Postal Rate Commission
Submitted 8/17/2006 3:06 pm
Filing ID: 52539
Accepted 8/17/2006

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. 2 (August 17, 2006)

Introduction

On July 21, 2006 the Commission issued Notice of Inquiry No. 2 (NOI No. 2).[1] In the notice, the Commission solicited comments from participants in Docket No. R2006-1 regarding the method that should be used to design rates for Standard Mail. Subjects of particular interest to the Commission included the use and applicability of efficient component-pricing (ECP), the use of an organizing technique such as the presort tree in analyzing rate differentials, and the use of single or multiple benchmarks in designing rates.

The Postal Service respectfully submits the following comments in response to NOI No. 2.

Summary

The Postal Service's views on the subjects discussed in NOI No. 2 can be summarized as follows:

- While the principles of efficient component-pricing (ECP) represent an important guide to pricing postal worksharing, they should not apply so as

[1] Docket No. R2006-1, Notice of Inquiry No. 2, issued July 21, 2006.

to dictate or unnecessarily constrain other principles and policies in designing rates to take account of other considerations pertinent to the characteristics of mail and mailer behavior.

- Even for worksharing, ECP should be only a guide in pricing. As the NOI observes (NOI No. 2, at 2), justifications often exist for deviating from pure economic efficiency which is the sole focus of ECP.
- Deviations from 100 percent passthroughs are not a de facto indication of price discrimination, especially for shape-related cost differences.
- While the presort tree may be a helpful tool, it should have appropriate, limited application.
- Using the presort tree is not required to avoid rate anomalies, or for any other purpose. Other mechanisms or controls can be used to achieve the objectives of the tree.
- The presort tree should not interfere with recognition of rate relationships other than traditional worksharing relationships.
- A presort tree, if used, has its principal application in examining worksharing passthroughs; other “passthroughs” may be less meaningful.
- The presort tree, if used, should be organized along lines that follow major mail flows.
- Multiple pricing benchmarks are a reasonable response to multiple product pathways, and should be chosen to reflect separate work and cost flows.

- Pricing benchmarks should be constructed with reference to their use in pricing, not in the abstract. Benchmarks should ideally be "typical piece" categories with pricing for alternative categories determined by applying discounts or surcharges to the benchmark pricing, as appropriate. The unit cost of a piece is not a controlling criterion for choosing the benchmark.

Discussion

1. *The efficient component pricing (ECP) model should not exclude or distort appropriate recognition of non-worksharing cost differences.*

The ECP model can provide some useful guidance on how to price postal worksharing activities.[2] The central tenet of the ECP approach is that the worksharing customer should pay a price that is equivalent to the non-worksharing price less the Postal Service's unit cost of providing the workshared service.[3]

The essence of the ECP method is that price differentials be based on what it costs the Postal Service to perform a service in-house and thus the workshare price is based on the Postal Service's costs avoided when a customer chooses to workshare. In the case of mail processing, transportation, or similar activities, the nature of the work that can be outsourced is obvious. The Postal Service can take unsorted mail and sort it to finer levels. Mailers can likewise presort their

[2] The Section 3622 pricing criteria, taken as a whole, do not require or suggest a pure ECP approach be followed in setting postal rates. In fact, as the Commission has noted, "[e]conomic efficiency is neither the exclusive nor even the paramount ratemaking objective under the Act." PRC Op. Docket No. R2000-1 at 210.

[3] Baumol and Sidak ("The Pricing of Inputs Sold to Competitors," Yale Journal on Regulation, 11:1, Winter 1994, pp. 171-202) refer to this cost as the *incremental cost* of providing the workshared services. This definition of incremental cost differs from the Postal Service's concept of incremental cost, which Baumol and Sidak would term the *average incremental cost for the entire service*. Baumol and Sidak's incremental cost can also be distinguished conceptually from

mail and thereby allow the Postal Service to avoid specific activities (and the associated costs) that would otherwise be performed on those mail pieces.

The ECP model is not a reliable guide when the cost differentials arise, not from some direct activity that the Postal Service avoids, but from other factors, such as mail piece characteristics, like shape, that result in different transportation, mail processing and delivery profiles. Occasionally, these separate streams may flow together for limited times. For example, letters and flats may be transported in the same vehicle from plants to delivery units (though in separate containers). However, for the most part, different mail shapes have distinct and readily identifiable pathways through the Postal Service network, from entry to delivery, creating in their wake, separate cost streams.

Unlike the activities that transform unsorted mail into sorted mail, or unbarcoded machinable mail into automation compatible mail, the Postal Service does not transform mail pieces from one category to another: flats are not converted to letters or vice-versa. In other words, with respect to non-worksharing cost differences, there is no transformative service performed by the Postal Service that a "more efficient" mailer can "avoid."[4] Changing from a letter to a flat (or vice-versa) is not one "component" in any of the Postal Service's processing and delivery activities that can be outsourced, leaving access to the same in-house components to be priced using the ECP method. Nevertheless,

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the marginal cost, since their incremental cost refers to the cost of changing output in discrete quantities that may not be small.

[4] NOI No. 2 broadens the term "avoided cost" (NOI No. 2, footnote 1). The usage, however, is not consistent with the term's generally understood meaning and tends to obscure what is going on. One of the facts that is easily obscured by inappropriate use of the term avoided cost is that actual measured cost differences between different mail processing categories reflect a host of differences other than shape, often including different degrees of worksharing.

the Postal Service is aware that many mailers can and do consider relative prices (among many other factors) when deciding what mail shape category to use. For many of these same mailers, the costs of transforming their mail pieces prevents them from rapidly or frequently switching between shapes based on relative price changes. For others the considerations of the desired aesthetics of a given mail piece configuration outweigh the potential cost savings from reconfiguring the piece. The choice of mail shape is not simply analogous to choosing a presort level, or choosing whether or not to barcode mail. The Postal Service understands that if relative prices between mail shapes persist at levels that stray too far from relative costs, undesirable consequences may result.[5] However, if such a situation arises the Postal Service believes it to be more prudent, and better policy, to address any shape-related cost-price imbalances gradually over time. Following this measured approach would not lead to substantial allocative inefficiencies in the provision of mail services. Without ignoring the foregoing issues and keeping in mind that other considerations may argue for "non-ECP" results, the Postal Service believes that the appropriate use of ECP as a firm guide should be limited to recognizing true worksharing relationships, where specific activities are truly avoidable. Since shape-based cost differences are not avoidable, ECP should not constrain effective rate design.

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[5] For example, if the prices for parcels were the same as letters, despite parcels' higher costs, advertisers might be induced to use parcels rather than in letters to deliver their messages, thinking that the intended recipients would be more likely to open parcels than letters. This would encourage the proliferation of mail pieces that were not covering their costs while discouraging pieces that were covering their costs.

2. The NOI's reliance on the identical absolute markup rule to detect price discrimination is misplaced.

The NOI suggests that deviations from 100 percent passthroughs result in price discrimination, supporting the notion that all cost avoidances should be reflected in rates with 100 percent passthroughs (unless there is some compelling reason for deviating). This conclusion, however, represents an inappropriately narrow definition of price discrimination in the context of postal ratemaking. The NOI uses a definition of price discrimination taken from George Stigler's The Theory of Price (3rd Edition, 1966). This definition rests on the notion that price discrimination exists if two products do not have identical absolute markups.[6] That is, for two products, #1 and #2, $P_2 - P_1$ is not equal to $MC_2 - MC_1$. However, Professor Stigler does not support or use this narrow definition in his text. He only mentions it as preferred by "some economists."[7]

The identical absolute markup definition is applicable (if at all) only to the very narrow situation where the two products are themselves virtually identical, and have almost the same marginal cost. The limitations of the definition can be seen clearly by considering a couple of simple examples. Consider first an automotive manufacturing firm that produces a range of automotive products. Among these are SUVs and sparkplugs. Under the identical markup rule, for the firm to avoid price discrimination, the absolute markup on sparkplugs (that is, P – MC) would have to be identical to the absolute markup on SUVs. Common sense, however,

[6] The term "absolute markup" used here and elsewhere is equivalent to what in postal pricing would be called per-piece contribution, measured in dollars or cent.

[7] It is also not supported by the Commission in prior decisions. In developing rates that were consistent with all the pricing criteria, the Commission has frequently declined to follow a pricing approach that would lead to identical absolute markups.

suggests that this is an unreasonable claim. In this and other examples the identical markup rule would also fail the reasonableness test, even when a less dramatic example is chosen, for example, comparing sparkplugs and starter motors. The identical absolute markup rule would be a reliable guide only in the very limited circumstances where the products were so similar as to be, themselves, virtually identical—red pencils vs. green pencils, for example.

The unreasonable conclusions that could result from applying the identical absolute markup rule strictly in all contexts may be the reason that Professor Stigler himself proposes a different definition—equal proportional markup—as a guide in his book (page 209). This definition proposes that price discrimination occurs when P_2 / MC_2 is not equal to P_1 / MC_1. In other words, Stigler asserts that price discrimination occurs when the percentage markups for "similar" products differ. This definition, furthermore, does not equate price discrimination with deviations from 100 percent passthroughs of costs.

Leaving aside considerations of price and marginal cost, there is no universal formula to explain just how "similar" products must be before the concepts of price discrimination have any real meaning. In the two examples given above, "automotive products" do not seem to be "similar" enough, nor do "car parts" like sparkplugs and starter motors. While red pencils and green pencils seem to be similar enough, clearly whether two products, postal or otherwise, would be similar enough to raise concerns over price discrimination is a judgment call and would have to be made on a case by case basis. No hard and fast rule should exist.

In sum, there is no solid basis to claim that different shape-based categories of Standard Mail result in price discrimination solely because certain rate differentials do not equate absolutely to the cost differentials. [8]

3. The presort tree can be a useful tool but neither it, nor other similar devices, should unreasonably dictate postal ratemaking.

The presort tree is one way of organizing information about cost and rate relationships, but it should not be considered the only way. Since Reorganization, the Commission has examined rate proposals and rate relationships, and recommended rates consistent with the Act, in all mail classes other than Standard Mail without using presort trees. In fact, presort trees have not always been necessary even in Standard Mail: the presort tree was not introduced until Docket No. R90-1. Indeed, even in R90-1, the Commission recognized that the presort tree could not be relied on to reflect all appropriate pricing considerations:

> [The presort tree] is somewhat limited in explaining the broader policy concerns we believe exist on this record. We believe these concerns -- which affect presort passthrough as well as shape -- are as important to the actual rate outcome as those which are more amenable to discussion in terms of the tree. Docket No. R90-1, PRC Op. at para. 5947.

In this docket, the Postal Service has proposed to increase Standard Mail price differentiation significantly, introducing many new presort rate differentials along with a rate design for Standard Mail Regular and Standard Mail Nonprofit Regular that is structured generally along the lines of mail processing categories. With the multiplication of rate categories, a single comprehensive presort tree

[8] Parcel Shipper's Association's (PSA) response to NOI No. 2 appears to endorse the equal absolute markup rule embodied in the price discrimination definition rejected by Professor Stigler. While the Postal Service does not agree that Standard Mail parcels and flats are "similar" enough products for price discrimination concerns to arise, it does believe that, if price discrimination issues needed to be addressed, Professor Stigler's equal percentage markup rule would be a more useful starting point for pricing these separate categories.

would run the risk of becoming so complex that it would introduce confusion rather than clarity. Indeed, the absence of clarity is evident in the obvious lack of agreement about which relationships should be included in the tree and which excluded.[9]

Whatever shape of tree is chosen, there is a further danger that the tree may draw attention away from the reasonableness of rate relationships into theoretical debates over the tree itself, and whether calculated passthroughs are consistent with notions of efficient component-pricing—even in cases where the ECP method may not be applicable. The Postal Service has proposed prices that balance a number of factors. Economic efficiency is important, but it should not become a controlling principle in developing reasonable rates and rate relationships. As is often the case, the consideration of economic efficiency must be tempered by many other important considerations including current and long-range operations planning, impacts on customers and competitors, the speed of change in rate relationships, and numerous public policy objectives. The presort tree is a useful starting point, but it, like any other mechanistic rate design tool, cannot address crucial non-cost pricing factors, as required by Section 3622 of the Act. The Commission has explicitly rejected methodologies that subordinate non-cost factors to efficiency considerations in postal ratemaking: “Economic efficiency is neither the exclusive nor even the paramount ratemaking objective under the Act.” Docket No. R2000-1, PRC Op. para. 4042.

As the Postal Service has often stated, its customers pay rates, not markups, contributions, etc. While the presort tree can play a non-exclusive, contributing,

[9] See, for example, Response to VP/USPS-T36-18a, Docket No. R2006-1, Tr. 5/1003.

role in evaluating one component of rate proposals, exclusive reliance on the presort tree diverts focus away from rates. Rate anomalies are discovered by examining rate charts; merely comparing the passthroughs in a presort tree will never provide reasonable assurance that all rate anomalies were uncovered.

4. It is reasonable to use multiple benchmarks for Standard Mail pricing.

The NOI identifies eight benchmarks in the Postal Service's rate proposals for Standard Mail Regular and Nonprofit Regular subclasses. As shown in his workpapers, witness Kiefer actually uses five benchmarks: machinable letters, nonmachinable letters, flats, parcels and NFMs ("not flat-machinable" pieces). (See USPS-LR-L-36, WP-STDREG.XLS, worksheet WP-STDREG-26). Prices for the three additional items identified in NOI No. 2 (automation letters, automation flats and nonmachinable parcels) are derived by applying proposed rate differentials to the nonautomation machinable (benchmark) rates for letters and flats and to the machinable parcel (benchmark) rates for parcels.

These five benchmarks correspond to the principal mail processing paths for Standard Mail Regular (including Nonprofit Regular) pieces. Typically (with the possible exception of NFMs), mail pieces, once entered, do not move between these distinct mail processing streams. These distinct mail processing streams also constitute distinct cost-causation streams and—for purposes of pricing—sufficiently distinct, and dissimilar, product groupings that make it reasonable and rational to use separate benchmarks to derive their pricing.

In witness Kiefer's response to POIR No. 5, question 3a (Docket No. R2006-1, Tr. 5/940-945), he noted that, when selecting benchmarks, it was not

appropriate to choose a category that was atypical of the class. As he pointed out, this is what one would have to do were one to follow rigidly the traditional procedure described in POIR No. 5, question 3. That question noted that it was long-established practice to choose the most costly category in the subclass as the single benchmark for the entire subclass.

There are at least two obvious reasons to favor selecting a "typical category," rather than simply the most costly category, as the benchmark for pricing a logical group of mail. First, typical pieces are more numerous and therefore more likely to show up frequently in the Postal Service's cost sampling system. Frequency in the sample increases the statistical confidence in the benchmark category's cost estimates that will serve as the starting point for pricing related mail categories. Second, over time, the mail processing and delivery processes become attuned to the typical mail categories (and vice-versa). The mail processing and delivery activities for the typical mail categories will then tend to become more standardized and, consequently, easier to cost out accurately. Therefore the ideal candidates for the Standard Mail benchmark categories should be, not necessarily the highest or lowest cost pieces, but the pieces that are most typical of the associated mail and which can be adequately costed for the purpose of rate design. Then, as the NOI points out correctly, the rates for pieces that differ from the benchmark categories can be priced by a combination of discounts and surcharges, as appropriate.[10]

[10] Instances of this already exist in other rate designs. For example, machinable single piece Inter-BMC Parcel Post is the benchmark for the whole Parcel Post subclass. But other Inter-BMC rates are derived from it by a combination of discounts (barcode, BMC and OBMC discounts) and surcharges (nonmachinable surcharge).

5. The five benchmark framework is a reasonable extension of the traditional approach for Standard Mail pricing.

A. Witness Kiefer's framework respects the principles behind the presort tree but adapts it to today's conditions.

The presort tree was originally proposed in a much simpler world: two shapes and four presort levels, but even then could not be applied mechanistically (see, *supra*, quote from PRC Op. R90-1). Today, Standard Mail exists in a much more complex environment. Not only are there more classifications, but more detailed and more complex information is available about costs and about how mail is used. Analysts also have a keener appreciation of the limits of how available cost data should be used. Into this already complex world, the Postal Service has introduced new pricing proposals that will make the Standard Mail rate structure even more complex. Any analytical tool or rate design methodology—whether it is the presort tree or something else—must evolve and adapt to the expanded information and expanded complexity of the rate structure. Moving from a one-trunk presort tree to multiple trunks is a logical evolution, based on today's conditions. Witness Kiefer's modifications are not a radical departure from the principles behind the former presort tree. Indeed, his approach is consistent with establishing five presort trees with the five trunks reflecting both costs and other important pricing criteria.

B. The original conception of the single-trunk presort tree cannot readily be adapted to current pricing complexity

Properly applied, the presort tree should be a simplifying tool, but as the pricing structure becomes more complex, in order to maintain the original single

trunk design, the analyst would be compelled to place rate categories that have little meaningful rate design relationships adjacent to each other on the tree (and calculate "passthroughs" between these adjacent categories). For example, the analyst is faced with the question: what rate category should be adjacent to nonmachinable letters? Should it be nonautomation flats? Automation flats? Nonmachinable parcels? NFMs? A case could be made for each one of these.

These choices would also have consequences within the single-trunk presort tree framework. For example, suppose the analyst chooses to place nonautomation flats adjacent to nonmachinable letters. In that instance, where would the automation flats branch go? The only sensible solution would be to expand the tree to a third dimension. How, then, would a three-dimensional presort tree be represented on paper without introducing further layers of confusion?[11]

Frequently, the reasonable solution to complex problems like these is to break the larger problem down into a set of related smaller problems and to explicitly consider the relevant interrelationships. Witness Kiefer's multiple benchmark framework takes this approach.

C. Each benchmark is chosen to reflect costs, current rates and current rate relationships

Witness Kiefer's multiple benchmark (or "multiple trunks") framework is consistent with past principles used to price Standard Mail but applies them on a

[11] Another complexity that has not received much attention in the presort tree debate is how the presort tree handles rate relationships that cross subclass boundaries. Examples include the relationship between the rates for ECR Basic letters and Regular Automation 5-digit letters and the relationship between Parcel Post Inter-BMC rates and Priority Mail rates.

smaller scale, while still paying attention to pertinent considerations between the trunks. Each trunk has a base piece (or benchmark piece), typically the most costly piece within the category (in line with the traditional approach). For example, for Standard Mail Regular machinable letters, this base piece is a non-drop-shipped nonautomation Mixed AADC letter. Then, as witness Kiefer has described in his response to NAA/USPS-T36-4, he developed prices for the base piece (and, by extension, other components leading off the trunk) starting from current rates and incorporating unit cost information, rate relationships between shapes, impacts of rate changes (both within the shape category and across categories) and other factors, such as the need to achieve the subclass revenue target. His pricing worksheets (USPS-LR-L-36, WP-STDREG-26 and WP-STDECR-16) display the combined base piece mail processing and delivery costs for each of the five separately benchmarked categories in the box in the upper left corner. Below these cost data are the per-piece and per-pound rate elements for each category. The reflections of the cost relationships between each of these categories were modified as needed by taking into account appropriate non-cost considerations like those cited above. In this way he incorporated consideration of shape-related cost differences into his benchmark rates, albeit not in the same mathematical manner traditionally employed in the single-trunk presort tree methodology.

Once the benchmarks have been established, pricing moves down each branch using worksharing cost differentials in the customary way to develop pricing for more heavily workshared versions of the each category of mail,

keeping in mind the rate relationships, not only within each branch, but across branches with traditionally important rate relationships.

In his usage of a multiple trunk framework, witness Kiefer has addressed these important rate relationships, as shown in his pricing worksheets. For example, the pricing for the base flat piece (a Mixed ADC origin entered nonautomation flat) is higher than the base price proposed for machinable letters (a Mixed AADC origin entered nonautomation letter), reflecting in part the higher costs of flats. But it also recognizes other factors as well. These include the following:

- Certain existing rate relationships between letters and flats which incorporate some of the important non-cost factors that have been recognized in the rates of the two shapes of mail over the years.
- The Postal Service's desire to broadly reflect, rather than microscopically trace, differences in measured costs.
- The impact of rate changes and rate relationship changes on mailers.

In a similar fashion, the proposed base piece (benchmark) pricing for nonmachinable letters reflects the higher costs of manual processing of nonmachinable letters compared to machinable letters. And, the higher costs of processing and delivering parcels and NFMs has been reflected in proposed pricing for the benchmark pieces (origin entered, machinable parcels and NFMs) that is higher than the benchmark pricing for the benchmark flat piece. Nevertheless, as witness Kiefer has testified (USPS-T-36, at 18), the potential impact of raising prices to fully reflect costs led him to propose piece and pound

rate elements for benchmark parcels that are lower than the costs would otherwise indicate. The benchmark NFM piece's proposed rate elements also take into consideration the current pricing of NFMs as flats, as well as recognition of some potential delivery cost savings from the "caseability" nature of NFMs. For these reasons, the benchmark price is set below the benchmark price for parcels but above the benchmark price for flats (see USPS-T36, at 22-23).

As these several examples show, the multiple benchmark approach does not set benchmark prices in an arbitrary or unconstrained fashion. Cost and non-cost relationships between the separate trunks were given appropriate consideration as they always have, despite the evolution of the model from the traditional single-trunk to a multiple-trunk framework.

6. Conclusion.

Postal pricing is an exercise that is not solely, or even primarily, focused on economic efficiency. The Postal Service, along with the Commission, considers a wide range of factors—both non-cost and cost-related—in developing prices that reflect all the pricing factors of the Act. Economic efficiency is one consideration, but, as the Commission has asserted, it is not the only factor, nor even the paramount factor (see, *supra*, quote from PRC Op. R2000-1). Moreover, when taking economic efficiency into account, there are a variety of methodologies, techniques, and tools—ECP (appropriately applied), presort trees, price discrimination rules, among others—that can be of use as guides. Each has its uses and its limitations, but none are infallible arbiters of economic efficiency in pricing, and none can replace a careful balancing of <u>all</u> factors when establishing

postal rates. The Postal Service will continue to propose pricing that results from a careful consideration of all the pricing factors of the Act; and it will continue to use the principles underlying ECP and the presort tree, where appropriate, as one tool to evaluate the appropriate application of the principles of economic efficiency to postal pricing.

Respectfully submitted,

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