Postal Rate Commission
Submitted 6/16/2006 4:22 pm
Filing ID: 49634
Accepted 6/16/2006

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

POSTAL RATE AND FEE CHANGES, 2006 | Docket No. R2006-1

RESPONSE OF UNITED STATES POSTAL SERVICE TO NOTICE OF INQUIRY NO. 1
(June 16, 2006)

The United States Postal Service hereby provides its comments on Notice of Inquiry No. 1 (Notice) issued on June 5, 2006 . In this Notice, the Commission requests comments on the different methodologies for determining the markup for the Periodicals Within County subclass. The Notice of Inquiry notes several differences between the Postal Service's and the Commission's Docket No. R2005-1 approaches, including whether the Outside County revenue figure reflects the 5 percent discount given to preferred rate mail, whether attributable costs are used instead of incremental costs, and the cost attribution methodology used. Notice at 1. The Notice requests discussion of the rationales for the Commission's Docket No. R2005-1 methodology, the methodology the Postal Service proposes in this case, and any other methodology that warrants consideration. Notice at 2-3.

The current framework for the treatment of preferred rates was established by Public Law 106-384 (Oct. 27, 2000). Under that framework, to determine the appropriate markup for the Within County subclass, one starts with the markup for "the most closely corresponding regular-rate category." 39 U.S.C. §3626(a)(3)(B)(i). The current Outside County subclass includes that regular-rate category, as well as the nonprofit and classroom rate categories. Because the costs for the regular-rate category are no longer separately estimated, however, a markup for the regular-rate category, in the sense of a simple comparison of the revenue of that category to the costs of that category, cannot be calculated directly. Instead, the regular-rate costs are estimated within an aggregate estimate of Outside County costs, which, as suggested above, also includes the costs of two preferred rate categories, nonprofit and classroom rate. Estimating Outside County costs in the aggregate was adopted to eliminate the volatility in the disaggregated estimates, the undesirable rate consequences of which Public Law 106-384 was, in part, intended to avoid. *See* Senate Report No. 106-468 (Oct. 3, 2000) at 2-3.

Given the available information (.i.e., an aggregate Outside County cost estimate, regular-rate revenues, nonprofit and classroom revenues before the discount, and nonprofit and classroom revenues after the discount), two options for estimating the regular-rate markup are readily apparent.[1] Both options, of course, must use the aggregate cost estimate in the denominator, as that is the only available cost information. But in the numerator, one option uses regular-rate revenue plus nonprofit and classroom revenue before the discount, while the other option uses regular-rate revenue plus nonprofit and classroom revenue after the discount. As the NOI indicates, the Postal Service has consistently utilized the first of these two options. The Postal Service believes that the Commission has also previously utilized the first option, in

[1] The following discussion may at times appear to suggest that "markup" is the ratio of revenue to cost. Obviously, that ratio is, in fact, the cost coverage, and to further derive the markup in percentage terms, 100 percent must be subtracted from the cost coverage percentage. For present purposes, however, that distinction is not particularly relevant, and is therefore glossed over to simplify the discussion.

Docket Nos. R2000-1 (PRC-LR-14, PRC-2Reg+.xla, worksheet Input, cell D12; PRC-2WC.xla, worksheet Input, cell D12) and R2001-1 (PRC-LR-9, PRC-9-OC1.xls, worksheet Rate Design Input, cell C12; PRC-9-WC1.xls, worksheet Rate Design Input, cell C12).

The Postal Service submits that the first option is preferred for the following reasons. By using the revenue from the preferred rate categories *before* the discount, as the numerator for calculating the regular-rate markup, the first option implicitly assumes that the markup before the discounts is the same for the regular-rate and preferred categories, although neither of those markups can be calculated directly. This, in turn, assumes that the unit costs for similar regular and preferred rate pieces are the same. Because of differences in mail mix, of course, the average unit costs for regular-rate and preferred rate pieces would not necessarily be expected to be equal. But the overall ratio of revenue to cost would be equal as long as the mail mix changes that create the differences in average unit cost also create corresponding differences in average unit revenue (when based on undiscounted rates).

Thus, the first option, using preferred rate revenue before the discounts, is appropriate if one is willing to assume that the mere fact that a Periodicals publication is classified as regular rate, nonprofit, or classroom does not have any intrinsic effect on its costs. Periodicals mail pieces with identical characteristics should have the same costs, regardless of how they are classified. This approach is consistent with the legislative intent of the current version of section 3626, to reflect a rate preference (e.g., a reduced share of institutional costs), rather than any intrinsic cost differences between regular-rate and preferred rate pieces. Senate Report No. 106-468 confirms that the intent of the nonprofit and classroom discounts is to continue rate preferences previously established through other procedures. Moreover, the “50 percent markup” rule is similarly intended to reflect rate preferences for Within County periodicals. Assuming similar cost characteristics, if the discounts for nonprofit and classroom are not added back to the revenues before calculating the “50 percent” markup, then the net result would be an excessive Within County rate preference, caused by layering the Within County preference on top of the nonprofit and classroom rate preference. Thus, the first option, the before-discount approach, makes sense and is consistent with the legislative intent.

The second option would be to use in the numerator the aggregate Outside County revenues *after* application of the prescribed discounts. If one had prior information that the unit cost for pieces of preferred rate mail were on average 5 percent lower than the unit cost for comparable pieces of regular-rate mail, then utilization in the numerator of total revenue after the 5 percent deduction had been taken from preferred rate revenue would yield a better estimate of the regular-rate markup. So if there were a basis to think that Congress believed that the 5 percent nonprofit and classroom discounts were necessary simply to offset intrinsic differences in costs between these categories and regular rate periodicals, utilization of the after-discounts preferred rate revenue might make sense. But, in fact, there is no basis for such an approach. There is no factual reason to think that preferred rate mail has intrinsically lower costs, and no reason to think that Congress so believed. Rather, Congress intended the discounts to reflect a reduced share of institutional costs.

The Postal Service submits, therefore, that the best estimate of the regular-rate markup uses Outside County revenues in the numerator assuming that nonprofit and classroom mail pay the full Outside County rates. Consequently, the Postal Service uses the total Outside-County revenue, before the subtraction of the 5 percent discount for the nonprofit and classroom categories. This approach is consistent with the Postal Service's approach in the previous docket, is consistent with the approach previously used by the Commission, and better aligns with the statutory requirement to base the markup on "the most closely corresponding regular-rate category."

The applicable law also specifies the use of "attributable" costs in determining the Within County markup. 39 U.S.C. §3626(a)(3)(A)(i). Solely for purposes of applying this provision in the context of the Postal Service version of costs, the Postal Service in past cases used incremental costs as the most appropriate measure of attributable costs. As noted in the Notice of Inquiry, in this case the Postal Service used volume variable costs in the denominator instead of incremental costs. In terms of identifying the ratio of revenues to costs for regular rate, reducing the markup ratio by half, and then applying the halved markup to Within County costs to establish target revenue, the substitution of volume variable costs for incremental costs might not have a noticeable effect on the result if the ratio of volume variable to incremental costs were approximately equal for both regular rate and Within County. Unfortunately, that condition does not necessarily hold. In retrospect, therefore, it would have been more consistent with past practice, and with its intent, if the Postal Service had used incremental costs rather than volume variable costs for purposes of applying the “50 percent markup” rule to establish its proposed target revenue for Within County.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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