⁵ The Postal Service submits that such protection can already be found in § 3010.7 of the proposed rules, which is specifically designed to achieve rate stability and predictability. Advo, on the other hand, affirmatively proposes that the cap compliance calculation be modified (although never providing actual substitute language for the proposed rule). The Postal Service contends that the technical analysis upon which Advo relies is premised on a fundamental misperception of cap compliance measurement in the context of a cap on rates. The root of the concern raised by Advo (excessive revenue rather than excessive rates) is no different from that raised by DMA, and the appropriate resolution of that concern is attention to the provisions of § 3010.7. Neither party offers a valid basis to adjust the proposed methodology for cap compliance merely because of the prospect of revenue consequences associated with mid-cycle rate changes.⁹⁶

⁹⁵ DMA Comments at 6-8.

⁹⁶ Advo additionally suggests a technical refinement in the measurement of the cap itself, proposing what it terms a shift from a weighted average to an unweighted average. See Advo Comments at 6; Crowder/Miller Statement at 11-15. First of all, as best can be determined, the proposed change would appear to have *de minimis* practical consequences. Second, while Advo's proposal may constitute an equally valid alternative calculation, the Postal Service is not convinced that it can necessarily be

Finally, as a separate matter, DMA, ANM/MPA, and NPPC all point to an apparent tension within §§ 3010.23(a) and (b) regarding seasonal or temporary rates.⁹⁷ The Postal Service believes that if a seasonal rate is expected to be offered over a similar portion of each succeeding year, it should be treated as a separate rate cell, and the billing determinants for that rate cell should be treated within the fixed weights in the same way as the billing determinants for all other rate cells.⁹⁸ The Postal Service understands this to be the intent of the second sentence of § 3010.23(a). If, however, a previous seasonal or temporary rate is no longer in effect at the time of notice of proposed rate changes, and there is no expectation that it will necessarily be offered again in subsequent years, then there is no basis to include such a rate within the set of current rates to which the cap would be applied. In such circumstances, the existing rate is, for cap calculation purposes, the current rate. The Postal Service understands this to be the intent of the third sentence of § 3010.23(b). The Postal Service is sympathetic, however, to the view of the parties that the intended interplay between these two sentences is not as clear as it might be. If the Postal Service's understanding of the third sentence of subsection (b) is correct, it could perhaps be reworded as follows:

In the case of seasonal or temporary rates, the most recently applied rate shall be considered the current rate, unless the seasonal or temporary rate is identified and treated as a separate rate cell pursuant to subsection (a).

Of course, the Commission may want to consider some alternative rewording to clarify its own intent. Overall, however, the Postal Service submits that possible

considered “statistically superior.” The Commission should decline to adopt the Advo alternative, and maintain its proposed methodology, which has much more intuitive appeal.

⁹⁷ See DMA Comments at 7; ANM/MPA Comments at 3-4; NPPC Comments at 6.

⁹⁸ See Postal Service Reply Comments on First Advance Notice at Appendix C, at 11-12.

clarification of the seasonal/temporary rate provisions of § 3010.23 is the only modification of the rate cap compliance methodology with potential merit. All other proposed changes should not be adopted.

IV. Other Market-Dominant Issues

A. The Commission should decline invitations to address at this time matters of substance concerning the “extraordinary or exceptional” provision

In its previous comments in this docket, the Postal Service expressed its belief that it is neither necessary nor prudent to determine the substantive availability of the “exceptional or extraordinary” provision at this time, in advance of an actual need to do so, because such an analysis would of necessity be highly fact-intensive.⁹⁹ The Commission largely followed this approach in its proposed rules, by setting forth a procedural framework through which the Postal Service can file, and the Commission can review, a request under § 3622(d)(1)(E). In response to comments regarding the substantive aspects of the provision, meanwhile, the Commission has specified that the Postal Service file a “focused explanation in support” of any Type 3 request.¹⁰⁰

Several parties propose modifications to the Commission’s rules that concern the substantive aspects of § 3622(d)(1)(E), none of which, in the Postal Service’s view, should be adopted at this time. ANM/MPA proposes that the Commission issue rules concerning the “rollback” of above-cap increases,¹⁰¹ the transition from a Type 3 increase back to the normal Type 1 increases,¹⁰² and how an above-cap increase

⁹⁹ See Postal Service Initial Comments on First Advance Notice at 16; Postal Service Reply Comments on First Advance Notice at 15.

¹⁰⁰ See Order No. 26 at 45.

¹⁰¹ See ANM/MPA Comments at 7; see also DMA Comments at 9.

¹⁰² See ANM/MPA Comments at 7.

should be structured with regard to the respective classes of mail.¹⁰³ NNA proposes that that the Commission issue a rule stating that anything within the “ambit” of management and labor cannot be considered “extraordinary or exceptional” under the Act.¹⁰⁴ The Postal Service submits that the record in this proceeding is not developed to the point where the Commission can reasonably resolve the issues raised by ANM/MPA. Nothing, moreover, requires the resolution of such issues at this time. The Commission should therefore defer its consideration of such issues. The Commission should also decline NNA’s invitation to impose substantive limitations on the meaning of “extraordinary or exceptional,” just as it has done with all other such arguments in this proceeding.

ANM and MPA also repeat their assertion that the failure of a class to cover its attributable costs cannot justify a Type 3 increase.¹⁰⁵ OCA and Valpak also raise this question.¹⁰⁶ While the Commission noted this issue in Order No. 26, it did not address its substantive merits.¹⁰⁷ This is consistent with Time Warner’s argument that the “[t]he Commission need not and should not decide that failure of a class to recover attributable costs could *never* constitute exigent circumstances justifying increases in excess of the applicable cap.”¹⁰⁸ The Postal Service concurs with this general position, for the reasons discussed above and in its earlier comments. Instead, the Commission should adhere to its careful approach of establishing a procedural framework for the filing and review of Type 3 increases, without specifying the circumstances in which

¹⁰³ See *id.* at 7-8.

¹⁰⁴ See NNA Comments at 12.

¹⁰⁵ See ANM/MPA Comments at 6 n.4.

¹⁰⁶ See Valpak Comments at 24-26; OCA Comments at 21.

¹⁰⁷ See Order No. 26 at 43-44.

¹⁰⁸ Time Warner Reply Comments on First Advance Notice at 33-34.

such filings can be made, the specific nature of allowable increases, or how the Postal Service and Commission might transition from a Type 3 increase back to the normal CPI-U increases.

Consistent with such an approach, the Postal Service endorses two proposed changes to the Commission's Type 3 rules, which serve to better conform those rules to the language of the Act. First, NPMHU suggests that the Commission delete the requirement in § 3010.61(7) that the Postal Service explain why the circumstance giving rise to a Type 3 request was not "foreseeable."¹⁰⁹ As NPMHU notes, there is no requirement in the Act that the "extraordinary or exceptional circumstances" be unexpected or unforeseeable.¹¹⁰ Second, both NPMHU and APWU note that the circumstances that could give rise to an above-cap rate request might not always have a temporary effect.¹¹¹ An example would be the passage of Do Not Mail legislation. In this regard, the Postal Service endorses NPMHU's specific suggestion that the Commission amend § 3010.61(6) so that it reads: "(6) An explanation of whether, and if so, when, or under what circumstances, the Postal Service expects to be able to rescind the exigent increases in whole or in part."¹¹²

Finally, APWU faults the proposed rules for not allowing interested parties to conduct discovery on a Type 3 request, and suggests that questions submitted by interested parties should be answered at the hearing contemplated by § 3010.65(b) unless they are irrelevant or objectionable.¹¹³ The Commission's proposed rules, however, seem reasonable in order to expeditiously handle a § 3622(d)(1)(E) request

¹⁰⁹ NPMHU Comments at 4-7.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 7-8; APWU Comments at 9.

¹¹² See NPMHU Comments at 8.

¹¹³ See APWU Comments at 9.

from the Postal Service. As the Commission notes, the short time frame contemplated by the statute for the review of the Postal Service's request precludes more elaborate proceedings.¹¹⁴ Overall, the proposed procedures seem to be fully consistent with the Act, and with the Commission's broad discretion concerning how to implement the requirement that parties be accorded "notice and opportunity for a public hearing and comment."

B. The Commission should maintain its decision not to adopt a service quality adjustment to the CPI-U index

Several parties raise the issue of adjusting the price cap in response to service quality degradation. ANM/MPA and NPPC ask the Commission to reconsider its decision not to adopt such an adjustment to the index, and propose in general terms a means for calculating such an adjustment.¹¹⁵ DMA and McGraw-Hill, meanwhile, urge the Commission to establish, in its rules, a general expectation that an adjustment to the index should follow service quality degradation.¹¹⁶

The Commission chose to defer consideration of a service quality adjustment, noting the absence on the record of any method for applying such an adjustment, and the lack of a need to develop any rules on this issue at this time.¹¹⁷ The Postal Service urges the Commission to adhere to this position. Most fundamentally, as the Postal Service discussed previously in this proceeding, the Act seems to provide no legal foundation for such an adjustment to the index.¹¹⁸ In addition, even if such an adjustment were permissible, nothing on this record indicates, with the precision

¹¹⁴ Order No. 26 at 46.

¹¹⁵ ANM/MPA Comments at 4-6.

¹¹⁶ See DMA Comments at 8-9; McGraw-Hill Comments at 8-9.

¹¹⁷ See Order No. 26 at 32-33.

¹¹⁸ See Postal Service Reply Comments to First Advance Notice at 16-17.

necessary for the promulgation of a rule, how such an adjustment could be calculated or applied. It also does not seem appropriate or necessary to include a rule stating that an adjustment to the index may occur, without any indication of exactly how. Overall, the Commission would be wise to follow its decision in Order No. 26 and let experience over time serve as a guide to whether additional regulations in this area prove necessary. This will allow the Commission to address fully and comprehensively the legal and practical questions concerning this issue on the basis of concrete facts, rather than hypotheticals.

C. The attributable cost “factor” should be applied at the class level

OCA and Valpak both raise questions as to the role of § 3622(c)(2) in the new regulatory regime, and urge the Commission to provide additional guidance in that regard.¹¹⁹ Valpak, for example, asserts that the failure of a “class or subclass” to cover its attributable costs violates both § 3622(c)(2) and the “just and reasonable” standard, and asks at what level (class or product) the (c)(2) “requirement” applies.¹²⁰

As the Postal Service noted previously in this proceeding, the provisions of § 3622 seem to be set forth in a hierarchical manner, with the “factors” of § 3622(c) subordinate to the other provisions of that section.¹²¹ Thus, the attributable cost principle laid out in § 3622(c)(2) clearly does not have the same primacy under the Act as it did in the prior regime, since it was not placed by Congress within the “objectives” of § 3622(b) or the “requirements” of § 3622(d).¹²² Nevertheless, the fact that this provision is still styled as a “requirement” suggests that it retains a level of importance

¹¹⁹ See Valpak Comments at 17-20; OCA Comments at 18-22.

¹²⁰ See Valpak Comments at 18-19.

¹²¹ Postal Service Initial Comments on First Advance Notice at 7-8, 21.

¹²² See, e.g., Time Warner Reply Comments on First Advance Notice at 30.

above that of the other “factors” of § 3622(c). It may therefore be useful, as Valpak and the OCA suggest, for the Commission to provide additional guidance as to the meaning of the provision.

Logically, § 3622(c)(2) should be interpreted as requiring that each “class” of market-dominant mail cover its attributable costs. The plain language of the Act applies it at the class level. While the Commission previously read the language of (c)(2) to apply at the subclass level under the PRA, the concept of a subclass is now, in the Commission’s words, “largely an irrelevant artifact” in the new regulatory system.¹²³ The classes, on the other hand, remain of central importance in the new regime since the price cap is applied at the class level. Furthermore, the provision should not be read as applying at the “product” level, since if Congress wished to apply it at the product level it would have assuredly said so, just as it did on the competitive side.¹²⁴ This seems consistent with the Commission’s understanding, since Order No. 26 distinguishes market-dominant from competitive products specifically by reference to the fact that the Act requires each competitive product to cover its attributable costs, and notes that because of this the “term ‘product’ has greater significance for competitive products than for market-dominant products.”¹²⁵

D. The Act sets forth no link between the Docket No. R2006-1 increases and the timing of the first price change under the new rules

DMA repeats its earlier argument that the Commission’s rules should expressly preclude the Postal Service from implementing its first rate increase under the new

¹²³ See Order No. 26 at 76.

¹²⁴ As the Commission notes, it can be assumed that in drafting the Act, “Congress was well aware of the Commission’s long-established definitions.” See *id.* Congress can thus be assumed to have intentionally chosen not to apply the (c)(2) factor at the “product” level.

¹²⁵ *Id.* at 78.

regime prior to May 14, 2008, one year after the implementation of the Docket No. R2006-1 increases.¹²⁶ Implementation before that date would, according to DMA, “violate” § 3622(d)(1)(A), unless the increase was pro-rated. As the Postal Service previously noted, however, there is no statutory link between the Docket No. R2006-1 increase and the first increase under the new rules.¹²⁷ The principle of annual increases not exceeding the rate of inflation is the norm going forward, but does not specify how the Postal Service and Commission should transition into the new regime.

In addition, the Postal Service sees no justification for a link between the two events. The implementation dates for the Docket No. R2006-1 increases were not chosen with transitioning to the new regime in mind, and thus should not affect the Postal Service’s ability to choose the first implementation date for the new regime, which will likely be of considerable importance going forward. Thus, the Commission should decline DMA’s invitation to create restrictions that do not arise from the Act.

E. The Commission should not adopt the ECP-based arguments of Pitney Bowes

Pitney Bowes raises several issues regarding Efficient Component Pricing (ECP).¹²⁸ The one very specific criticism of the proposed rules it advances is the Commission’s inclusion of “substantially” in the last sentence of § 3010.14(b)(6):

The Postal Service shall also identify and explain discounts that are set substantially below avoided costs and explain any relationship between discounts that are above and those that are below avoided costs.

¹²⁶ DMA Comments at 2-3.

¹²⁷ See Postal Service Reply Comments to First Advance Notice at 23.

¹²⁸ Pitney Bowes Comments at 2-7. Much of its comments concerning ECP have been addressed previously by the Postal Service in this proceeding, particularly as they relate to the proper role for ECP in the statutory scheme.

Pitney Bowes argues that “substantially” should be stricken from this rule.¹²⁹ The result of this modification would be that, in addition to justifying all discounts that exceed avoided costs, the Postal Service would also have to identify and explain each and every workshare discount set below the level of avoided costs, even if the difference is by the most minimal of margins.

This proposal is a transparent attempt by Pitney Bowes to rewrite the statute. The Act indicates that workshare discounts should not be above avoided costs unless certain specified exceptions apply.¹³⁰ If Pitney Bowes had its way, however, similar restrictions would apply equally to discounts below avoided costs as well. Pitney Bowes is trying to get the Commission to create an absolute symmetry that is simply absent from the statute. Had such symmetry been intended, Congress undoubtedly could have required it.

Pitney Bowes initially argues that its proposed revision would not prejudice the Postal Service, because there would be no absolute bar against discounts below avoided costs.¹³¹ Yet one wonders why Pitney Bowes would be advocating this revision if it truly believed that the change would have no effect on the Postal Service’s ability to set discounts at levels which the Postal Service might otherwise be inclined to select. More likely, this revision is intended to ultimately restrict the Postal Service’s pricing flexibility, in a manner not contemplated by the Act.

Indeed, Pitney Bowes is somewhat more forthcoming later in its comments, when implicitly acknowledging that adoption of full-scale ECP would constrain the Postal

¹²⁹ See *id.* at 2-3.

¹³⁰ 39 U.S.C. § 3622(e).

¹³¹ Pitney Bowes Comments at 3.

Service's flexibility under the price cap regime.¹³² Nonetheless, Pitney Bowes argues, since the Postal Service's pricing flexibility is already statutorily constrained by virtue of the provision regarding discounts in excess of avoided costs (as well as by the attributable cost floor), imposition of an additional, non-statutory, constraint regarding discounts below avoided costs should not be a concern.¹³³ The logic seems to be, what is the harm of one more slice from a loaf that has already been cut?

In fact, though, the Postal Service has some concerns about the Commission's proposal to require an explanation of any discounts "substantially below" avoided costs. To the extent that the fundamental purpose of a price cap regime is to trade-off detailed regulatory scrutiny of every aspect of rate adjustments for a simple requirement to keep overall price changes below the rate of inflation, each new source of pressure to revert to mechanistic cost-of-service methodologies further undermines the whole rationale for the new framework. Understanding, however, that the Commission is attempting to navigate through a wide variety of competing concerns in developing an entirely new system, the Postal Service was willing accept the rule as proposed as a practical compromise, which would still allow the Postal Service to achieve a workable balance for rate design purposes. If, however, the word "substantially" were removed as Pitney Bowes advocates, this balance would be upset. A system designed to presumptively lock-in all workshare passthroughs at exactly 100 percent of avoided costs would remove much of the flexibility that a price cap system is intended to achieve. The proposal of Pitney Bowes to remove the word "substantially" from § 3010.14(b)(6) should therefore be rejected.

¹³² *Id.* at 6-7.

¹³³ *Id.*

Similarly, the Commission should reject Pitney Bowes' proposal to extend ECP beyond the traditional workshare functions specified in the statute.¹³⁴ Pitney Bowes argues that:

The principles underlying ECP can and should be extended by the Commission regulations to apply to all cost-causative characteristics of mail including shape, weight, distance, payment evidencing, address hygiene, and others.¹³⁵

The comments of NPPC appear to espouse this view as well.¹³⁶ Given these comments, it is necessary to revisit why such an extension of ECP should be rejected.

The principles of ECP become untenable if extended beyond the relatively narrow "worksharing" context for which the concept was derived. For ECP to warrant consideration in a regulatory environment, two conditions are required: (1) a *public policy* objective to enhance (though not necessarily maximize) productive efficiency,¹³⁷ and (2) a product line that is relatively homogeneous and fungible. So, for example, it is generally advantageous to the entire postal sector, and to society, for the Postal Service to offer a discount of 5 cents on a letter that is presorted, if the presort saves the Postal Service 5 cents in costs. Any mailer or third party intermediary who can presort for less than 5 cents will then have an incentive to do so, thereby reducing costs

¹³⁴ *Id.* at 3-4.

¹³⁵ *Id.* at 4.

¹³⁶ See NPPC Comments at 2-3. The structure of the NPPC comments on this issue is somewhat confusing. The initial portion of the discussion emphasizes that the workshare discount provisions of the new law apply only to traditional workshare activities, and exclude the broader activities of the type addressed by Pitney Bowes. These passages create the impression that, since the discount provisions do not apply, NPPC must be of the view that the Postal Service should be under no passthrough constraints with respect to non-workshare characteristics. Yet NPPC reaches a contrary conclusion (*id.* at 3), asserting that ECP should govern rate design for those rate elements. NPPC is apparently attempting to suggest that stricter ECP standards (ceiling and floor) should apply merely because the statutory workshare discount standards (ceiling only) do not apply. Such a conclusion would be entirely illogical.

¹³⁷ Productive efficiency, in turn, is a necessary but not sufficient condition for optimal resource allocation, *i.e.*, the maximization of consumer and producer surplus. For this, the promotion of "allocative efficiency" is also required.

for the entire postal sector. This promotes productive efficiency. Just as importantly, no mailer or third party intermediary for whom it costs more than 5 cents to presort will have an incentive to do so. This protects against an increase in costs for the entire postal sector, again promoting productive efficiency.

However, the model works because letters, whether presorted or not presorted, are sufficiently homogeneous and fungible. A letter that is not presorted can fairly easily be converted into a letter that is presorted, and still retain its essential nature (*e.g.*, an envelope containing a bill payment). What about the mail characteristics specified by Pitney Bowes as producing “non-workshare related cost differences?”¹³⁸ Let us examine, with the benefit of two hypothetical examples, weight and shape.

With respect to weight differences, when one customer tenders to the Postal Service a parcel that weighs twice as much as that of another customer being sent to the same destination, the Postal Service’s handling costs for the two parcels will differ. The traditional ECP/worksharing argument—that that productive efficiency can be promoted—does not pertain, however, and thus could not justify the rigid application of ECP. This is because the two parcels are not homogeneous or fungible. Without the benefit of alchemy, the first parcel cannot easily be “converted” into the second. It is constrained by its contents. Consequently, there is little or no risk that a mailer or third party intermediary will undermine productive efficiency by spending more than the amount that the Postal Service would save in handling if the heavier parcel were magically converted to the lighter parcel. In this particular *non-worksharing* situation, promoting productive efficiency—the *raison d’être* of ECP—is a false objective.

¹³⁸ Unlike “non-workshare related” cost differences, workshare-related cost differences traditionally are referred to as “cost avoidances.”

With respect to shape differences, the extended ECP solution once again fails because productive efficiency is a false objective. Clearly, postal costs for pieces of different shapes differ. For example, a parcel costs more than a flat. It is, however, neither common nor generally easy to convert parcels into flats. The former typically consist of ordered merchandise and gifts, the latter of documents. The two are generally not homogeneous or fungible. As a result, there is little or no risk that a mailer or third party intermediary will undermine productive efficiency by spending more than the amount that the Postal Service saves to convert a parcel into a flat.

Neither Pitney Bowes nor NPPC offer any specific language for revised rules that would extend ECP to non-worksharing activities. This seems to be at least an implicit recognition of the unrealistic stretch necessary to get from the plain language of a statute intended (within bounds) to foster flexibility, to the much more rigid ratemaking system they advocate. Not only would such a system deviate from the intent of the statute, however, but there are very real issues relating to whether the extension of ECP beyond traditional worksharing contexts is even likely to achieve its assumed efficiency objectives. The Commission should not embrace the proposals of Pitney Bowes and NCCP on this topic.

F. The price cap unambiguously applies at the class level

Under the guise that it wishes to “clarify” the proposed rules, the OCA seeks to modify rule 3010.11(c) to state that the price cap is “applicable to each class or service.”¹³⁹ The Postal Service opposes this change as unsupported by the Act.

¹³⁹ See OCA Comments at 23.

The Act, at § 3622(d)(2)(A), unambiguously applies the price cap at the class level. Unused rate adjustment authority is defined as the difference between the maximum amount of a rate adjustment allowed and the amount of rate adjustment actually made.¹⁴⁰ Thus, “banked” authority is derived at the class level. The statute does not support, as OCA implies, the concept that the banking authority also applies at the “service” level.

In support of its “clarification,” OCA points to § 3622(d)(2)(c)(iii), which refers to “service” when setting forth the CPI plus 2 percent limit on the use of “banked” rate adjustment authority. The Postal Service notes that this is the only use of the term “service” in the entire discussion of the rate adjustment authority, and that it does not appear to place any further limits on the level of product aggregation used when applying the cap. The Commission should accordingly reject the OCA’s proposed modification.

G. The Commission should decline to adopt APWU’s call for a special procedure to review workshare discounts

APWU argues that the Commission should establish a procedure to review workshare discounts for compliance with § 3622(e) after the price cap review, and before the annual compliance review.¹⁴¹ Such a procedure is not, however, specified by the Act, and is in any event completely unnecessary. The Postal Service will, at the time it files its rate adjustment notice, compare workshare discounts with historic cost avoidance numbers from the last annual compliance review, and will justify any

¹⁴⁰ 39 U.S.C. § 3622(d)(2)(C)(i).

¹⁴¹ See APWU Comments at 5.

discounts that constitute a greater-than-100-percent passthrough.¹⁴² This will provide transparency using the best available workshare data,¹⁴³ and thus suffices for gauging compliance with § 3622(e) between the annual general price change and the next annual compliance review. The Commission should therefore decline the APWU's ill-conceived invitation to create procedures not set forth by the Act.

V. Competitive Products

A. The Commission's determination of the initial "appropriate share" is a challenging yet attainable benchmark that can be revisited if circumstances warrant

The Commission has proposed that, for purposes of the "appropriate share" requirement of § 3633(a)(3), the Postal Service be required to cover 5.5 percent of the total institutional costs of the Postal Service through revenues from competitive products.¹⁴⁴ The Commission calculated the 5.5 percent figure by reference to competitive products' contribution levels in FY 2005 and FY 2006.¹⁴⁵ The Commission noted that setting the initial "appropriate share" at these recent historic levels "is a reasonable means to quantify appropriate share, particularly at the outset of the new form of competitive rate regulation."¹⁴⁶

Two parties commented on this issue. First, PSA asks the Commission to reconsider its decision, and to instead recommend a 4.5 percent figure.¹⁴⁷ PSA points out that the Commission's approach of specifying the "appropriate share" based on a

¹⁴² See 39 C.F.R. § 3010.14(b)(5)-(6) (as proposed).

¹⁴³ As the Postal Service noted previously in this proceeding, cost avoidance data should only be measured annually, as part of the annual compliance report. See Postal Service Reply Comments to First Advance Notice at 21-23; Postal Service Reply Comments on Second Advance Notice at 15-17.

¹⁴⁴ See 39 C.F.R. § 3015.7(c) (as proposed).

¹⁴⁵ See Order No. 26 at 73-74.

¹⁴⁶ *Id.* at 74.

¹⁴⁷ See PSA Comments at 6.

specific share of institutional costs, rather than through a minimum percentage markup, makes the Postal Service's ability to comply heavily dependent on volumes. It then expresses concern, because competitive volumes are dependent on factors outside of the Postal Service's control (such as economic conditions and competitor actions), and because competitive volumes have declined in recent years, that the 5.5 percent figure reflects no margin of safety when compared to recent (FY 2005 and FY 2006) experience. PSA states, in contrast, that a 4.5 percent requirement would "provide a much-needed margin of safety to cushion against factors outside of the Postal Service's control."¹⁴⁸

UPS, on the other hand, expresses its concern about the Commission's decision, but does not oppose the "appropriate share" number at this time. Instead, UPS urges the Commission to establish in the future what the Commission considers to be an expectation of actual contribution, rather than merely a minimum required contribution (a "floor"), and argues that the selected level should be more in accord with historical contribution levels.¹⁴⁹

The Postal Service views the 5.5 percent figure chosen by the Commission as a challenging, though attainable, requirement at this time. The Postal Service is, of course, acutely aware of the increasingly intense competition faced by these products, and the consequent prevailing effect on their volume trends. Yet both PSA and UPS point out the fundamental flexibility the Commission has going forward to revisit the figure in the future if circumstances so require. Indeed, the Commission itself recognized this flexibility in its Order, and "emphasize[d] that its initial quantification of

¹⁴⁸ *Id.*

¹⁴⁹ UPS Comments at 2-3, 4-5.

appropriate share is not written in stone.”¹⁵⁰ The Commission then noted specifically that “it anticipates that [the need to review the appropriate share] may arise for any number of reasons, e.g., additions or deletions to the competitive products lists and market conditions.”¹⁵¹

Though UPS does not recommend an alternative appropriate share figure, several of the positions it takes in its Comments merit a brief response. For example, UPS is off base to argue that the Commission should set the appropriate share at a level that competitive products can be expected to contribute, rather than as a minimum contribution floor that should be exceeded. The new law expressly contemplates that the “appropriate share” be a floor that can and should be exceeded, as demonstrated by the assumed income tax provision of § 3634. Under the UPS approach, that tax provision would essentially become a nullity, as there would be no expectation of any competitive product “income” to tax. In addition, UPS argues that “[e]ventually, the ‘appropriate share’ should represent the actual contribution that competitive products must make.”¹⁵² Once the Commission declares a level to represent the contribution that competitive products “must make,” however, it has necessarily set a contribution “floor.” UPS appears to advocate an approach that would constantly result in a ratcheting up of the “appropriate share” in the endless pursuit of something “more” than whatever “minimum” level had been set previously, to the detriment of the Postal Service and mailers.

UPS also suggests that the Commission’s method of calculating the appropriate share—by referring to competitive products’ contribution to institutional costs in the past

¹⁵⁰ Order No. 26 at 74.

¹⁵¹ *Id.*

¹⁵² UPS Comments at 2.

two years—is “too shortsighted,” and that the Commission should instead use data from a longer time period.¹⁵³ UPS provides data stretching back to FY 1990. At the same time, however, UPS also asserts that it is inappropriate to refer to the contribution levels between FY 2003 and FY 2006 because the rates in effect during those years were the result of settled cases.¹⁵⁴ One must question, however, any suggestion that the contribution level of competitive products in 1990 or 1997 or 2002 should be relevant to determining the appropriate share, but the contribution level in FY 2005 and 2006 should not. This seems to defy logic.

It is also contradicted by the statute. Section 3633(b) speaks to the “*prevailing* competitive conditions in the market” as being relevant to the determination of the “appropriate share,” not to conditions in the marketplace 5, 10, or 15 years ago.¹⁵⁵ More fundamentally, UPS is well aware those prevailing market conditions indicate that the Postal Service may find it increasingly difficult to hold on to its customer base and maintain historical volume levels. If the Postal Service is unsuccessful in that endeavor, as PSA observes, the challenge simply to meet a target set with reference to the last two years may overcome the Postal Service’s best efforts to achieve efficiencies and restrain costs. The approach used by the Commission in Order No. 26 is appropriately grounded in current reality, rather than obscured by what may have been historical reality.

¹⁵³ UPS Comments at 3-6.

¹⁵⁴ UPS Comments at 4 n.2.

¹⁵⁵ See 39 U.S.C. § 3633(b) (emphasis added).

B. The Commission's rules for competitive rate decreases should only apply when the average rate for the product as a whole decreases

PSA suggests that the filing requirements of proposed § 3015.3, which apply to decreases in competitive products' rates, should only pertain when the average rate for a competitive product decreases, and not when a few rate cells within the product decrease. The Postal Service agrees that the Commission's proposed rules can be clarified in this regard, and agrees with PSA's approach.

In addition, PSA suggests that the requirements of § 3015.3 should only apply to the product whose average rate is being decreased, and not to other competitive products that may be increased at the same time. This accords with the Postal Service's interpretation of the current language in the Commission's proposed rules.

VI. International Mail

A. While the Postal Service, XLA, and FedEx share some common views, the competitors' views do not account for many practical and legal considerations that must be considered

Federal Express Corporation (FedEx) comments on three major issues: the classification of inbound international mail, customs parity, and the monopoly. Express Delivery & Logistics Association (XLA) also comments on the classification of inbound international mail and customs parity. Although the Postal Service is in agreement with FedEx and XLA on many of the points they raise, it disagrees with their interpretation of certain legal requirements. Moreover, FedEx and XLA fail to address practical issues that should not be ignored.

1. Classification of inbound international mail

FedEx presents the Commission with detailed comments on the manner in which inbound international mail ostensibly should be classified.¹⁵⁶ XLA also argues that inbound international mail should be classified and endorses basically the same division between the market-dominant and competitive categories for inbound mail that the Postal Service proposed for outbound mail.¹⁵⁷ The Postal Service submits that inbound international mail should be treated on an exceptional basis for the reasons outlined in its initial comments; it should neither be “classified” within the Mail Classification Schedule (MCS) nor be subject to the price cap.¹⁵⁸ Differing treatment is justified by § 407 of the Act, which establishes a framework for oversight and transparency of inbound international mail, as well as by a variety of practical considerations. Moreover, as the Postal Service noted, negotiated bilateral contractual agreements with foreign posts, which are subject to the transparency requirements of § 407, should be examined by the Commission in their entirety. This examination should take account of the reciprocal nature of inbound rates for mail exchanges, thereby leading to an interplay between inbound and outbound charges depending on the net flow.¹⁵⁹ As the Postal Service made clear, however, exceptional treatment should be accorded inbound traffic from foreign postal administrations, but not inbound mail received from customers by virtue of customized arrangements. The latter, *i.e.*, customer shipments from abroad, is appropriately subject to the regulatory regime of Chapter 36.¹⁶⁰

¹⁵⁶ FedEx Comments at 4-14.

¹⁵⁷ XLA Comments at 1-2.

¹⁵⁸ Postal Service Initial Comments at 13-24.

¹⁵⁹ *Id.* at 19.

¹⁶⁰ *Id.* at 22 n.36.

Although inbound international mail need not be classified, the Postal Service nevertheless recognized that costs and revenues for this mail still need to be reflected in its finances. The Postal Service therefore presented a proposed division of the inbound costs and revenues between the market-dominant and competitive categories, a division not too dissimilar to those proposed by FedEx and XLA.

The Postal Service concurs with FedEx and XLA's characterization of inbound EMS as competitive.¹⁶¹ With regard to parcels, however, there is only partial agreement. XLA seemingly argues that all "bulk packages" should be considered competitive.¹⁶² FedEx, in turn, argues that inbound parcels should be categorized as competitive if they are identified by the origin postal administration as "multi-item mailings tendered by a single mailer" with "multiple quantities . . . entered at the time of each mailing or throughout the course of a given term, pursuant to volume commitments or other types of annual guarantees."¹⁶³

The Postal Service does not concur with FedEx and XLA's proposed classification criteria for inbound parcels. Rather, the Postal Service submits that costs and revenues for inbound parcels tendered by posts at *negotiated* charges properly belong in the competitive category; costs and revenues for inbound parcels tendered at UPU-set inward land rates, however, should be placed in the market-dominant category.¹⁶⁴ FedEx's proposed solution—allowing foreign postal administrations to use

¹⁶¹ FedEx Comments at 7; XLA Comments at 2. Of course, the Postal Service's agreement with FedEx and XLA's characterizations of whether particular types of inbound international mail belong in the market-dominant or competitive categories is limited to agreement that this is the proper placement for costs and revenues, not that it is the proper placement for purposes of classification in the MCS and attendant regulation under Chapter 36.

¹⁶² XLA Comments at 2.

¹⁶³ FedEx Comments at 11 (quoting Postal Service Initial Comments on the Second Advance Notice at 13); see also XLA Comments at 2.

¹⁶⁴ Postal Service Initial Comments at 23-24.

the above-quoted definition to classify their shipments “for purposes of U.S. law”—is simply unworkable.¹⁶⁵ First, there is a very real issue of how to determine which parcel shipments are, in fact, bulk. The Postal Service has no ability to control how the foreign posts might choose to interpret the definition, in the first instance. Second, the Postal Service has no viable means for verifying the foreign posts’ classifications for accuracy. Third, it would be a daunting task to segregate, identify, and collect data on inbound traffic by flow according to the multi-item mailing definition that the origin post applies. The division proposed by the Postal Service—distinguishing between negotiated and UPU-set inbound charges—is much more sensible and easier to administer.

Furthermore, the competitive pricing rules are incompatible with the setting of inward land rates by the Postal Operations Council (POC),¹⁶⁶ because the competitive pricing rules implicitly assume that the Postal Service has some ability to control delivery costs and set prices for parcels received from UPU Member Countries. If the POC’s inward land rate formula results in rates that are not cost-remunerative, the competitive pricing rules may not be satisfied, despite the United States’ obligation to carry such parcels. The UPU Convention requires member countries to provide parcel service; it is not optional.¹⁶⁷ Furthermore, a special rate for inbound “bulk” parcels has not been established. The Postal Service thus has no guarantee of receiving compensatory rates for inbound parcels unless it undertakes to negotiate inward land

¹⁶⁵ FedEx Comments at 12.

¹⁶⁶ Universal Postal Convention (Convention), art. 35 (Convention), *in* UPU INT’L BUREAU, LETTER POST MANUAL I.4 (2006); UPU Parcel Post Regulations RC 188-89, *in* U.P.U. INT’L BUREAU, PARCEL POST MANUAL N.3-7 (2007).

¹⁶⁷ “Member countries shall also ensure the acceptance, handling, conveyance and delivery of postal parcels up to 20 kilogrammes, either as laid down in the Convention, or, in the case of outward parcels and after bilateral agreement, by any other means which is more advantageous to their customers.” Convention, art. 12, section 5.

rates for such traffic, which it has managed to negotiate with some, but certainly not all, foreign posts.

The Postal Service also does not share FedEx's views regarding the proposed classification of inbound bulk letters from foreign postal administrations.¹⁶⁸ FedEx states that bulk inbound letters should be categorized as competitive products, and suggests that they should fall within the definition of "bulk mail" under the UPU Letter Post Regulations.¹⁶⁹ Again, permitting foreign postal administrations to apply the Postal Service's definition is as problematic for letter post as it is for parcels for the reasons noted previously.

Moreover, the UPU regulations on which FedEx's argument is based are not relevant here. UPU regulations define "bulk" mail as the "receipt, in the same mail or in one day when several mails are made up per day, of 1,500 or more items posted by the same sender; ...[or] the receipt, in a period of two weeks, of 5,000 or more items posted by the same sender."¹⁷⁰ This definition, however, has little to do with the Postal Service's product classification and pricing. It is not directly related to the elasticity factors that serve to demarcate the market-dominant and competitive categories. Rather, the UPU definition is instead designed to enable receiving countries to charge

¹⁶⁸ FedEx Comments at 12-14. XLA's position on inbound letter post is not entirely clear. XLA expressly discusses packages but also refers to outbound commercial direct entry (bulk letters and packages) as properly being included in the competitive category and indicates that inbound mail should be classified under the same structure as outbound. XLA Comments at 2. Accordingly, to the extent that XLA also believes that inbound bulk letter post should be deemed competitive, the comments that follow are equally applicable to XLA's position. As the Postal Service previously indicated, however, it intends to seek a transfer of outbound First Class Mail International above 13 ounces to the competitive category and, for consistency, inbound letter post costs and revenues for pieces above 13 ounces also should be included in the competitive category, if such a transfer occurs. Postal Service Initial Comments at 23, n.39.

¹⁶⁹ FedEx Comments at 13-14.

¹⁷⁰ UPU Letter Post Regulation RL 124.8.1, *in* LETTER POST MANUAL, *supra* note 166, at D.11-12.

slightly higher rates to prevent against “ABC” remail arbitrage.¹⁷¹ Further, no UPU postal administration dispatches its international letters to the Postal Service using the UPU’s “bulk mail” provisions as cited in the UPU Letter Post Regulations, as making up separate dispatches with different documentation is very costly from an operational standpoint. The UPU regulations therefore should not be used to determine compliance with the Act, a purpose for which they were never intended.

Finally, FedEx’s proposed classification of inbound bulk letter post seemingly disregards the applicability of the Private Express Statutes. As a general matter, private carriage of non-urgent inbound letters is not permitted unless an exception or other suspension applies, or the letters meet the new price or weight tests contained in the Act (once the Commission issues its regulations for competitive products).¹⁷² This strongly suggests that, as the Postal Service has proposed, costs and revenues for inbound letter post tendered by posts should be placed in the market-dominant category.¹⁷³

2. Customs Parity

FedEx argues that the Act requires identical customs treatment for postal and privately carried shipments, but notes that the Commission’s responsibilities do not extend to consideration of customs parity.¹⁷⁴ As a preliminary matter, the Postal Service concurs with FedEx that § 407(e) authorizes federal agencies other than the

¹⁷¹ “ABC” remail occurs when letter items originating in country A are transported to country B and put into the postal system there in order to be sent via the international postal system for delivery in country C. Mailers have an economic incentive to engage in this practice when the international rates offered from country B to country C are lower relative to those offered for international mail originating in country A. This may arise because posts in developing countries have a different terminal dues rate structure when they send mail to industrialized countries.

¹⁷² See 39 U.S.C § 601.

¹⁷³ Postal Service Initial Comments at 23.

¹⁷⁴ FedEx Comments at 14-27.

Commission to administer the customs parity provisions of the Act.¹⁷⁵ As FedEx correctly observes, the Commission's authority extends to determinations of the categorization of products as market dominant or competitive. Any consideration of the hypothetical implications of that classification for customs authorities would not be relevant to the instant rulemaking.¹⁷⁶

The Postal Service must, however, respectfully part company with FedEx's comments on the scope and extent of the customs parity provisions of the PAEA.¹⁷⁷ FedEx argues that the Postal Service's inbound mail should be subjected to the same customs requirements as imports by private shipping companies as set forth in § 407(e)(2). However, § 407(e)(2) does not necessarily require customs equality as FedEx interprets the concept. Rather, § 407(e)(2) limits its scope to "shipments by the Postal Service and similar shipments by private companies." The Postal Service submits that postal traffic is unique and not "similar" to private-sector traffic. The Postal Service's existing international services differ from comparable offerings by private sector providers in several key respects. For both historical and practical reasons, in the United States and abroad, different customs procedures are currently applied in connection with postal articles compared to those carried by private operations.

¹⁷⁵ *Id.* at 17-18.

¹⁷⁶ Given that other federal authorities have yet to determine the appropriate customs treatment of international postal services relative to private shipments, it would be speculative for the Commission to factor the current customs regime into its classification of mail products, as XLA requests. See XLA Comments at 3-4.

¹⁷⁷ It is not clear why FedEx devotes a considerable portion of its comments to this topic, given that it observes that the Commission has no role in implementing the customs provisions of § 407(e). Presumably, FedEx wishes to make a record of its views concerning customs parity. While the Postal Service does not intend to convert the instant rulemaking into a debate about customs parity, it does believe that FedEx's concerns merit a brief response, so that Commission and the participants in this docket receive a balanced perspective of the differing interpretations of § 407(e).

First, Postal Service and private carrier services differ based on user and recipient characteristics. Private sector shipments are usually sent by sophisticated, commercial customers with whom private carriers have a continuing relationship because the customers are repeat users. By contrast, users of Postal Service international services tend to be individual, household consumers in several key product segments. Second, the nature of the traffic that foreign posts tender to the Postal Service differs from the traffic carried by private carriers, which normally carry larger volume and higher value consignments. Third, Postal Service products offer customers different features than those of private express carriers. With the exception of GXG service, Postal Service products do not offer customers the same type of speed in clearance. Fourth, the Postal Service's implementation of the Universal Postal Union (UPU) Acts also serves as a key distinguishing feature. The United States has agreed as a member of the UPU to provide certain basic letter post services, and the United States has historically met that obligation through the Postal Service's implementation of the UPU Acts.¹⁷⁸ Private sector operators have no such obligation, thereby distinguishing Postal Service traffic.¹⁷⁹

¹⁷⁸ See Convention, *supra* note 166, at art. 12 (Basic Services).

¹⁷⁹ The Act explicitly directs that comparisons between postal and private sector shipments be limited to a defined class of competitors. In particular, the Act explicitly directs that Customs & Border Protection (CBP) consider application of the customs requirements that apply to private companies "substantially owned or controlled by persons who are citizens of the United States." 39 U.S.C. § 407(e)(1). For outbound mail, this implies that CBP is not directed to compare the customs treatment of Postal Service shipments against the procedures that apply to foreign-owned and operated extraterritorial offices of exchange (ETOE), since, by definition, these firms are affiliated with or owned by foreign operators. Hence, comparisons to CBP's treatment of ETOEs' handling of outbound letter post mail are not germane to the "similarity" exercise that the Act requires CBP to make. For inbound mail, the definition of "private company" implies that only the customs practices applied to U.S. firms operating abroad, such as FedEx and UPS, should inform the determinations on similarity. The Act does not require that CBP analyze comparisons between inbound shipments received from foreign postal administrations and foreign-owned private companies. The application of the Act to inbound postal shipments therefore is limited even further to comparisons between the U.S. firms that operate abroad and import inbound shipments on behalf of foreign customers.

The inherent differences between the characteristics of mail exchanged among postal administrations and privately carried shipments were recently recognized by an arbitral tribunal convened in an investor suit brought by UPS against the government of Canada under the North American Free Trade Agreement (NAFTA). The tribunal concluded that Canada's customs procedures, which provide for simplified treatment for postal shipments carried by Canada Post, are not inconsistent with NAFTA obligations even though they distinguish between Canada Post traffic and shipments carried by U.S.-owned private operators.¹⁸⁰ In its suit, UPS claimed that Canada Post's relationships with Canada Customs and other governmental departments "results in less favorable treatment to UPS than to Canada Post as a competitor in the non-monopoly segment of the market."¹⁸¹ As a U.S. owned investor operating in Canada, UPS contended that these relationships constituted illegal, nationality-based discrimination because UPS and Canada Post "compete in the same market and for the same market share" and their products "are generally substitutable."¹⁸²

The tribunal rejected UPS's claims and agreed with Canada that "there are inherent distinctions between postal traffic and courier shipments that require the implementation of different programs for the processing of goods imported as mail and for goods imported by courier."¹⁸³ The tribunal based its decision in part on evidence demonstrating that the two programs are "dealing with different flows of goods with different characteristics."¹⁸⁴ For example, couriers provide detailed information to

¹⁸⁰ See generally *United Parcel Serv. of Am. and Canada*, __ ICSID Rep. __ (W. Bank 2007), at paras. 80-120, available at <http://www.international.gc.ca/tna-nac/parcel-en.asp> [hereinafter *UPS v. Canada*].

¹⁸¹ *UPS v. Canada*, __ ICSID Rep. __, at para. 80.

¹⁸² *Id.* at para. 87. UPS's arguments in the NAFTA arbitration resemble those that XLA advances in the instant proceeding. See XLA Comments at 2.

¹⁸³ *UPS v. Canada*, __ ICSID Rep. __, at para. 98.

¹⁸⁴ *Id.* at paras. 91-93.

customs officials in advance of shipments, conduct self-assessment instead of submitting to officer determinations, offer greater security along shipping chains, face time-sensitive delivery standards that necessitate expedited clearance, and have contractual relationships with their clients.¹⁸⁵ The tribunal also relied on distinctions offered by customs and postal experts from the World Customs Organization and Universal Postal Union.¹⁸⁶ These distinctions included the observations that “most postal traffic is private person-to-person or business-to-person while express carriers, on the other hand, deal very largely with business-to-business consignments,” and that postal operators’ universal service obligations and other commitments do not permit them to refuse consignments.¹⁸⁷ The tribunal observed that the distinction between private operator and postal traffic is consistent with experience in the United States, the United Kingdom, and elsewhere, as well as with Canada’s obligations under the Universal Postal Convention and the World Customs Organization’s Kyoto Convention.¹⁸⁸ The tribunal commented that “[w]hile individual postal items are restricted in size, their numbers are enormous and, to avoid creating unacceptable delays, special administrative arrangements are necessary to deal with them.”¹⁸⁹ In light of this “overwhelming”, “compelling,” and “convincing evidence,”¹⁹⁰ the tribunal concluded that privately carried express shipments and postal traffic are not in “like

¹⁸⁵ *Id.* at para. 102. Further, the tribunal found that the express courier industry is more heavily computerized, which allows it to supply information to customs officials in advance; customs officers must physically sort packages in the less sophisticated postal stream. *Id.* at paras. 104, 107. See also POSTCOMM (UK), A REVIEW OF ROYAL MAIL’S SPECIAL PRIVILEGES 18 (2004) (“Postcomm recognises that the anonymous nature of the universal service (especially the provisions relating to inbound international packets) may put Royal Mail in a different position to private operators who generally have control over the whole process from receipt in one country to delivery in another.”).

¹⁸⁶ *UPS v. Canada*, ___ ICSID Rep. ___, at paras. 104-16.

¹⁸⁷ *Id.* at para. 104.

¹⁸⁸ *UPS v. Canada*, ___ ICSID Rep. ___, at paras. 103-19.

¹⁸⁹ *Id.* at para. 115.

¹⁹⁰ *Id.* at paras. 117-19.

circumstances” that would require equality of customs treatment under the NAFTA’s nationality-based non-discrimination provisions.

The same logic applies with equal force to postal and private carrier traffic crossing U.S. borders. Mail simply does not have the same characteristics as private carrier traffic, for the reasons cited by the tribunal. Hence, it is not self-evident, as FedEx appears to suggest, that customs equality, as FedEx interprets that concept, is required with respect to any postal products.¹⁹¹ As the tribunal recognized, postal shipments’ unique characteristics justify and, in some cases, necessitate different practices than those applied to privately carried matter. The Postal Service does not believe that the issues raised by FedEx are ripe for consideration at this time. Nor does the Postal Service believe that the instant rulemaking is the appropriate forum in which to raise and address these issues, since the Commission has no direct responsibility for administration of the customs laws.

3. The Letter Monopoly

In its initial comments, FedEx hints at its views on the proper scope of the letter monopoly, yet advises the Commission “to either withhold judgment . . . about the scope of the postal monopoly in this proceeding or provide the parties a specific opportunity to address the scope of the postal monopoly laws in detail.”¹⁹²

¹⁹¹ Implementation of unilaterally-imposed customs requirements with respect to inbound mail would be contrary to the UPU’s overall objectives of simplifying and standardizing mail operations. The Postal Service nevertheless agrees that measures must be undertaken to promote advance electronic manifesting for incoming postal shipments. The Postal Service has been collaborating with CBP and the State Department in assessing U.S. policy within the UPU on advance electronic manifesting of postal shipments and in preparing proposals for the upcoming Nairobi Congress to achieve the objectives of the Act.

¹⁹² FedEx Comments at 28. FedEx also notes that the Act contains an anomaly, in that bulk international mail, which presumably could include some portion of letters covered by the Private Express Statutes, is categorized in § 3631 of title 39 as competitive. The Postal Service does not believe, however, that this presents an obstacle to classifying non-urgent outbound letters in the competitive category, since the Act

The Postal Service does not share FedEx's preliminary views on the monopoly. Although the Act redefined the price and weight limits applicable for determining when letters can be carried outside the mails in amended § 601,¹⁹³ it did not change the definition of the term "letter" as that term is used in the Private Express Statutes.¹⁹⁴ It does not appear that Congress authorized the Commission to make changes in that definition or, for that matter, to make other changes affecting the scope of the letter monopoly. Congress vested the Commission with rulemaking authority to implement the provisions of § 601, not the authority to redefine or suspend the letter monopoly. Amended § 601 states, in part, that "[a]ny regulations necessary to carry out this section shall be promulgated by the [] Commission."¹⁹⁵ Congress therefore reserved the power to change the scope of the letter monopoly to itself.

Congressional intent that the Commission's rulemaking power does not include the authority to redefine the letter monopoly is also made apparent by § 702 of the Act. That section requires the Commission to submit a report on universal service and the

creates a statutory exception in § 601(b)(3) of title 39 for the existing suspensions to the Private Express Statutes promulgated by the Postal Service, including the suspension for outbound letters in 39 CFR § 320.8. Although the outbound letter suspension applies only if outbound letters are delivered by a foreign post, when comparing the postal and private carriage of letters (i) originating in the United States and (ii) tendered to a destination country postal administration, the market has in fact long been completely liberalized. Further, the Postal Service has proposed that that the revenues and costs for inbound letters tendered by *postal administrations* be placed in the market-dominant category, for consistency with the product transfer prohibition for monopoly products in § 3642. The Postal Service recognizes that the classification of non-urgent inbound letters tendered to the Postal Service by foreign *customers* (and not posts) under customized agreements would, however, give rise to a potential inconsistency, to the extent such letters are categorized as competitive. Since the volume of inbound letters from customers is very small, however, it does not appear to be an issue that requires urgent attention in the classification exercise, and may well be dealt with when the Commission undertakes to implement its regulations under § 601.

¹⁹³ That section provides that letters may be carried outside the mails when the amount paid for private carriage is at least 6 times the first-ounce single-piece letter rate or when the letter weighs at least 12½ ounces. 39 USC § 601(b)(1)-(2) (2007).

¹⁹⁴ 39 USC § 601. A "letter" is defined as "a message directed to a specific person or address and recorded in or on a tangible object" 39 CFR § 310.1 (2007).

¹⁹⁵ 39 USC § 601(c).

monopoly to the President and Congress by December, 2008.¹⁹⁶ In preparing this report, the Commission is required to “solicit written comments from the Postal Service and consult with the Postal Service and other Federal agencies, users of the mails, enterprises in the private sector engaged in the delivery of the mail, and the general public”¹⁹⁷ Such report is to include “any recommended changes to universal service and the postal monopoly as the Commission considers appropriate, including changes that the Commission may implement under current law and changes that would require changes to current law”¹⁹⁸ There would be no reason for Congress to specify that the Commission merely *recommend* changes unless Congress intended to reserve for itself the authority to act upon the Commission’s report.

The pertinent legislative history also appears to support the conclusion that this was Congress’ intent. When introducing S. 662 in the 109th Congress, which contained amendments to § 601 nearly identical to those ultimately enacted, Senator Collins advised that:

[t]he President’s Commission recommended that the regulator be granted the authority to make changes to the Postal Service’s universal service obligation and monopoly. The vast majority of the postal community, however, shared my belief that these are important policy determinations that should be retained by Congress. The Collins-Carper bill keeps those public policy decisions in congressional hands.¹⁹⁹

The legislative history of the amendments to § 601 make clear that Congress did not intend to confer authority to the Commission to change the scope of the letter

¹⁹⁶ PAEA, § 702(a)(1), 120 Stat. 3198, 3243.

¹⁹⁷ *Id.* at § 702(c)(1), 120 Stat. at 3244.

¹⁹⁸ *Id.* at 702(b)(1), 120 Stat. at 3243. The Commission is required under § 3642 to consider the monopoly in connection with requests to transfer products from the market-dominant to the competitive category. That section prohibits the Commission from transferring products covered by the monopoly from the market dominant to the competitive category.

¹⁹⁹ 151 CONG. REC. S3013 (daily ed. March 17, 2005) (statement of Senator Collins).

monopoly.²⁰⁰ FedEx’s apparent suggestion that the Commission engage in revisiting the scope of the monopoly—whether now or later—thus does not appear consistent with either the plain language of the statute or the intent of the statute as expressed in the legislative history.

B. The Postal Service recommends that the Commission adjust its price cap procedures when dealing with outbound international mail

In its Initial Comments on Order No. 26, the Postal Service expressed the view that rates for outbound international mail present unique challenges in a price cap regime, explained its concerns, and stated its intent to submit a proposed rule addressing those circumstances shortly.²⁰¹ Consequently, a draft of a proposed new provision of the rules regarding adjustments to the price cap for market-dominant classes of international mail is attached as Appendix A, along with a hypothetical illustration of its application.²⁰²

The intent of this provision is more straightforward than perhaps might be presumed based on review of the verbal description of its mechanics. The fundamental concept is premised on the fact that, as discussed in the Postal Service’s initial comments, the amounts that the Postal Service pays postal administrations for final

²⁰⁰ Moreover, the House Report on H.R. 22, which contained amendments to § 601 identical to the section as enacted in the Act, gave clear indication that the Commission was granted rulemaking authority and nothing more. The House Report stated, “[t]he Postal Regulatory Commission is authorized to adopt regulations necessary to carry out the exceptions to the postal monopoly set out in section 601 as amended.” H.R. REP. NO.109-66, part 1 at 58 (emphasis added).

²⁰¹ Postal Service Initial Comments at 20 n.35.

²⁰² The Postal Service appreciates that reply comments are not the ideal vehicle to convert a more abstract concept into a very concrete proposed rule. Nonetheless, such specificity would appear to be of great potential utility to the Commission as it strives to promulgate comprehensive rules for the new ratemaking process. Moreover, in this instance, the link between the concept and its implementation through the proposed adjustment process is direct and straightforward. Of course, the Postal Service would have no objection if other parties perceive a need to file supplemental reply comments in response to this proposal.

delivery of outbound mail depend on several factors over which the Postal Service has little or no control, such as currency conversion rates, or increases in the UPU terminal dues cap rates set by the 191 UPU member countries every four years at the UPU Congress. These types of variables are not directly affected by the factors which influence measures of domestic inflation. Accordingly, an adjustment is necessary that would allow recovery of fluctuations in such delivery charges beyond what the price cap would otherwise permit.

To achieve that objective, an adjustment in the cap is calculated which is designed to reflect any disproportionate changes in delivery costs and allow those costs to be passed through to outbound international mailers. In this fashion, the operation of the cap is limited to restraining rate increases only to the extent that those increases relate to the portions of the total mail service performed by the Postal Service, and over which it can exercise some control over costs.

Note that, in theory, the discrepancy between inflation as measured by CPI-U and changes in delivery charges could be either positive or negative. So, for example, if exchange rate fluctuations cause the Postal Service to pay more dollars to cover delivery charges, all else equal, the discrepancy would be positive, but if contrary movements in exchange rates allow smaller dollar payments to cover delivery charges, the discrepancy would be negative. Under the latter circumstances (*i.e.*, a stronger dollar), without an adjustment mechanism, application of the unadjusted cap would create space for recovery of above-cap increases in other costs. The adjustment methodology proposed by the Postal Service allows for adjustments in either direction.

All of the additional inputs needed for the adjustment calculation would come from a comparison of the international cost data reported in the most recent annual compliance report with corresponding data reported in the previous year's annual compliance report.²⁰³ Calculation of the adjustment amount also needs to account for the fact that another source of potential variation in total delivery costs is variation in outbound mail volume. Necessary control for that source of variation is achieved by focus on changes in *unit* costs, rather than total costs.

Looking at the respective annual compliance reports, therefore, the items of interest are total unit costs for the international class, and a decomposition of those total unit costs into unit settlement delivery costs, and unit "all other" costs. The "all other" unit cost figure, as the name might suggest, is simply the residue of total unit costs after unit delivery costs have been excluded. In essence, the adjusted cap is meant to represent the change between the previous year's total unit costs, and an aggregation of the actual unit delivery costs in the most recent year, plus what all other unit costs would have been had they changed precisely by the applicable CPI-U change.

Therefore, the first step is identification of the total unit costs for the class in the previous year's annual compliance report, referred to in the proposed rule as the "base total unit costs." The second step is identification of all other unit costs in the previous year, and calculation of what all other unit costs would have been in the most recent year if, starting with the previous year figure, they had changed by the cap amount applicable to the domestic market-dominant classes. The third step is identification of actual unit settlement delivery costs in the most recent year. The fourth step is to add

²⁰³ The other input, naturally, would be the unadjusted cap, which would presumably already have been calculated for application to the domestic classes and would thus be readily available for these purposes as well.

the constructed estimate of all other unit costs from the second step to the actual unit settlement delivery costs from the third step. In the proposed rule, the sum resulting from the fourth step is referred to as the “adjusted total unit costs.” The last step is to derive the percentage change between the previous year’s base total unit costs (from the first step) and the adjusted total unit costs (from the fourth step). This is achieved through the familiar equation of dividing adjusted total unit delivery costs by the base total unit costs, subtracting one, and expressing the result as a percentage. This percentage becomes the adjusted percentage cap applicable to the rates for the outbound class of international mail.

A simple example can illustrate the process. Assume that unit settlement delivery costs for the class, as reported in the two most recent annual compliance reports, grew from 40 cents in the previous year to 45 cents in the most recent year, that all other unit costs grew from 50 to 65 cents, and total unit costs therefore grew from 90 cents to \$1.10.²⁰⁴ Further assume that the general CPI-U price cap is 2.5 percent.

In the first step, 90 cents is identified as the base total unit costs from the previous year. In the second step, the 50-cent all other unit cost figure from the previous year is applied to the 2.5 percent cap amount, yielding 51.25 cents. This represents what all other unit costs for the class would have been in the most recent year if they had merely changed by the same amount as the CPI-U index. Next, the 45 cents for actual unit settlement delivery costs in the most recent year is added to the

²⁰⁴ Although all of the components of these figures are currently reflected in data reported in the ICRA, to the extent that perhaps some amount of re-aggregation to correspond to the new international classes might be necessary, the Postal Service will ensure an appropriate format in future reports that allows simple direct extraction of the component data necessary for this analysis.

51.25 cents constructed for all other unit costs, thereby obtaining an adjusted total unit costs of 96.25 cents. The adjusted percentage cap in this hypothetical example is the percentage difference between 90 cents and 96.25 cents, or 6.9 percent. Instead of a 2.5 percent rate cap, therefore, the outbound international rate cap would be 6.9 percent.

As noted above, the adjustment could work in the opposite direction. Assume a *decline* in unit delivery costs from 40 cents to 35 cents. Using all of the other assumptions from the earlier example, the adjusted total unit cost is 35 cents plus 51.25 cents, or 86.25 cents. The adjusted cap under this example would be *minus* 4.2 percent, corresponding to the percentage decline from a 90-cent base to 86.25 cents. Under this example, the Postal Service would actually be required to reduce rates on average by 4.2 percent for this class of international mail in order to comply with the adjusted cap.

VII. Conclusion

As the Postal Service noted previously in its Initial Comments, the Commission's proposed rules provide a solid foundation for the achievement of the purposes of the Act. While the ultimate success of the rules will depend on the manner in which they are implemented going forward (and supplemented in the later rulemakings that the Commission must conduct on issues such as the complaint process, the Annual Compliance Review process, and confidentiality), the Postal Service believes that the Commission has taken an important first step towards a regulatory system that truly marks a decisive step away from the past. This is wholly consistent with the intent of Congress, which recognized that heavy-handed regulation is incompatible with

technological progress and market evolution, and that a more flexible regulatory framework is needed in order to account for fundamental technological and market changes. The Postal Service urges the Commission to continue along the same path as it considers its final rules.

Respectfully submitted,

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Appendix A

Proposed Outbound International Mail Price Cap Rule

Proposed Rule

§ 3010.29 Annual Limitation Adjustment for International Mail.

(a) For international classes of mail and services, when destination delivery charges fluctuate at levels that differ from the percentage annual limitation calculated pursuant to section 3100.21, an adjustment may be made to that percentage annual limitation.

(1) For purposes of this rule, "unit destination delivery charges" are defined as the per piece average settlement charges paid to postal administrations for delivery of a class of international mail in the market dominant category, as reported in the PRC Annual Compliance Report. Similarly, "unit other costs" are defined as the average per piece of all other costs of a class of international mail in the market dominant category, excluding the "destination delivery charges," as reported in the PRC Annual Compliance Report; and "total unit costs" are defined as the sum of unit destination delivery charges and unit other costs for a class of international mail.

(2) Examining the most recent PRC Annual Compliance Report and that of the previous year, the "base total unit costs" is the total unit costs from the previous year. The "adjusted total unit costs" is calculated in three steps. The first step is to identify the actual unit destination delivery charges reported in the most recent PRC Annual Compliance Report. The second step is to identify the unit other costs reported in the PRC Annual Compliance Report from the previous year, and increase that amount by the applicable percentage annual limitation calculated pursuant to section 3100.21. The third step is to add the results of the first two steps, and the resulting sum is the adjusted total unit costs. The adjusted total unit costs resulting from these three steps represents what total unit costs for the most recent year would have been if unit destination delivery costs had changed between the previous year and the most recent year as they actually did, but unit other costs had changed over that period exactly by the applicable change in CPI-U.

(b) The adjusted annual limitation for a class of international mail is calculated by dividing the adjusted total unit costs by the base total unit costs and subtracting 1 from the quotient. The result is expressed as a percentage. The adjusted annual limitation, combined with the allowable recapture of unused rate authority, equals the price cap applicable to each class of international mail.

(c) The Postal Service shall identify and explain all assumptions it makes with respect to the treatment of destination delivery costs in the calculation of the percentage change in rates and provide the rationale for any assumptions made in its calculations.

ILLUSTRATION OF PROPOSED INTERNATIONAL CAP ADJUSTMENT PROCESS

	Unit Settlement Costs	Unit Other Costs	Unit Total Costs
	(Inputs from PRC Annual Compliance Report)		
Year 0	40.0 cents	50.0 cents	90.0 cents
Year 1	45.0 cents	65.0 cents	110 cents

Assume otherwise applicable change in the CPI-U index is 2.5 percent

Step 1) Base total unit costs (from Year 0) are 90 cents.

Step 2) Apply 2.5 percent to 50.0 cents Unit Other Costs from Year 0, yielding 51.25 cents.

Step 3) Substitute 51.25 cents in the Year 1 row for the Year 1 Unit Other Costs of 65.0 cents.

Step 4) Adjusted Year 1 row now appears as:

Adj. Year 1	45.0 cents	51.25 cents	96.25 cents
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Step 5) Divide adjusted total unit costs of 96.25 by base total unit costs of 90.0, subtract one, and express the result as a percentage.

$$96.25/90.0 - 1 = 1.069 - 1 = 0.069 = 6.9 \text{ percent}$$

Result: The adjusted cap for this class would thus be 6.9 percent.