UNITED STATES OF AMERICA
Before the
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

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OFFICE OF THE SECRETARY

Postal Rate and Fee Changes, 2000) Docket No. R2000-1

ANSWER OF THE OFFICE OF THE CONSUMER ADVOCATE
TO INTERROGATORY OF THE UNITED STATES POSTAL SERVICE
WITNESS: TED P. GERARDEN (USPS/OCA-T6-21(a))
REDIRECTED FROM WITNESS CALLOW
(June 26, 2000)

The Office of the Consumer Advocate hereby submits the answer of Ted P. Gerarden to interrogatory USPS/OCA-T6-21(a), dated June 12, 2000, and redirected from witness Callow. The interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

Emmett Rand Costich

TED P. GERARDEN
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USPS/OCA-T6-21(a)

(a) Have you evaluated, either quantitatively or qualitatively, how presort mailers feel about the uncertainty in volumes and profits that you discuss above? Please explain and provide copies of any related documents.

RESPONSE TO USPS/OCA-T6-21(a)

Yes. The OCA first presented the SPFC rate stability concept in a paper issued in November 1999. The paper was provided to the Postal Service. In response, the OCA received comments from Donald O'Hara, Manager, Classification and Product Development for the Postal Service, pointing out that presort mailers would be affected by swings in volume as the relationship between the workshare mail rates and the SPFC rate changes due to holding the SPFC constant through two cases. This in turn caused the OCA to perform further study on the proposal. The results of this further study were also shared with the Postal Service.

As suggested by Mr. O'Hara, the OCA contacted Joel Thomas, Executive Director of the National Association of Presort Mailers ("NAPM"), to discuss the SPFC concept, and provided Mr. Thomas with copies of the studies prepared by the OCA as well as Mr. O'Hara's comments. Mr. Thomas responded with thoughtful comments and observations. Mr. Thomas offered to set up a meeting for the OCA to discuss the SPFC concept with representatives of NAPM. That meeting took place on March 20, 2000, and provided an opportunity for the OCA to discuss with some NAPM members how they feel about the potential swings in volumes to and from the Postal Service from rate case to rate case. The result of all these discussions is that the OCA incorporated into its SPFC proposal in Docket No. R2000-1 a "safety valve" to limit the volume that would swing between presort mailers and the Postal Service if the SPFC proposal is implemented.

The OCA paper was provided to the Postal Service and is available on the Commission website. The Postal Service is already in possession of the comments sent by Mr. O'Hara and the further OCA study material. Attached hereto are the comments of the NAPM. No notes were taken of the meeting with NAPM members.

NAPM National Association of Presort Mailers

January 13, 2000

Mr. Ted P. Gerarden
Director
Office of the Consumer Advocate
Postal Rate Commission
1333 H Street, N.W.
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Re: *Re-thinking First Class Rates*

Dear Mr. Gerarden:

Thank you for requesting the NAPM's views on *Re-thinking First Class Rates*. Your first recommendation, that the U.S. Postal Service consider stabilizing rates for single piece First Class ("SPFC") mail by changing the SPFC letter and card rates only every other rate case, is intriguing. However, before exploring that idea, I would like to note the NAPM's strong agreement with your second recommendation to make First Class mail more price-competitive with alternatives by moderating the institutional costs assigned to First Class mail.

The NAPM is concerned, as are you, that "[t]he actual revenue contribution of First Class mail to the Postal Service's institutional costs has exceeded the target amounts in recent years and is moving out of line with historical benchmarks." We are particularly concerned that is happening at a time when the mark up on First-Class mail should be moving the other way. It should be decreasing in order to preserve First-Class mail volumes and lessen, not increase, the U.S. Postal Service's dependence on the extraordinary mark up on First-Class mail.

The loss of a significant portion of First-Class mail volume will almost surely destroy the U.S. Postal Service, as we know it. The high--we believe excessive--mark up on First-Class mail, means that the loss of a First-Class letter can only be made up for by many additional pieces of mail from any other class of mail. Increases in mail volumes in classes other than First-Class sufficient to make up for the loss of First-Class mail seem unlikely at best. Thus, the primary goal of the U.S. Postal Service, and others who wish to maintain a non-subsidized mail service, should be the maintenance, if not enhancement, of First-Class mail volume.

There are those who seem to believe that the U.S. Postal Service should exploit its First-Class mail monopoly as long as it lasts. However, the NAPM believes that steps should be taken now to prevent or lessen either the sudden or the gradual loss of First-Class mail to other media. Neither the U.S. Postal Service nor the PRC should wait until First-Class mail volume falls to act. We would have thought that we would all have learned from the U.S. Postal Services experience with parcel post that it is easier to keep a customer than to recover a customer.

If First-Class mail volume declines, there is a real danger that the entire rate structure could fall into a "death spiral," if the reduced number of pieces of First-Class mail are expected to provide the same absolute level of USPS institutional cost coverage as was previously provided by more pieces. If, as First-Class volume drops, First-Class rates rise, more and more First-Class mail will be driven out of

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the system inducing additional rounds of even greater rate increases which drive out even more First-Class mail.

As we noted, your recommendation that the U.S. Postal Service consider mechanism, such as the proposed "Reserve Account," that would allow for a whole integer SPFC rate stabilized over two rate cases is intriguing. Unlike your second recommendation, which could be implemented without legislation, it appears to us that implementation of your first recommendation would require legislation.

Provided certain, necessary safe guards are put in place, the NAPM believes the U. S. Postal Service should give serious consideration to your recommendation for eliminating the "integer effect" and establishing a fully self-financing method of stabilizing SPFC rates over a two-rate-case and, if warranted, support appropriate authorizing legislation.

The extent to which your first recommendation hinges on the elimination of the "integer constraint" or "integer effect" is not clear. The NAPM believes that the "integer effect" is real and that it has, overall, a negative, destabilizing effect on First-Class rates. However, the NAPM is unable to qualify the negative impact of the "integer effect" and thus determine the priority that should be accorded to eliminating this effect.

The NAPM is also concerned with your assumption that rate cases will occur on a fairly regular, two-three year cycle and that rate increases in sequential cases will be of approximately the same size. Evenly spaced, somewhat frequent rate cases are, we believe, a goal of the U.S. Postal Service. However, for a variety of reasons, that goal may not be realized. If the timing of rate cases is more erratic, than you have assumed, balancing the Reserve Account over a two rate case cycle could become a major problem.[1] We are also concerned that the amount of the rate increases for First-Class mail could be quite different in different rate cases.[2] If they are, it could be very difficult to balance the surplus in the first period with the deficient in the second. In view of this, it seems only prudent to provide some mechanism to deal with the possibility that the Reserve Account may either grow too large or prove seriously inadequate. One way to address this concern would be to provide that the estimated loss in the second part of the two rate case cycle could not be more than the amount of the surplus generated during the first rate case. If a larger adjustment were need than

[1] For example, if the "first-stage" rate was 34.3¢ and the SPFC rate was set at 35¢ and that rate remained in effect for two years, the Reserve Account would have a positive balance. However, even if the "first stage" rate in the second case was 35.7¢ (exactly the same as the "extra amount" charged in first "half" of the cycle) and it also lasted for two years, the Reserve account would end the full two-rate-case cycle with a negative balance. How would this be made up? More importantly, what would happen if the second "half" of the two-rate-case cycle lasted three or more years instead of two?

[2] For example, what would happen if the "first-stage" rate in the first "half" of a two-rate-case cycle was 34.3¢ and the SPFC rate was 35¢ but inflation hit and the "first-stage" rate in the second case should be 38.8¢? The deficit in the Reserve Account at the end of the two-rate-case cycle could be enormous. How would such a deficit be recovered? If, in the third rate case the "first stage" rate should be 42.3¢ would you really want to make it 45¢ or more to recover the deficit and contribute to building a new positive balance in the Reserve Account? Finally, what would happen in the unlikely event that rates were to decrease so that the "first-stage" rate in the second half of the cycle was less than in the first?

could be accommodated by the Reserve Account, the goal of keeping SPFC rates stable for two rate cases would have to be abandoned and an increase implemented. Using the balance in the Reserve Account might reduce the increase, of course.

The NAPM is also concerned that your first recommendation could have more serious adverse effects on workshared mail than you suggest. On page 3 of your memo to Anita Bizzotto, Don O'Hara and Ashley Lyons, you suggest that "it is unlikely that there will ever be much more than a plus or minus 1.5¢ difference between the SPFC integer rate and the 'first -stage' potential rate." The NAPM's first reaction is: Why is this so? Our second reaction is: What if there were? It seems to us that the while it may be unlikely that the SPFC rate would be much more than 1.5¢ in first "half" of the two-rate-case-cycle, it might be much more than 1.5¢ in the second "half" of the two-rate-case-cycle if the SPFC rate was held constant.

Even if the SPFC rate is "only" 1.5¢ less than the "first-integer" rate, that is 71% of the difference between the current single piece one-ounce letter rate and the nonautomation presort rate. It is 25% of the 6¢ discount for the basic automation, presort mail. With respect to cards, the impact is even greater. 1.5¢ is 75% of the difference between the current single piece card rate and the nonautomation presort rate and almost 45% of the difference between the SPFC card rate and the basic automation rate. Thus, it would seem that your recommendation could effectively eliminate nonautomation presorted cards and could seriously reduce the use of the basic automation presort rate for letters in the second half of the proposed two rate case cycle. This strikes us as very radical.

Everyone needs to understand that injury to the presort mail industry could translate into increased rates for SPFC mail. The current rate structure passes through only a portion, not the entire, savings realized by the Postal Service from workshared mail. Thus, the Postal Service makes a profit on workshared mail that it does not make on mail it processes. As a result, any reduction in workshared First-Class mail reduces the Postal Service's profit, that is used, in part at least, to keep SPFC mail rates as low as they are. Thus, even if First-Class mail volumes do not decline, the Postal Service will make less money if a smaller portion of the First-Class mail is workshared.

Without more information than it has right now, the NAPM is uncertain how serious this problem could be. In the course of the next general rate case, which we expect will be filed soon, we will examine this issue and be in a better position than we are now to comment on this potentially serious problem. Indeed, it seems to us that when authorized by law your first recommendation should be considered in the context of a general rate case when the effects of the stabilization surcharge and discount could be assessed in the light of the rate schedule into which they would be inserted. One thing is clear, however. If the discounts now provided for worksharing were to decline, the adverse impact of the reduced rate differential for SPFC mail in the second stage of the two-rate-case cycle could become a far more serious problem. Thus, we suggest that, at the least, the rate differential between the SPFC rate and the basic presort rate be limited to no more than, and possibly less, than 25% of the discount for nonautomation presort mail.[3]

Finally, we note that the "excess" (an unfortunately pejorative term) profits in one part of the cycle may be inadequate to offset **insufficient** profits or **losses** in the other part of the cycle in part, at

[3] This limitation could pose a problem for cards, as it could make elimination of the integer effect impossible, as 25% of the small discount could be less than the amount needed to reach a full integer.

least, because of income taxes. Presort companies will be taxed currently on the "excess" profit. Unless they are insurance companies, they cannot set up untaxed reserves to cover future loses. Perhaps the legislation that authorizes new approach to pricing First-Class mail should also authorize presort mailers to hold untaxed "reserves."

In summary our overall reaction to your proposal is:

The NAPM strongly agrees that steps should to be taken to make First-Class mail more price-competitive. It believes that the first step in that process is to reduce the current, excessive, markup assigned to First-Class mail since protecting, and, if possible, enlarging First-Class volume, is far more important to both SPFC and workshare First-Class mailers than simply stabilizing rates for SPFC mail over longer periods of time or developing a fully self-funding mechanism for eliminating the destabilizing effects of the "integer effect" on First-Class rates.

The NAPM believes that various constraints may be necessary to prevent serious adverse effects from the implementation of the your first recommendation that could easily out weigh the limited benefits. Thus, the rate reduction below the first-stage rates in the second part of the two rate case cycle, must be limited so as not to unduly encroach on the workshare discounts and shift large volumes of mail from workshared to SPFC mail in the second half of the two rate case cycle. Such restraints will also be necessary to make sure that the Reserve Account does not become seriously overdrawn.

Third, because closer study of the volume shifting potential of the rate differentials between workshared and SPFC mail over the full two-rate cycle is needed, the NAPM believes after this recommendation has been properly studied by the Postal Service and authorized by law, it should be presented in the context of a general rate case.

Sincerely,

Joel T. Thomas
Executive Director

DECLARATION

I, Ted P. Gerarden, declare under penalty of perjury that the answer to interrogatory USPS/OCA-T6-21(a) of the United States Postal Service is true and correct, to the best of my knowledge, information and belief.

Executed June 23, 2000

Ted P. Gerarden

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.

Emmett Rand Costich

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Washington, DC 20268-0001
June 26, 2000