

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

POSTAL RATE AND FEE CHANGES, 2006

)
) Docket No. R 2006-1
)

Comments of the
American Bankers Association (ABA)
In Response to Notice of Inquiry 3 (NOI 3)

(August 17, 2006)

The American Bankers Association (ABA) hereby submits these comments in response to the Commission's Notice of Inquiry Number 3 in this docket. We welcome this NOI and appreciate the Commission's desire to thoroughly air all aspects of this very important issue.

This case presents the Commission with the opportunity to update its 30-year-old approach to deciding when and how to recognize intra-subclass cost differences in intra-subclass rate design. In this docket, the Commission can realign its rate-setting approach to match the changes that modern mail processing and the evolution of the contemporary mailstream have created in the mailing industry, and to better align rates with costs.

We strongly urge it to do so.

I.
Preliminary Points

Several preliminary points need be made. The first is that, in recognition of the gradual transmutation that has occurred in bulk mail entered at First-Class rates over

the years, we will use the term Bulk First-Class Mail (BFCM)¹ to refer to what has previously been known as “workshared” or “Presorted First-Class Mail.” We do so because we have found that the terms “workshared” and “presorted” are no longer adequate descriptions for this category of mail, and thus tend to create a false impression—i.e., that BFCM is just like Single-Piece First-Class Mail except that it is “presorted” and “workshared.”² We take this approach in light of the fact that this area of postal rate making is very confusing, and based on archaic terminology and assumptions that have been used for so long that they have taken on a life of their own. It is time for that to change, and for the Commission to update its methodology.

The second point is that in NOI 3 the Commission seems to suggest that the Postal Service is, at least implicitly, proposing to treat Single-Piece First-Class Mail and Bulk First-Class Mail as separate subclasses. NOI 3 at 2. This language is being taken by many in the postal community as an indication that the Commission thinks that the Postal Service has opened up the question of a separate subclass in its proposal. Our understanding of the Postal Service’s Proposal is that the Postal Service is consciously trying *not* to treat Single-Piece First Class and Bulk First Class as separate subclasses. Key to separate subclass status is having separate cost *and* separate demand characteristics. Key to pricing on a subclass basis is pricing based on *both* the separate cost and demand characteristics. Nowhere in the Postal Service’s proposal are

¹ The ABA is not suggesting that this term is the best expression to use for this group of mail, and thus is not suggesting that the Commission formally adopt it. The choice of the proper term to use for this group of mail should be decided collectively by the major uses of BFCM.

² Specifically, “Bulk First-Class Mail” is that mail that pays the rates set forth in existing Rate Schedule 221 for “Presorted,” “Automation Letters,” and “Automation Flats” and in proposed Rate Schedule 221 for “Presorted,” “Automation Letters,” “Automation Flats,” and “Business Parcels.”

separate demand issues for Bulk First-Class Mail raised, much less analyzed, or applied.

Instead, the Postal Service simply proposes to recognize, more fully than at present, all cost differences in intra-subclass rate pricing, not just cost avoidances. That has nothing to do with demand, nor with a subclass approach.³ Granted that the Postal Service decided to calculate separate revenue requirements for Single-Piece First Class and Bulk First Class, but that was done in order to enable the Postal Service to achieve its stated goal of an equal unit contribution for Single Piece and Bulk within the subclass.

The third point is that this Notice implies that the existing “cost avoidance” methodology is superior to the Postal Service’s proposed methodology because the existing methodology sends “correct” price signals. We disagree with that proposition. In order to send proper signals, rates must track costs. Under the current methodology, BFCM rates do not track costs, a fact the Postal Service has (finally) admitted.⁴ If rates are not tracking costs today, then the “correct” price signals are not being sent today, a fact that the Postal Service’s proposal attempts to rectify.

In the pages below, we will examine these points within the context of the contemporary mailing industry, and discuss why and how the Commission should accommodate the Postal Service’s decision to price within subclasses by a series of

³ Indeed, we submit, demand issues are irrelevant to the Postal Service’s approach. In this respect, the discussion at pages 5 and 6 of NOI 3 about overlapping markets focuses on a straw man, and is *not* a necessary inquiry. In examining the Postal Service’s approach, it should make no difference whether the markets for Bulk First-Class Mail and Single Piece overlap or not, for an approach dealing with cost benchmarks within a subclass is not an approach that calls for a demand or market analysis.

⁴ Direct Testimony of Altaf H. Taufique in Docket R 2006-1, USPS-T-32 at 14-15.

separate benchmarks and to recognize a broader cost base.⁵ In doing so, we will not delve into the theoretical economics of pricing, nor trace the ways that the current costing approach has worked over the years to penalize Bulk First-Class Mail.

II. The Factual Context In Which The Commission Should Address These Issues.

A. The Realities of Modern Mail Processing

The Postal Service's processing environment has changed radically since the early days of "workshared" and "presorted" mail, when the notions of recognizing only "avoided costs" and "converting" from Single Piece had a certain validity. Today, it is an entirely different world. Where clerks once manually handled presorted mail a bit quicker than non-presorted mail, now just one machine zips tens of thousands of letters per hour on belts through readers and mechanical gates. Similar machines handle flats and parcels, although at a much slower speed. As a result of this divergence in processing speed among letter, flat, and parcel sorting machines, shape has become—and will remain—one of the preeminent drivers of mail processing costs. Thus, shape-based costs are costs intrinsic to the piece being mailed, and are not "costs avoided" by the Postal Service due to mailers doing the work instead of the Postal Service.

In this Docket the Postal Service proposes to better recognize the much higher costs of flats and parcels by creating a shape-based rate structure.⁶ In making its

⁵ Shape appears to be the predominant cost driver in this broader base, although a number of other drivers are present also. See Taufique at 14.

decision to recognize shape, the Postal Service has decided to propose an approach that not only recognizes shape, but goes beyond it and beyond recognizing only “avoided costs.” The approach that the Postal Service developed for this case is to de-link Bulk First-Class Mail from Single Piece, create a series of AADC benchmarks in First Class for letters, flats, and parcels, and then build discounts off of those benchmarks. The American Bankers Association strongly supports the approach, and urges the Commission to adopt it.

B. The Realities of the Contemporary Bulk First-Class Mailstream

Just as the Postal Service’s mail processing environment has radically changed over the last thirty years, so too have the characteristics of “workshared” and “presorted” mail. This type of mail has evolved to such a degree, that it has in fact transmuted into a different “type” of mail. Where individually-prepared single-piece mail once “converted” to “workshared” mail because of mail discounts, now commercial mail is prepared, printed, barcoded, presorted, and entered—hundreds of thousands at a time—into the mail stream in bulk at First-Class rates. This process happens in much (if not exactly) the same way as commercial mail is prepared, printed, barcoded, presorted, and entered into the mail stream in bulk at Standard Mail rates.⁷ Thus, most Bulk First-Class Mail is far different from the Single-Piece First-Class Mail that is

⁶ The United States is not the only country shifting over to shape-based pricing. In Great Britain, the British Post is engaged in a similar shift and has created the rubric “Pricing by Proportion,” to characterize and explain its efforts.

⁷ A mailer could personalize a piece to be sent at First-Class rates more than a piece sent at Standard Mail rates, or not.

entered one piece at a time by businesses and Aunt Minnie.⁸ This fundamental difference is reflected in the significant difference in the average cost of Bulk First-Class Mail and Single-Piece First-Class Mail, somewhere around 18 cents. *Less than half* of those costs—around 8 cents—are recognized as “avoided costs.”⁹ That means that almost 10 of the 18 cents of the cost difference are *not* recognized. That is an *enormous* difference.

In terms of Advertising Mail, as the recent First-Class NSAs have shown so well, financial institutions have a choice to enter an advertising piece as either First Class or Standard Mail. They make that decision based on postage rate levels, speed of delivery, available budget resources, and upon the demographic and psychographic characteristics of the targeted audience. The advertising piece that could go either First Class or Standard Mail is generally the same type of piece regardless of the rate at which it is entered. Also, it is a piece that is prepared using the same databases for addressing, and under the same print and quality control processes. In the end, the piece generally has the same mailing characteristics, regardless of whether it is entered as First Class or Standard Mail.

In like fashion, when financial institutions prepare monthly statements for credit cards, mortgages, home equity loans, and other personal or business loans, they too use a uniform piece (which is individually personalized), use the same databases, go through the same print and quality control processes, and do so in bulk—thousands at a

⁸ Moreover, the amount of growth in Bulk First-Class Mail that comes from conversion of single-piece mail, including BMM, is relatively infinitesimal.

⁹ NAPM has reported to its members that the weighted average of the FY 2005 “worksharing” discounts is 8 cents.

time. In the end, statement mail has very much the same mailing characteristics as Advertising Mail.¹⁰

Indeed, if one were to compare BFCM to Single-Piece First-Class Letter Mail (even to BMM) and then compare it to Regular Standard Letter Mail, one would find that the mailing characteristics of BFCM are far closer to Standard Regular Letter Mail than to Single-Piece First-Class Letter Mail.

Admittedly, because of the Private Express Statutes, were Bulk First-Class Letter Mail rates to hypothetically disappear, the invoices and bills that make up part of Bulk First-Class Mail would be legally forced to become Single-Piece First-Class Mail,¹¹— assuming they even remained in the mail. In “reality,” if BFCM rates were to disappear, the race to the internet and email would be on, and the growth in electronic delivery of invoices and bills would be sudden and explosive. *Cf.* pages 11-12, *infra*.

This is not true for that part of Bulk First-Class Mail (roughly 18% of First-Class Mail received by households)¹² that is made up of Advertising Mail. If Bulk First-Class Mail rates were to hypothetically disappear, that Advertising Mail would instantly shift into Standard Regular, or just disappear into other non-mail marketing channels. In any case, while both of these “what if” scenarios would be relevant to a demand inquiry, they are not relevant to the type of cost inquiry that the Postal Service’s proposed delinking requires.

¹⁰ The one clear exception is address accuracy. Address accuracy of statement mail tends to be much better than the address accuracy of advertising mail since companies almost always know the correct address of the vast majority of their customers, and take great pains to keep it updated. Additionally, it is in their customers’ interest to see that the company has correct addresses.

¹¹ That shift would be caused by legal constraints, not by economics.

¹² Direct Testimony of Peter Bernstein in Docket R 2006-1, USPS-T-8 at 13.

In sum, while “presorted” and “workshared” mail started out as just that—mail that was converted and presorted in response to workshared discounts—as time went on, that mail evolved and what was essentially a difference in quantity changed to a difference in quality. Mail that could be converted largely disappeared and was largely replaced by Bulk First-Class Business Mail. Thus, while the image of Bulk First-Class Mail as “converted” single-piece mail is a wonderfully charming, picturesque and quaint image, it has little to do with the reality of the vast majority of today’s commercial mail.

III. The Commission’s Current Rate-Setting Approach Recognizes Either Demand & All Cost Characteristics, Or Just “Cost Avoided” Cost Characteristics

The most fundamental question the Commission asks when setting rates is whether mail could be placed in its own subclass, or whether it could share a subclass with other mail. The test for subclass status turns on two issues, whether the mail in question has cost characteristics distinctly different from other mail, and then whether the mail in question has demand characteristics distinctly different from other mail. See MC95-1 Opinion and Recommended Decision at V-14, ¶ 5030. If the mail has sufficiently different cost characteristics, and sufficiently different demand characteristics, then it may be placed and priced in a separate subclass.

The significance of being priced as a separate subclass is twofold. First, all of the mail’s distinct cost characteristics are recognized and attributed to that mail. Second, the mail’s distinct demand characteristics are recognized and taken into account in pricing, as the attributable costs of the mail are used as a base from which to “markup” the mail and obtain an appropriate cost coverage ratio, in recognition of demand and the other factors of Section 3622(b).

Where mail does not pass this bifurcated test of sufficiently distinct costs *and* demand characteristics, or where the Postal Service chooses not to price mail as a separate subclass,¹³ differences in mail costs are recognized in intra-subclass pricing. In intra-subclass pricing, the Commission ignores demand characteristics. It also largely ignores cost characteristics that are not “cost avoided” characteristics, such as shape.¹⁴ As a consequence, the specific rate levels within the subclass are set on the basis of the “avoidable cost differences” between the mail in each rate category within the subclass, regardless of whether all cost gaps are taken into account.

In sum, when pricing on a subclass basis, the Commission currently takes into account *both* the total cost characteristics and the demand characteristics of the mail. In sharp contrast, when pricing on an intra-subclass basis, the Commission takes into account *neither* the demand *nor* the total cost characteristics of the mail, *but just* the “avoided-cost” cost characteristics of the mail.

IV. The Need For Change.

A. Economic and Fairness Considerations.

Where the costs of the different mail within a given subclass vary only slightly, or where the costs of different mail within a given subclass vary only by avoidable costs, a system such as the Commission’s can be fair, equitable, and encourage economic

¹³ In this case the Postal Service has not proposed to place Bulk First-Class Mail in a separate subclass. Nor will the ABA make such a proposal. However, ABA would like to make it perfectly clear, before proceeding, that the positions it takes in this case should in no way be read as acquiescing to the Postal Service’s decision not to seek a separate subclass for Bulk First-Class Mail, and ABA reserves the right to revisit that question in the future, should ABA feel it appropriate.

¹⁴ There have been some recognition of non-avoided cost differences in various First-Class surcharges, but it has been fairly minimal, as least when compared to the recognition of non-avoided cost differences in periodical and standard mail. In standard and periodical mail a host of nonavoided costs are recognized in a wide variety of ways.

efficiency. However, where rates set under such a system end up failing to reflect significant cost differences of any type, such rates tend not to be fair, not to be equitable, and not to encourage economic efficiency.

The ABA urges the Commission to step back, look at the larger picture, and consider that the most fundamental principal of cost-based rate setting is that *rates should reflect costs*. Having rates that do not reflect costs inevitably leads to the inefficient allocation and use of resources, and to “cease-to-mail” decisions by mailers. These are decisions “not-to-mail” that would not have been made, had rates tracked costs. The larger the group of mail whose rates do not track costs, the greater the potential dislocation. Good public policy suggests that the more mail services cost, the more a mailer should pay, and conversely the less mail services cost, the less a mailer should pay. That principle has been violated time after time after time again in regards to Bulk First-Class Mail as the Commission has ignored many of BFCM’s inherent cost characteristics in setting rates. This must stop.

As largely conceded by Witness Taufique, various pieces of testimony have shown over the years that the costing of Bulk First-Class Mail does not reflect actual costs.¹⁵ This is a matter of great concern to First-Class Mailers, and should be of great concern to the Commission. The use of “hypothetical” mail as a basis for pricing, the misclassification of costs and costs pools, and the removal of legitimate cost savings from “avoided cost” calculations have skewed the playing field for too long.

¹⁵ See, for example MMA SR-T-1 and ABA&NAPM SRT-1 in R 2001-1; MMA T-1 and ABA&NAPM ST-1 in R 200-1; MMA T-1 and ABA T-1 in R94-1; CPUM/NRF T-1, NAPM T-2, and ABA/MMA T-1 in R90-1.

B. Electronic Diversion Considerations.

For years, various groups have proclaimed that the Postal Service was in crisis due to the diversion of bill payment and bill presentation mail to email and to the internet. No such death spiral has developed. What has developed, however, is that the statements segment of Bulk First-Class Mail has ceased to grow, and is beginning a slow, steady, and persistent erosion.¹⁶ Instead of the large growth rates of the 90s, growth rates for Bulk First-Class Mail have dropped to miniscule proportions, and in 2003 Bulk First-Class Mail volume actually declined.

This comes as no surprise to the financial services industry, for we are taking increasingly strong steps to deliver our bills and account statements electronically to our customers. The challenge for the Postal Service is to manage this erosion. Electronic diversion is a trend, and a trend that probably will not be reversed. However, if managed carefully, Postal Service efforts in this area could have a noticeable effect and preserve tens to hundreds of millions of dollars in institutional cost contribution that it would otherwise lose.¹⁷ Such a management strategy is critical to the future of our postal system.

The challenge for the Commission is to ensure that the Postal Service has the pricing tools and pricing flexibility necessary to do what it must for this mail. Above all, if the Postal Service is to manage this critical issue properly, the Commission must give the Service the freedom to manage it, even the freedom to make an occasional mistake. Not that the Commission should concede its authority to the Postal Service. It

¹⁶ Bill payment mail is also converting to electronic delivery at a pace somewhat faster than bill presentation mail. See Taufique at 13.

shouldn't. That would be a fundamental mistake. But there is little doubt that certain parties in this case will, by the time the case is finished, end up urging the Commission to reject the innovations in methodology that the Postal Service has proposed, in favor of retaining a methodology that is at least a decade out of date. The Commission should reject such suggestions. Rather, it must recognize current economic realities and it should create a pricing and costing structure that is appropriate for the 21st Century by adopting the Postal Service's proposal.

The Postal Service faces very challenging times. One of the keys to success will be pricing Bulk First-Class Mail properly, and we urge the Commission to recognize that the fate of the Postal Service may well rest on what happens to BFCM in the next ten years. Companies are run by business people, not computers, and it is their subjective, informed judgment that gets a company through challenging times. Postal customers, being business people, will not make their decisions based on some variation of an economic theory. Rather, they will make their decisions based upon how the cost and value of BFCM relate to other alternatives, and the outcome of that analysis will depend in part on whether the price of BFCM accurately reflects its costs to the Postal Service.

In order to more accurately have rates reflect costs, the Postal Service requests that the Commission cut the tie between Single Piece and BFCM. We believe that the Commission should do so, and allow Bulk Business First-Class Mail to de-link and to be costed separately.

¹⁷ Two such efforts are present in this case: 1) the long-overdue lowering of the First-Class additional ounce rate, and 2) the delinking of Bulk First-Class Mail from Single-Piece Mail and the recognition of shape-based pricing.

V.
The Postal Service's Proposal In This Case
Is An Intermediate Approach That Recognizes
That Rates Differences Should Reflect Cost Differences.

In this case, the Postal Service proposes, on an intra-subclass basis, to price both on total costs (in setting separate benchmarks) and on the basis of “avoided costs” (in setting workshare discounts off the benchmarks). It is a welcome approach that seeks to more fully recognize costs such as shape, without stepping to the quagmire of demand analysis and separate subclasses.

In this case the Postal Service has created a middle ground for pricing Bulk First-Class Mail that does not recognize the separate demand characteristics of that mail, but does take a firm step towards recognizing a larger set of cost characteristics that goes beyond just “avoided costs.” To do this, the Postal Service has chosen to create a series of shape-based benchmarks at the AADC level, in order to more fully track rates and costs, and to base them on CRA costs. The fact that the Postal Service bases these costs on CRA costs is critical, for as Witness Taufique points out, these CRA costs are not just “avoided costs”:

The CRA and the rollforward model, which forecasts costs by using the base year CRA as a starting point, have long reported separate, independently-derived estimates of the costs and revenue for Single-Piece Letters and for Presort Letters. [footnote omitted] The costs developed for these CRA line items are “bottom-up” costs, reflecting the results of the full range of cost estimation systems and techniques used to inform the CRA (e.g., the In-Office Costs System, the City Carrier Cost System, TACS, etc.)

The comparison of costs as reported for Single-Piece Letters and for Presort Letters does not simply reflect the cost avoided by the Postal Service when a mailer chooses to perform worksharing activities, such as presorting or applying a barcode. Because the costs are developed in total, they reflect the full range of differences between the two sets of mail — differences perhaps unrelated to the actual worksharing activity but reflective of the different cost characteristics of business-orientated mail entered in large quantities, as compared to single-piece mail. These cost characteristics may reflect such things as the number of postal facilities through which the mail traverses, the proportion of the mail transported via air rather than ground transportation, the readability of the mail, the proportions of the mail that are undeliverable-as-

addressed, the utilization of retail facilities for entry, etc. ***Thus, a comparison of the relative costs and rates (and resulting cost coverages) for Single-Piece Letters and Presort Letters reflects more than simply the costs avoided by performing worksharing activities which the Postal Service the Postal rate Commission have determined are appropriately reflected in rate differences.***

Taufique at 13-14 (emphasis added).

Adopting such an approach would eliminate, as Witness Taufique points out, much of the debate over cost pools, extraneous cost characteristics, and “dirty” versus “clean” mail. As Witness Taufique states—and we concur—adopting this approach will also help maintain higher volumes of Bulk First-Class Mail, with its high markup, in the system. *Id.* at 15. Adopting such an approach would also allow the Postal Service to develop more accurate and less controversial cost measurements over time, and perhaps even better-measured benchmarks.

In sum, the American Bankers Association applauds the Postal Service for recognizing the essential truth of what it and other business mailers have been saying for years. This change in methodology is long overdue. We very strongly urge the Commission to accept it.

Respectfully submitted,

/S/ Robert Brinkman
Robert J. Brinkmann
Irving Warden

Gregory F. Taylor, Esq.
American Bankers Association
1120 Connecticut Ave., N.W.
Washington DC 20036
(202) 663-5434

1101 17th Street, N.W. Suite 605
Washington, D.C. 20036
202-331-3037, 202-331-3029 (f)
robert.brinkmann@rjbrinkmann.com
wardenlaw@comcast.net

Counsel for the American Bankers Association

August 17, 2006