Postal Rate Commission
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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268–0001

POSTAL RATE AND FEE CHANGES PURSUANT TO PUBLIC LAW 108-18	Docket No. R2005–1

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS TAUFIQUE TO QUESTION 7 OF PRESIDING OFFICER'S INFORMATION REQUEST NO. 6
(June 14, 2005)

The United States Postal Service hereby provides the response to witness Taufique to Question 7 of Presiding Officer's Information Request (POIR) No. 6, issued May 27, 2005. The question is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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7. Please refer to the response to POIR 3, Question 1 (revised May 24, 2005), including Table 1A of the attachment to the response.

Table 1. Comparison of Incremental and Cummulative Passthroughs

			Traditional Approach Incremental			USPS Proposed Approach Cummulative		
Rate Category	USPS Worksharing Cost	Postage Rate	Cost Avoidance	Discount	Passthough	Cost Avoidance	Discount	Passthough
A (no w/s)	20	30						
B (some w/s)	13	25	7	5	71%	7	5	71%
C (more w/s)	12	22	1	3	**300%**	8	8	**100%**

Table 1 above presents Postal Service costs, discounts and the resulting incremental and total passthroughs for hypothetical rate categories A, B, and C. While both methods reveal the inefficiency of the discount for category B, the cumulative approach results in a passthrough of 100 percent for category C, implying that the discount for category C sends a price signal that will encourage efficient mailer behavior. In contrast, the incremental approach results in a 300 percent passthough for category C, suggesting that the discount will potentially encourage inefficient mailer behavior. A demonstration of how this inefficiency can occur is presented in Table 2.

Table 2. Demonstration of Result of Hidden Inefficient Signal

	Mailer Expenses			Society Costs		
Rate Category	Mailer Worksharing	Postage Rate	Total	Mailer Worksharing	USPS Worksharing	Total
A (no w/s)	0	30	30	0	20	20
B (some w/s)	4	25	29	4	13	**17**
C (more w/s)	6	22	**28**	6	12	18

In this example, a mailer can do the work necessary to qualify for category B for 4 cost units, or can instead incur 6 cost units (perhaps by hiring a presort consolidator) to do the work necessary to qualify for category C. All else being equal, this mailer will choose to use category C for the lowest combined expense of 28 cost units. However, this choice leads to a higher total cost for society (18) than if the mailer utilized category B (at a cost of 17) instead. Therefore the discount for category C is clearly not efficient – a fact concealed by the cumulative passthrough approach.

a. Please discuss the advantage, described in the response to POIR 3, of keeping the passthrough at each level independent of the passthroughs at the previous levels, as compared with

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disadvantage of presenting passthrough percentages that can potentially conceal inefficient price signals of the type demonstrated in Table 2 above.

b. Please discuss the relative merits for each First-Class Mail automation presort category of using bulk metered mail as the benchmark versus using the next-least presorted category as the benchmark. For example, which is the mail more likely to convert to automation 5-digit presort letters: bulk metered mail or automation 3-digit presort letters? Include a discussion of the choices mailers may make with respect to preparing (and sorting) mailings in-house or using the services of a third-party mail consolidator to achieve a greater depth-of-sort.

RESPONSE:

a. As I stated in my response to question 1 of POIR 3, both methods of calculating passthroughs would be equivalent if the incremental method utilizes a 100 passthrough at each level. The arithmetic in both tables appears to be accurate. However, I would like to make a few observations about the example in Table 2. First, neither the Postal Service nor the Commission has information on the mailers' cost of preparing the mail. This information is not and should not be relevant to establishing workshare discounts. What matters is that mailers are provided appropriate signals based on the workshare savings accruing to the Postal Service (because more highly prepared mail is entered) and the policy considerations of the Act. Second, calculating lowest combined costs, as in the example in Table 2, requires estimates of the mailer's costs of preparing workshared mail. Changing these estimates may lead to results where the discount for workshare level C produces the lowest combined cost for the whole society. If an assumption is made that the mailer's cost

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for Rate Category B is 5.5 units and for Rate Category C is 6 units, then Rate Category C would provide the lowest combined cost to the society. Since mailer costs are not known, realistically it is impossible to incorporate estimates of these costs into calculations of postal workshare discounts.

More fundamentally, this question attempts to rigidly apply Efficient Component Pricing (ECP) rules without considering the context in which the pricing decision is made. While the Postal Service believes that ECP generally provides for the optimum allocation of resources for society, the pricing criteria also call for evaluating other factors that may result in results that are not completely consistent with any single pricing theory. Rate design must consider the totality of all factors at a given time, a fact that the Commission has often recognized in its rate design. The Commission and the Postal Service have the responsibility of objectively evaluating these "efficient pricing theories" in light of all the other factors enumerated in the pricing criteria.

The Postal Service methodology of calculating the total passthrough by comparing the total cost avoidance to the total discount (using an undiscounted rate as a benchmark) results in each level of worksharing being judged as efficient or inefficient independently. As a result, the determination as to whether a rate is an efficient price signal is not affected by a judgment that was made for another level of

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worksharing. In the instant proceeding, the incremental passthrough for the 3-Digit presort level is 219 percent due to the choice of passthroughs at previous levels. The passthrough (using the incremental approach) for the 3-Digit presort level of 219 percent can be reduced to 100 percent by cutting the discount and raising the 3-Digit rate by approximately one-half cent. This change would then increase the passthrough for the 5-Digit rate to 150 percent. A hike of approximately 0.7 cents would be needed in the 5-Digit rate to make the passthrough for this level 100 percent. The already high cost coverage for the workshare mail would increase further, and the 3-Digit and 5-Digit rates would increase by 7.2 and 7.9 percents, respectively, instead of the target 5.4 percent. Therefore, while the signals using incremental passthroughs become efficient, another signal (the value of the total amount of worksharing) is inefficient.

The total passthrough approach implicitly recognizes that customers (either on their own behalf or through service bureaus) may not "step up" through individual levels of worksharing (sorting to mixed-AADC, then deciding to sort further to AADC, then to 3-digit, and finally to 5-digit), but rather may make a "yes or no" decision to workshare or not and, once this decision is made, attempt to reach the highest level of sortation possible. In fact, the Postal Service's regulations require a 3-digit sortation, with the intent that as many pieces will be presorted to at least this level, given the available volume and density. Anecdotal examples of

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both types of decisions – supporting both approaches to passthroughs -- can probably be found. Similarly, examples can be constructed that could be used to portray either approach to passthroughs as sending contradictory "efficient" or "inefficient" pricing signals.

Ratemaking is as much of an art as it is science, and for a variety of policy reasons (mitigating the effect of a rate change or gradually moving towards a desired rate objective), an individual passthrough (measured on either an incremental or a total basis) may differ from 100 percent. The entire context of the rate proposal must be considered, before a rate decision is made. For First-Class Mail, the Postal Service generally has presented passthroughs calculated on a "total" basis reflecting the evaluation of whether a price as a whole is efficient or inefficient, but we do not ignore the incremental signals sent, and we generally do review the potential effects of "incremental" passthroughs and the resulting pricing signals. While we believe the total passthrough approach is the primary tool for evaluating discounts, we do not rule out using incremental cost avoidances as an additional check to see how incremental discounts line up with cost avoidances. Differences between intermediate discounts and cost avoidances should be reviewed, and the rationale for those differences understood.

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Applying any pricing rule (including the choice of how to present passthroughs) as a rigid pricing determinant is inconsistent with the application of the statutory pricing criteria as well as simple common sense. Generally, we believe the incremental approach to workshare discounts could too rigidly limit the discount decisions made by the Postal Rate Commission and the Postal Service. As long as the process of ratemaking provides correct signals to mailers based on the Postal Service's cost structure, in conjunction with other relevant policy determinations, then this goal should be achieved.

b. It is truly difficult to generalize and make a categorical statement regarding the conversion of mail to a specific higher level, be it 3-Digit or AADC. The decisions of individual mailers are based on their own operations, whether they prepare their mail or whether they choose to use third-party service providers to prepare mail. In some cases, customers' mail preparation may be very similar to how the Postal Service would process the mail; in other cases there may be substantial differences. For example, my understanding is that some large mailers are able to electronically presort their lists prior to creating their mail, while others physically presort the mail much in the same way as the Postal Service would. Similarly, other customers present unsorted mail to presort businesses which combine their mail with mail from other customers to

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gain finer presort and to upgrade the mail by applying barcodes. Regardless of the method used, mailers do not move through the levels of sortation in a step function, i.e. first electing to presort to only to the mixed-AADC level, then moving up to the AADC-level, and so on. As noted previously, the Postal Service's regulations require a 3-digit sortation, with the intent that as many pieces will be presorted to at least this level, given the available volume and density. In addition, it appears that the business strategy for some large presort bureaus is the conversion of single-piece mail or other less workshared mail to 5-Digit workshared mail, if at all possible.