

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

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| Postal Rate and Fee Changes | : | Docket No. R2006-1 |
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COMMENTS OF TIME WARNER INC.
IN RESPONSE TO NOI NO. 2 AND NOI NO. 3
(August 17, 2006)

In Notice of Inquiry No. 2 (issued July 21, 2006) and Notice of Inquiry No. 3 (issued July 26, 2006), the Commission observes that "the Postal Service's approaches to developing First-Class Mail and Standard Mail rates in this omnibus rate case . . . exhibit significant differences from the accepted rate design practices established in previous omnibus rate cases." The Commission invites comments "discussing the legal or policy ramifications of the Postal Service proposals, or identifying attendant issues not highlighted in the Notices of Inquiry." Additionally, it "encourages participants to develop and submit testimony responsive to the issues presented in either or both of these Notices of Inquiry." It states:

Testimony on the theoretical and practical issues associated with designing rates for these classes should thoroughly develop the record and facilitate consideration of alternatives.¹

In these comments, Time Warner Inc. (Time Warner) will explain why it agrees with the Commission's statement of the "accepted rate design practices established in previous omnibus rate cases" and with the importance the Commission attaches to those practices. It will also identify what it believes to be an important issue "not highlighted in the Notices of Inquiry," namely that the Postal

¹ NOI No.. 3, at 1.

Service's Periodicals Class rate proposals also "exhibit significant differences from the accepted rate design practices established in previous omnibus rate cases." In its direct case, Time Warner intends to address these issues in greater detail, with particular attention to the Commission's desire that such testimony "should . . . facilitate consideration of alternatives."

General character of the Postal Service's rate proposals

When the Commission states in NOI No. 2 (at 5) that "without some analytical framework by which the relationship of rate differences and cost differences can be evaluated, there can be no assurance that rates within a subclass are cost-based or that any departures are consistent with the other policies of the Act," it puts its finger on the reason that the Postal Service's proposals in this case are so generally disappointing. Whatever the merits of proposed rates may be individually, the Postal Service's rate proposals overall seem largely designed to reach predetermined ends, with little regard to established or coherent ratemaking policy. Indeed, the testimony of a number of the Postal Service's key rate-design and rate-policy witnesses reveals little sense of an obligation even to acknowledge important ratemaking concepts that have dominated the ratemaking process for the last decade and more and that the Commission has repeatedly pronounced, and pronounces again in NOI Nos. 2 and 3, are essential to its evaluation of proposed rate levels in relation to one another under the terms of the Act. Clear intrasubclass relationships are the key to judging both the efficiency and the fairness of the relative rate levels. But the USPS approach in this docket often obscures rather than clarifies such relationships.

The presumption in favor of cost-based rates

Time Warner agrees with the Commission that costs should be the key reference point for ratesetting, both at the subclass level and below the subclass level. As the Commission stated in its Opinion in Docket No. R2005-1, "Cost-based rates have been the touchstone of postal ratemaking for 35 years."² This basic principle derives from "an axiom of regulatory theory that the rates that would be generated by the forces of a competitive market, were such a market possible, are fair and equitable rates, and that regulation should tend to replicate such rates, where feasible."³ Thus the ratesetting process begins with the "presumption that rates within a subclass should fully reflect cost differences that are caused by such differences," whether the cost differences are the result of "cost-saving characteristics that are the result of worksharing" or of "cost-causing characteristics that do not result from worksharing, such as weight and shape." NOI 2 at 1, 2. "[T]o the extent feasible, cost-causing characteristics are evaluated and rate distinctions are implemented to recognize those characteristics." *Id.* at 2.

The presumption against price discrimination

In setting the relative rate levels for the rate categories within a subclass, another fundamental axiom of regulatory economics comes into play: namely, the presumption that, all else being equal, differences in rates should be proportional to differences in costs.⁴ Rates that conform to this principle are said to be free from

² PRC Op. R2005-1 (issued November 1, 2005), p. i ("Summary").

³ Docket No. C2004-1, Direct Testimony of Robert W. Mitchell (TW et al.-T-1), Tr. 847 [p. 50].

⁴ The Commission cites a generic definition of price discrimination from the late Professor George Stigler's *The Theory of Price*. Stigler, a President of the American Economic Association and a Nobel Prize Laureate in Economics, was highly regarded for his ability to make complex things simple, consistent with fundamentals.

"price discrimination." Such rates are deemed to serve the interests of fairness and equity, which require that similarly situated mailers be treated similarly, and of economic efficiency, which requires that rates "send economically efficient price signals to mailers." *Id.* at 3.

The Commission explains in NOI No. 2 (at 3) what is required in order to put the presumption against price discrimination into effect:

[I]n order to evaluate whether rates relationships within a subclass are fair, and whether rates send economically efficient price signals to mailers, it is necessary to be able to compare the avoided costs associated with each rate category to all other rate categories within the subclass.

Such comparisons, in rate structures as complex as those overseen by the Commission, are necessarily complex and challenging. Over the years, the Commission has experimented with and utilized a number of methodological approaches to meeting this challenge. Two that have proved most fruitful and that are now solidly established in a long series of Commission decisions are the "presort tree," first adopted in Docket No. R90-1, a device that "helped the rate designer detect and correct rate anomalies and allowed those evaluating rates to explicitly and systematically consider all shape-related, presort, and automation cost differences in reconciling rates with the policy and pricing factors of the Act," *id.* (footnote omitted), and the concept of "implicit cost coverage" or "implicit markup," of which the Commission said in its Docket No. R2000-1 Opinion: "Rate design for a

The equations in the definition cited by the Commission make clear that issues of discrimination do not arise until one of two types of inequalities applies. Only when the ratio of price to marginal cost is not the same for two products, or the difference between price and marginal cost is not the same, depending on the definition used, can one say that discrimination exists. That is, prices separated from costs in appropriate ways do not involve discrimination. .

A particular characteristic of Stigler's definition deserves note: if two costs are different and the rates are the same, discrimination exists.

subclass can be thought of as setting the implicit percentage markups for each rate category.”⁵

Thus, the Commission has described as follows its starting point in evaluating whether rate relationships within a subclass are fair and are consistent with economic efficiency:

The Commission begins the rate design process assuming equal implicit markups. This is a neutral starting position which seems to be implied by § 3622(b)(1), a fair and equitable schedule. It is consistent with the Commission’s general policies that the rates for each rate category be above cost; that rates reflect the costs developed in the record; and that rate design results in identifiable relationships between rate categories.

PRC Op. R2000-1, ¶ 5533 [p. 390].

In the same passage the Commission goes on to note: "Equal implicit markups, however, are only a starting place, and often may not be practical or appropriate." The most important instance in which the Commission has held that equal implicit markups "may not be practical or appropriate" is when rate differentials are based on mailer worksharing, in which case the Commission applies a different regulatory approach known as "efficient component pricing." The Commission has explained:

The Commission bases worksharing discounts on avoided costs. Basing discounts on avoided costs does not result in equal implicit markups, rather it results in equal per-piece markups. It also results in worksharing mail having higher

⁵ PRC Op. R2000-1, ¶ 5533 [p. 390].

"The phrase 'implicit coverage' (or 'implicit cost coverage') is used in rate proceedings to refer to cost coverages calculated for categories or other groupings of mail that fall *within* subclasses. Such coverages are usually expressed in percentage terms. The numerical value of an implicit coverage is not necessarily *implied* by anything other than that the numerator is the revenue of the category and the denominator is the corresponding cost. In percentage terms, the implicit *markup* equals the implicit coverage minus one hundred percentage points." Docket No. C2004-1, Direct Testimony of Robert W. Mitchell (TW et al.-T-1), Tr. 841 [p. 44, n. 37].

implicit markups than mail which is not workshared and the most heavily workshared pieces (*i.e.* those with the largest discount) having the highest implicit markups.

This approach to worksharing discounts is called “efficient component pricing” (ECP) in the economic literature. The theory requires the discount to be 100 percent of the cost savings. The Commission tries to achieve 100 percent passthrough of the worksharing savings, but again it frequently may depart from this standard for a variety of reasons. An important virtue of ECP is that the mailer will perform the workshared activity (*e.g.* presort) when he can do so at a lower cost than the Postal Service. This leads to productive efficiency (*i.e.* the most efficient provider does the work resulting in the lowest cost to society). Because ECP also lowers the real cost of mailing, volume should increase in response to lower effective prices.⁶

The theory of efficient component pricing, which has been central to the Commission's approach to worksharing discounts since its decision in Docket No. MC95-1, receives scant attention in the Postal Service's rate proposals.

The role of non-cost based factors

The pricing provisions of the Act also require the Commission to recognize some factors that may not manifest any identifiable relationship with the cost-causing characteristics of the mail. Giving weight to such factors necessarily introduces some degree of price discrimination into the rates, but the discrimination may be justified, and the presumption against price discrimination overcome, if the discrimination is required in order to give reasonable recognition to one of the non-cost factors specified in the Act. For purposes of the current discussion, the point that bears emphasis is that such discriminatory rates are always an exception to the presumed preferability of cost-based rates and must always therefore have a particular justification that is grounded in the Act. In the context of the Commission's

⁶ PRC Op, R2000-1, ¶¶ 5533-35 [p. 390].

responsibilities, this means that the proponent of a discriminatory rate must bear the burden of explaining the justification for the discrimination. "[I]n order to justify price discrimination, one must first determine its nature and degree." NOI No. 2 at 6. The Commission succinctly summarizes this point in NOI No. 2 (at 5):

Without some analytical framework by which the relationship of rate differences and cost differences can be evaluated, there can be no assurance that rates within a subclass are cost-based or that any departures are consistent with the other policies of the Act.

The importance of well designed rate categories

A central and, we believe, entirely correct theme of NOI Nos. 2 and 3 is that in order for the Commission to perform its function properly, the categories within subclasses must be defined in a way that makes comparison of cost and rate relationships between and among those categories possible and meaningful. In explaining the utility of the "presort tree," for example, the Commission observed:

This device helped the rate designer detect and correct rate anomalies and allowed those evaluating rates to explicitly and systematically consider all shape-related, presort, and automation cost differences in reconciling rates with the policy and pricing factors of the Act.

NOI No. 2 at 3 [footnote omitted] .

In a footnote to this passage, the Commission alludes to an essential precondition for such comparisons to have value: the need to define rate categories in ways that relate well to cost drivers.⁷ The Commission's task of evaluating "whether rates relationships within a subclass are fair, and whether rates send economically efficient price signals to mailers" can be impeded or thwarted not only

⁷ The footnote points out that "[t]he introduction of separate rates for letters and flats created two sets of discounts by which the rate for a nonautomated 3/5-digit letter could be calculated."

by rate proposals that obscure the relationships between existing rate categories but by those that fail to understand--or, if understood, to recognize in the rate design--significant factors that drive costs.

Consider, for example, pieces sorted to 3-digit bundles. Some of these bundles may be in 24-piece sacks while others are in 100-piece sacks. Similarly, some may be on 500-pound pallets while others are on 1,500-pound pallets. Other differences could involve the makeup of the containers and the nature of the entry point. If the cost drivers behind these different situations are recognized in rates, then mailers have a chance to respond and increase the efficiency of the mailstream. But if the cost drivers are not recognized in the basic structure of the rate design, they cannot be recognized in rates. An excellent example of this is the role of containerization in affecting/driving Periodicals costs. As demonstrated by Stralberg in the TW Complaint case, the division of cost causation only into pieces and pounds has become inadequate, because mailings with the identical number of pieces and of pounds will have substantially different processing costs depending on how they are containerized.

As witness Mitchell, the originator of the presort tree in Docket No. R90-1, stated in more recent testimony:

Our understanding of cost incurrence and how it should be reflected in rates progresses as we make advances in cost analysis. . . . [R]ecently, attention has focused increasingly on cost drivers and on linkages among cost drivers and volume. Part of the interest in cost drivers derives from the increased use of mechanization and automation by the Postal Service. For example, with bundles now being sorted on small parcel and bundle sorters (SPBSs), the cost of sorting bundles is virtually independent of the weight of the bundles and the number of pieces in them. Similarly, with the use of sack sorters and lift trucks, the costs of sorting sacks and pallets are virtually independent of the nature of their contents. Moreover, the processing these receive depends on their makeup and their entry point. When these factors are not recognized in rates, mailers cannot be

expected to understand or respond to the costs of handling their mail.⁸

Recognizing such factors in rates, Mitchell stated, "would be in line with Commission emphasis in recent years on cost recognition, efficient component pricing, worksharing, and notions of lowest combined cost."⁹ In this docket, at least in the case of Periodicals Class mail, the Postal Service has been conspicuously inattentive to these well established approaches to the ratemaking process.

Mitchell's Docket No. C2004-1 testimony provides a description of the strong presumption in favor of cost-based rates, the importance of clear intrasubclass relationships in judging the efficiency and fairness of relative rate levels, and the necessity of well designed rate categories that reflect the factors driving costs to the very possibility of fair and efficient rate relationships. Mitchell's view is, we believe, entirely consonant with the Commission's established method of designing rates and lends support to the broad concerns raised by the Commission in NOI Nos. 2 and 3:

[Section 3622(b)(3)], has been interpreted, for the most part, to require that *subclasses* of mail recover their costs, with appropriate cost coverages. But, as the Commission noted in Docket No. R2000-1, quoted also above "[r]ate design for a subclass can be thought of as setting the implicit percentage markups for each rate category." Op. p. 390, ¶ 5533. Clearly, the interest in tracing costs goes well below the subclass level as, I believe, it should. Indeed the contribution that the classification approach makes to the setting of appropriate rates is that it helps provide a fair path to establishing rates for particular mailpieces that recognize their costs and other appropriate factors. If the cost coverages on particular mailpieces were found to be substantially higher than the coverage for the subclass as a

⁸ Docket No. C2004-1, Direct Testimony of Robert W. Mitchell (TW et al.-T-1), Tr. 811-12 [pp. 14-15] [footnotes omitted].

⁹ Id. at Tr. 810 [p. 13].

whole, or even if substantially lower, including the possibility of coverages below 100 percent (indicating below-cost rates), a case could be made for inquiry into whether the pieces are appropriately classified and rated. Much of the history of ratemaking under the Reorganization Act has involved questions of whether new rate categories (within subclasses) should be established and of how these categories should be priced.¹⁰

The Postal Service's Periodicals Class rate proposal

In Docket No. C2004-1, Time Warner Inc. and four other complainants, all major users of Periodicals class mail, proposed "fundamental reform of the Periodicals rate structure to achieve greater conformity with the ratemaking provisions of the Act."¹¹ The complainants believed that there was

a lack of congruity between the elements of the Periodicals rate structure and the actual cost-causing characteristics of Periodicals mail that has become increasingly troubling, and increasingly well understood, during nearly three decades of study and analysis.

TW et al.-RT-1 at 5: Tr. 5/1429.

The complainants identified cost drivers that the existing Periodicals rate design fails to recognize and presented extensive analysis of the ways in which this failure prevents the development of cost-based, efficient, fair, nondiscriminatory intrasubclass rate relationships that conform to the approach adumbrated by the Commission in NOI Nos. 2 and 3:

Because they are substantially inconsistent with cost incurrence as now understood, the signals sent to mailers in Periodicals rates are significantly inefficient, so much so that they impair the value of Periodicals mail service by raising

¹⁰ Id. at Tr. 848-49 (pp. 51-52).

¹¹ Docket No. C2004-1, Complaint of Time Warner Inc. Et Al. Concerning Periodicals Rates (January 12, 2004) ("Complaint"), at 4.

costs and failing to recognize the mail's preparation, neither of which results is contemplated by the Act. Improvements in cost analysis in the past decade, along with advances in mechanization, have shown that costs are determined in meaningful and systematic ways by the makeup of bundles, sacks, and pallets and associated interactions, including entry points. . . . More than half of Periodicals mail processing costs in today's environment are incurred handling the bundles, sacks, and pallets in which mail is entered. Yet the rates provide little information concerning what these costs might be, and, accordingly, there is no way that mailers can make efficient decisions.

Complaint at 6.

In essence, Complainants argued that the existing Periodicals rate design makes it impossible to "correct rate anomalies and . . . to explicitly and systematically consider all shape-related, presort, and automation cost differences in reconciling rates with the policy and pricing factors of the Act."¹²

After extensive hearings, the Commission concluded in its final order addressing the Complaint, issued less than a year from the date of these comments, that the complainants had largely succeeded in demonstrating what they had set out to demonstrate:

It appears from the costing evidence presented on the record of this docket that a portion of Periodicals costs is, in fact, bundle and container oriented, and that the linkages to presort level and entry point cited by witnesses Mitchell and Stralberg affect costs in a meaningful way. Moreover, Stralberg's model appears to be a sound theoretical starting point for developing rates based on heretofore unrecognized cost elements. Witness Mitchell makes a reasoned attempt to align rates for Periodicals mail more closely with costs incurred in the postal operating environment.

This effort represents a substantial step forward in the process of redesigning rates to keep pace with changing

¹² NOI No. 2 at 3 (describing the uses of the "presort tree").

technology in the processing and transportation of Periodicals mail.¹³

The Commission concluded that "the evidence of record . . . shows that progress towards a more cost-based [Periodicals rate] structure is both possible and necessary,"¹⁴ and It

urge[d] the Postal Service to proceed forthwith to develop a rate design for Periodicals that better serves the needs of all interested stakeholders and thereafter file a request for a recommended decision with the Commission.¹⁵

The response of the Postal Service to these developments has been a Periodicals rate proposal in this docket that manifests the same indifference to rate structure coherence and to established approaches to rate design that Nos. 2 and 3 ascribe to its Standard Mail and First-Class Mail proposals. It relies on essentially the same model presented in R2001-1, failing to take account of or even to attempt to take account of significant cost drivers that are now well documented, even to the point of repeating errors that it has acknowledged on the record in previous dockets. It proposes a new container charge that it represents as responsive to the Commission's call for "progress towards a more cost-based [Periodicals rate] structure"¹⁶ but that bears only a remote relation to the factors that drive costs and is insensitive to differences in presort level and entry point. Contrary to the Postal Service's representations, its Periodicals rate proposal appears designed to do as

¹³ Docket No. C2004-1, Order No. 1446, Order Addressing Complaint of Time Warner Et Al. (issued October 21, 2005), ¶¶ 4032-33.

¹⁴ Id. at ¶ 1013.

¹⁵ Id. at App. B at 7, ¶ 13.

¹⁶ USPS-T-35 [Tang], at 4-5.

little as possible to make progress toward a cost-based rate structure, while giving token recognition to the Commission's conclusions in Docket No. C2004-1.

Time Warner intends to address these matters further in its direct case and on brief.

Time Warner believes that appropriate recognition of costs is important, as the Commission notes, and that further progress is both desirable and possible in designing rates that recognize additional cost drivers. It commends the Commission's expressions of concern for sound ratemaking methodology in NOI Nos. 2 and 3.

Respectfully submitted,

s/

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