

BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON, DC 20268-0001

POSTAL RATE AND FEE CHANGES, )  
2006 )

Docket No. R2006-1

**COMMENTS OF  
ASSOCIATION FOR MAIL ELECTRONIC ENHANCEMENT,  
FINANCIAL SERVICES ROUNDTABLE,  
NATIONAL ASSOCIATION OF PRESORT MAILERS,  
NATIONAL POSTAL POLICY COUNCIL  
AND PITNEY BOWES INC.  
IN RESPONSE TO NOTICE OF INQUIRY NO. 3  
(August 17, 2006)**

The undersigned parties respectfully submit these comments in response to Notice of Inquiry No. 3. The NOI solicits comments on the Postal Service's proposal in this case to de-link the rates for the Single-Piece and Presort categories of First-Class Mail.

The NOI presents a welcome and timely opportunity to reexamine the Commission's 30-year-old standards for recognition of intra-subclass cost differences in rate design. It is time to expand on the existing "cost avoidance" approach by moving toward recognition of *all* differences in attributable cost between the Single-Piece and Presort categories. The Postal Service's proposal in this case to de-link First-Class Presort rates from Single-Piece rates is a reasonable step in that direction. De-linking does not require the Commission to establish a separate subclass, or to determine separately the coverage ratios for

Presort and Single-Piece First-Class Mail. The Commission should recommend both the de-linking proposal and the rates that it produces.

### **SUMMARY OF COMMENTS**

NOI #3 raises a perennial issue in postal ratemaking: should the rate structure recognize *all* cost differences between rate categories—or just the subset that can be attributed to narrowly-defined worksharing “cost avoidance”? The more restrictive approach may have been a reasonable first step in the infancy of presort discounts three decades ago. The maturation of Presort Mail, however, has made increasingly clear the need for a fresh look at this subject.<sup>1</sup>

First-Class Mail is, as the Commission has recognized, a heterogeneous service. Its costs are affected by many quality attributes other than the degree of presortation—e.g., weight, shape, length of haul, accuracy and legibility of the address, retail sales channel or method of payment evidencing, and rigidity and durability of the mailpiece. The cost effects of these quality attributes, however, are recognized only partially in the rate structure.

To establish rate differentials between groupings of First-Class Mail, the Commission has adopted a binary, all-or-nothing approach. The threshold test is whether the differences in cost and demand between two groups of mail service

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<sup>1</sup> As the Commission emphasized almost 20 years ago, presort discount standards are not set in stone:

It should be made clear to the parties, as it has become to the Commission in our review of the record in this proceeding and the history of the presort discounts, that one designated costing methodology or approach may not be appropriate for a particular presort discount throughout the history of that category’s existence.

R87-1 Op. & Rec. Decis. ¶ 5185.

are great enough to treat them as separate “subclasses”—or just separate “categories” within the same subclass.

For subclasses, the Commission estimates the average attributable costs of each group of service separately, and establishes “coverage ratios” (markups to cover institutional costs) for each group based on a separate consideration of demand elasticities and the factors prescribed by 39 U.S.C. § 3622(b).

For categories, the Commission disregards not only any differences in demand within the parent subclass, but also a large share of the differences in average attributable costs. Instead, the Commission designates one category of mail as the “benchmark” category, and other categories as its derivatives. Rate differentials between the benchmark category and a derivative category generally do *not* reflect the full difference in average attributable costs, but only the subset of cost differences that the Commission finds to be the result of narrowly-defined mailer worksharing (so-called “cost avoidances”).

Moreover, many of the attributes of First-Class Mail that affect its cost, but which are not classified as narrowly-defined worksharing cost avoidances, are also unrecognized in any other element in the current rate structure. Some of these cost drivers (e.g., length of haul) are not recognized in the First-Class rate structure at all. Other important cost drivers (e.g., shape), while recognized through separate rate elements, are recognized only partially because cost passthroughs are less than 100 percent. As a result, a large share of intra-subclass cost differences go unrecognized anywhere in the current First-Class rate structure. The average difference in attributable costs between Presort and Single-Piece First-Class Mail that is recognized in *neither* the average rate

differential between the two categories *nor* in any individual rate element has grown in recent years, and is now approximately ten cents per piece.

The Commission's binary approach to cost recognition has led to years of wrangling. Which category of Single-Piece Mail is the proper "benchmark" for Presort Mail? From what hypothetical source category of mail has Presort First-Class Mail "converted"? Once the "benchmark" category has been chosen, which cost differences from that benchmark should be recognized through "discounts" for "cost avoidances"? And which cost differences should be treated as mere "cost differences," and therefore disregarded in rate design?

We respectfully submit that much of this controversy is unnecessary. The notion that rate differentials between Presort and Single-Piece First-Class Mail should be limited to the subset of cost differences found to be presort-related cost avoidances under existing costing methods is a misreading of the relevant principles of economic efficiency, including the Efficient Component Pricing Rule ("ECPR"). First, the failure to model cost avoidances in all relevant mail processing cost pools, coupled with the default assumption that unmodeled cost pools are unaffected by the level of presortation, has produced artificially low estimates of even narrowly-defined presort-related cost avoidance and thus workshare discounts. Second, analysts have assumed that the benchmark mail category from which to compute cost avoidances is the mail most likely to be workshared; in fact, the correct benchmark is the average Postal Service cost of processing the *marginal* mail type. Third, proper application of the ECPR requires that rate differences recognize the costs of *all* components of service

avoided by the average piece in the lower-cost category, not just the cost avoidances caused by presorting.

Correcting these three errors would substantially narrow the gap between “cost difference” and “cost avoidance” under existing methodologies, while satisfying all relevant principles of economic efficiency, including the ECPR. The Postal Service’s proposal in this case to de-link Presort rates from Single-Piece rates represents a significant movement toward the correct approach. Moreover, de-linking does not require the Commission to determine coverage ratios separately for Single-Piece and Presort First-Class Mail, or to undertake the analysis of markets and demand needed to justify the establishment of separate subclasses. For these reasons, the Commission should approve de-linking and recommend the First-Class rates proposed by the Postal Service.

## **COMMENTS**

### **I. EXISTING RATE DESIGN STANDARDS IGNORE A LARGE SHARE OF THE COST DIFFERENCES BETWEEN SINGLE-PIECE AND PRESORTED FIRST-CLASS MAIL.**

As NOI #3 notes, the Commission’s existing standards establish a binary scheme for setting rate differentials between different groupings of mail. The threshold test is whether costs of and demand for two groupings of mail service differ enough to warrant treating them as separate subclasses, or just as separate categories within the same subclass. See, e.g., R80-1 Op. & Rec. Decis. ¶ 692, *aff’d*, *Newsweek, Inc. v. USPS*, 663 F.2d 1186, 1210 (2<sup>nd</sup> Cir.

1981); R84-1 Op. & Rec. Decis. ¶¶ 5090-5106; R87-1 Op. & Rec. Decis. ¶ 5144; MC95-1 Op. & Rec. Decis. ¶¶ 3022-25, 5030-34.<sup>2</sup>

Rate differentials *between* subclasses are set from the bottom up. The Commission estimates separately the attributable costs of each subclass, and sets a coverage ratio for each subclass. The coverage ratio for each class or subclass is based on subclass-specific demand elasticities and subclass-specific application of the other factors specified in 39 U.S.C. § 3622(b). See MC95-1 Op. & Rec. Decis. ¶¶ 2073, 3017-18.

For different categories within the *same* subclass, the Commission usually sets rate differentials from the top down. The Commission begins by designating a low-worksharing rate category within the subclass as the rate benchmark for other categories with more worksharing. Rates for the latter, derivative rate categories are set by subtracting from the benchmark rate any differences in attributable costs that the Commission finds to be avoided by the worksharing. All other cost differences between the categories are ignored. In the Commission's parlance, inter-category rate differences may reflect worksharing "cost avoidances" but not "cost differences."<sup>3</sup> Differences in demand elasticities

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<sup>2</sup> We take no position here on the merits of establishing separate subclasses for Single-Piece and Presort First-Class Mail, or determining the coverage ratios or per-piece contributions determined separately for the two types of mail. We assume for the sake of argument that the existing classification of these two groupings of mail as categories rather than separate subclasses is correct, and focus solely on the proper method of recognizing differences in attributable costs between the two groupings.

<sup>3</sup> See NOI #3 at 2-4 (quoting R84-1 Op. & Rec. Decis. ¶ 5132 and R90-1 Op. & Rec. Decis. ¶¶ 5066-67, 5088). The Commission often used a "cost difference" approach until 1995. See R87-1 Op. & Rec. Decis. ¶ 5195. Since MC95-1, however, the Commission has adhered to a "cost avoidance" approach. See MC95-1 Op. & Rec. Decis. ¶ 4222.

also play no role in setting rate differentials between categories, and the Commission does not set different unit contributions for individual categories. See R87-1 Op. & Rec. Decis. ¶¶ 5149-5151; MC95-1 Op. & Rec. Decis. ¶¶ 2073, 3071.

The “cost avoidance” approach, as currently applied, leaves unrecognized more than half of the average difference in attributable costs between the Single-Piece and Presort categories of First-Class Mail. As the Commission has recognized, First-Class Mail service is “heterogeneous”: it has it has multiple dimensions of quality other than the amount of mail sorting performed by the Postal Service. These quality differences in turn can produce a wide spectrum of attributable costs:

There are a myriad of reasons why the pieces of mail within [single piece First-Class Mail] have varying costs. For example, they are sent different distances; they are sent in different parts of the country; they are to be delivered to rural or urban areas; they are addressed in different ways; the paper used is different; the mail-piece is shaped differently; the list goes on and on.

MC95-1 Op. & Rec. Decis. ¶ 3064; *accord*, NOI #3 at 3 (quoting R84-1 Op. & Rec. Decis. (Sept. 7, 1984) at ¶¶ 5093 & 5129).

Many of these non-presort quality attributes are recognized only partially, if at all, in individual rate elements. For example:

1. First-Class rates include neither destination-entry discounts nor distance based rate zones, and thus do not recognize the cost effects of the distance between the entry point and the addressee.
2. Until now, the First-Class rate structure has offered little recognition of the cost effects of the shape of the mailpiece (letter, flat, or parcel). Although the USPS is proposing in this case to give

increased rate recognition to shape as a cost driver, the recognition is far from complete; the proposed passthroughs of shape-related costs are substantially below 100 percent.

3. The unit cost of First-Class Mail is also affected by the number of pieces in a mailing, and the total volume of all mail pieces entered by a given mailer in a year. Greater mail volumes reduce the *unit* transaction costs of mail acceptance and enforcement of mail design and address quality requirements.
4. The First-Class rate structure recognizes none of the unit cost differences caused by the sales channel (e.g., retail window or CAPS account) or postage evidencing methods (postage stamps vs. meters vs. permit indicia) used by the mailer.
5. Mail addressing requirements allow wide variations in the correctness, completeness, and legibility of addresses, particularly for Single-Piece Mail.

The lack of rate elements for many individual cost drivers might be of little concern if the overall cost effects of these quality characteristics were distributed evenly between the Single-Piece and Presort categories of First-Class Mail. In fact, the non-presort characteristics are *not* evenly distributed. Compared with Single-Piece Mail, the average piece of First-Class Presort Mail is less costly in multiple respects, and has significantly lower unit costs than Single-Piece Mail *even after* presort cost avoidances are netted out:

Presort mail tends to be “cleaner.” In comparison to the nonpresort benchmark, presort mail is normally printed (or typewritten), and more uniform than nonpresort mail. These factors, and possibly others, which are unrelated to mailer preparation, may contribute to

the magnitude of the cost difference between presorted and nonpresorted mail.

R90-1 Op. & Rec. Decis. ¶ 5067.

The Commission's existing methodology of determining cost avoidances between Single-Piece and Presort Mail, coupled with the nonrecognition of many significant cost drivers in the individual rate elements, has led to substantial underrecognition in rates of the cost differences between Single-Piece and Presort First-Class Mail. Three aspects of existing standards share responsibility for this.

(1) As noted above, cost avoidances found to result from mail attributes other than presortation are excluded from consideration.

(2) The Postal Service's methods of modeling presort-related mailflows also systematically understate the costs avoided by presortation itself. The Postal Service does not attempt to model all cost pools affected by the degree of presortation; for these unmodeled cost pools, the Postal Service simply assumes by default that presorting avoids no costs at all. This is a clear source of downward bias. As the Commission found in MC95-1:

If costs avoided by a worksharing operation are difficult to isolate, they tend to be omitted by engineering models. Therefore, cost differentials based on engineering models tend to be underinclusive.

MC95-1 Op. & Rec. Decis. ¶ 4220.

The same is true in this case. Written discovery and oral cross-examination of the Postal Service witness Abdirahman have confirmed that the Postal Service did not model all costs of mail processing operations. Rather, the cost pools containing costs for tasks that were actually modeled were labeled as

“proportional” whereas, the cost pools containing costs that were not modeled were labeled as “fixed.” See *e.g.*, 4 Tr. 609 (response to PB/USPS-T22-4); *id.* at 528 (response to MMA/USPS-T22-1); *id.* at 618-20, 660 (Abdirahman). The Postal Service costing witness also acknowledged that there were no econometric or operational studies to support the contention that the cost pools labeled “fixed” actually are fixed with respect to presort level and conceded that many of the cost pools labeled as “fixed” may well contain costs that are in fact proportional with respect to presort level. See *id.* at 609 (response to PB/USPS-T22-4); *id.* at 661, 670, 675 (Abdirahman). Moreover, Mr. Abdirahman acknowledged that the classification of cost pools as either “proportional” or “fixed” is not trivial because under the Postal Service methodology, only the costs in “proportional” cost pools that have been modeled can affect differences between rate categories. *Id.* at 670, 675-76 (Abdirahman)

(3) The effect of these errors is compounded by the use of an inappropriate category of Single-Piece Mail as the benchmark from which the cost avoidances are estimated. The currently used benchmark is the category of mail most likely to be workshared, a benchmark that the Commission models by assuming a nonexistent “category” called “bulk metered mail.” The notion that the most likely alternative to Presort Mail is a type of mail that mailers have almost entirely abandoned is illogical. There is a more basic flaw with the most-likely-to-be-workshared standard, however: the most appropriate benchmark is not the mail *most likely to be workshared*, but mail with the average characteristics of *marginal* pieces of First-Class Mail (i.e., pieces for which the

incremental cost of presorting equals the cost of sorting thereby avoided by the Postal Service).

Because First-Class Mail is heterogeneous in its characteristics and costs, the omission of individual rate elements for significant cost drivers will cause some productive inefficiency, no matter which benchmark category is used to estimate presort cost avoidances.<sup>4</sup> The *least* inefficient cost benchmark in these circumstances, however, is the average Postal Service processing cost of the *marginal* type of mail, not the category of Single-Piece Mail most likely to be workshared.

The cumulative shortfall in cost recognition resulting from these problems is large. In Docket No. R2005-1, the Commission found that the difference in unit attributable costs between Single-Piece and Presort Mail was over 18 cents per piece. R2005-1 Op. & Rec. Decis., App. F, p. 4. Even the deepest presort discounts established in R2005-1, however, are only about half that amount. *See id.*, App. 1, Rate Schedule 221.

## **II. NONRECOGNITION OF COST DIFFERENCES BETWEEN SINGLE-PIECE AND PRESORT FIRST-CLASS MAIL VIOLATES BASIC PRINCIPLES OF EFFICIENT PRICING.**

Efficiency requires that rates recognize all significant differences in cost between Single-Piece and Presort Mail—not just the differences that result from “cost avoidance.” In market economies, “price plays at least two crucial roles in allocating resources. First, price determines the quantities of various goods and

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<sup>4</sup> See J. Panzar, “Clean Mail and Dirty Mail: Efficient Work-sharing Discounts in the Presence of Mail Heterogeneity” (2006), presented at the 14<sup>th</sup> CRR Conference on Postal and Delivery Economics, Bern, Switzerland (June 1, 2006).

services that consumers will purchase. Second, price (in tandem with cost) determines profit levels and, thus, provides important signals both to firms deciding whether to enter or exit from a market and to firms deciding how much to produce of various outputs.” MC95-1 Tr. 33/15007 (Schmalensee). The former condition is known as allocative efficiency; the latter is known as productive efficiency. See Stanley Reiter, “Efficient Allocation,” in *The New Palgrave: Allocation, Information and Markets* 1 (1989); MC95-1 Op. & Rec. Decis. ¶¶ 4254-57. In perfectly competitive markets, both conditions are achieved when prices equal marginal (or average variable) cost. See, e.g., Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization* 71-72 (1990).

Structural differences between perfectly competitive markets and markets for postal service make the rules for efficient pricing of postal services more complex. In brief:

1. The Postal Service has a legal monopoly over many kinds of mail service, and arguably some element of natural monopoly as well.
2. The prices of most domestic postal services are set not by unregulated market forces, but by a government regulator, the Commission.
3. Many components of mail service (e.g., acceptance, sorting and transportation) are potentially competitive. The Commission therefore needs to establish a price structure that encourages supply of these components by competing vendors (or mailers themselves) where they can do so at a lower cost.

4. Estimates of the costs of individual services, and the elasticities of demand for those services, are imperfect, and developing these estimates is costly; so is establishing and enforcing a rate and classification structure. This requires the Commission to recommend rates for groupings of mail, not individually for each piece of mail.
5. The Postal Service has declining average costs for at least some of its services, over at least some relevant range of output. This means that the Postal Service cannot satisfy a break-even requirement without setting at least some of its prices above marginal cost (or attributable cost).
6. The least inefficient way to recover the Postal Service's institutional costs, in the absence of a government subsidy, is Ramsey pricing: setting markups over marginal cost that are inversely proportional to own-price elasticities of demand, with secondary adjustments for cross-elasticities of demand. (Note, however, that Ramsey pricing maximizes aggregate consumer surplus but does not optimize economic efficiency.)
7. The Postal Reorganization Act, and in particular 39 U.S.C. § 3622(b), require the Commission to consider a variety of other goals as well as economic efficiency.

Notwithstanding these elaborations, the basic rules of efficient pricing still apply to the pricing of postal services. Postal rates, to send efficient signals to

producers and consumers of postal services, must recognize differences in the marginal (or attributable) costs of those services. As the Commission has noted:

Prices for postal service also send signals to consumers. They indicate the costs that consumption of postal services impose on society. Prices set below marginal cost understate the costs that society incurs, causing excessive consumption of postal services and waste of society's resources, while prices set above marginal cost overstate social costs and consumers to turn to substitutes that impose greater costs on society. These losses in social welfare that arise when prices deviate from marginal cost are "allocative efficiency" losses because they misallocate resources among the goods and services that society consumes.

MC95-1 Op. & Rec. Decis. ¶ 4257 (quoting MC95-1 Tr. 33/15008 (Schmalensee)).

Adequate recognition of cost differences is also essential for productive efficiency. The Efficient Component Pricing Rule, a specialized rule for productive efficiency in the pricing of individual components of vertically integrated goods or services offered by a regulated monopolist, requires that the components available from competing suppliers be priced at their marginal (or average incremental) cost. See MC95-1 Op. & Rec. Decis. ¶ 4256; J. Panzar, "Reconciling Competition, Downstream Access, and Universal Service in Postal Markets," in M. Crew and P. Kleindorfer, eds., *Postal and Delivery Services: Delivering on Competition* 100 (2002).

Failing to recognize the full cost differential between rate categories results in *productive* efficiency by signaling mailers to demand, and the Postal Service to produce, a variety of components of Single-Piece Mail service instead of substitute components that third-party vendors, or the mailers themselves, could supply at a lower cost to society. For example:

- Mailers demand that the Postal Service produce mail sorting services that mailers or third-party vendors could bypass at a lower cost to society through presorting.
- Mailers demand that the Postal Service provide intercity transportation that could be bypassed at a lower cost to society through destination entry and/or distributed printing.
- Mailers demand that the Postal Service provide mail acceptance services for multiple mailings—services that could be bypassed in substantial part, at a lower net cost to society, by consolidation of mailings into fewer, larger mailings.
- Mailers purchase postage through sales channels and methods of postage evidencing whose unit costs could be bypassed in substantial part by making the investments needed to make use of lower cost sales channels and methods of postage evidencing.

These principles may be illustrated with a simple analogy. Imagine a city where the prices charged by restaurants were regulated by a government agency. Suppose further that the regulator recognized two categories of restaurants—Fast Food (i.e., self service) and White Tablecloth—and limited the price differential between the two kinds of restaurants to the “self service cost avoidance” at the Fast Food eateries—i.e., the absence of any labor and other costs for waiters. All *other* cost differences caused by the higher quality bundles of goods and services offered by the White Tablecloth restaurants—the added real estate costs of providing more widely spaced tables, the greater capital costs

of the fancier furnishings and fixtures, the labor costs of the maitre d', the higher labor costs of the kitchen staff, the capital and labor costs of the reservation system, the higher unit costs resulting from the slower hourly turnover of customers, and the added costs of the higher quality ingredients and larger portions at the White Tablecloth restaurants—could easily be ignored in setting prices on the ground that none of these costs differences were *caused* by the bypass of waiter service.

A pricing regime of this kind would encourage both productive and allocative inefficiency. Because the difference in price between a hamburger at the fast food restaurant (the counterpart of Presort Mail) and a White Tablecloth restaurant (the counterpart of Single-Piece Mail) would be less than the aggregate difference in cost resulting from the full gamut of quality differences, the following forms of productive inefficiency would result:

- Diners would demand waiter, maitre d' and reservation service when they could bypass these components by eating without a reservation, finding their own tables, placing their own orders, and carrying their own food to the tables, all at a lower net opportunity cost to society.
- Diners would demand to eat meals at widely spaced tables, when they could bypass this component of restaurant service by eating meals at restaurants with more closely spaced tables.
- Diners would demand meals from costlier kitchen staffs, when these costs could be bypassed by eating at restaurants with less skilled, but lower paid kitchen employees.

- Diners would demand more leisurely meals instead of eating at restaurants without the pleasant but costly amenities that encourage diners to linger.
- Diners would order the oversize, top-grade beef patties offered at White Tablecloth restaurants instead of bypassing these quality attributes by ordering the smaller, lower-grade patties offered at the fast food eateries, and making up the difference by snacking at home afterwards.

The restaurant analogy actually understates the effects of the mispricing of First-Class Mail. In the real world, the restaurant industry in the United States is highly competitive, and diners in most localities have a vast array of food, service and price options. First-Class letter mail delivery, by contrast, is town where all the restaurants have the same owner.

The Commission has argued that limiting recognition of intra-subclass rate differences to presort-related cost avoidances is required by the ECPR, a test for productive efficiency, and that productive efficiency trumps allocative efficiency. See NOI #3 at 2, 5; MC95-1 Op. & Rec. Decis. ¶ 4259 *et seq.* In the Commission's words, the price-signaling purpose of workshare rates is to "send price signals that encourage worksharing by mailers only if the mailer's cost of preparing mail to meet worksharing specifications is less than or equal to the resulting reduction in USPS costs." NOI #3 at 2.

This chain of reasoning, and the supposed conflict between productive and allocative efficiency, overlook several critical qualifications of the ECPR. First, the estimated "reduction in USPS costs" used to establish workshare rate

differentials must be a good estimate of the *actual* “reduction in USPS costs.” Cost avoidance methodologies that systematically understate actual cost avoidances obviously cannot serve as the basis for ECPR-compliant rate differentials. See pp. 9-10, *supra* (noting systematic tendency of existing methodologies to understate presort cost avoidances).

Second, the “reduction in USPS costs” must be estimated by reference to the correct cost benchmark. Because Single-Piece Mail service is heterogeneous in its attributes and costs, and the quality attributes that give rise to the heterogeneity are only partially specified in the rate structure, the *least* inefficient cost benchmark is the average Postal Service processing cost of *marginal* pieces of First-Class Mail, not the type of Single-Piece Mail most likely to be workshared. See pp. 10-11, *supra*.

Third, the “reduction in costs” must reflect *all* of the components of mail service that mailers bypass to qualify for Presort rates. In this regard, the category name “Presort” is a misnomer: the eligibility conditions for this rate category require or encourage bypass of multiple components of mail service in addition to sorting. As noted above, these components include:

- The retail channels for the sale of postage and acceptance of mail.
- Labor-intensive methods of payment evidencing such as adhesive stamps.
- Purchased transportation (a component that the minimum quantity requirements for Presort Mail encourage mailers to bypass, by requiring them to amass larger quantities of mail for entry per mailing, thereby reducing the unit incremental costs of destination entry).

- The forwarding of misaddressed mail, return of undeliverable mail, and manual handling of PKR (“personal knowledge required”) mail by delivery carriers—components partially bypassed by mailer investment in the Move Update services required for entry of mail at Presort rates.
- The labor and capital needed to verify that each piece entered at a one-ounce rate actual weigh no more than one ounce—a component of service bypassed by presorting mailers, who must perform this task themselves.
- The labor and capital needed to enforce the entry of mail in trays, properly faced—components of service bypassed by presorting mailers, who must perform this function themselves.<sup>5</sup>

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<sup>5</sup> The Commission suggested in MC95-1 that the costs avoided “as a result of ancillary workshare requirements” for the Presort category should be disregarded in setting rate differentials because the resulting “compound” marginal costs are “difficult to calculate” and “send a signal to producers that is more complicated and difficult to interpret than a discount set equal to the marginal cost of a single worksharing activity.” MC95-1 Op. & Rec. Decis. ¶ 4266. The parties sponsoring these comments appreciate the Commission’s solicitude about the difficulties of interpreting complicated price signals. Like the Postal Service, however, we would prefer presort pricing signals that are correct to signals that are simple but erroneous.

If the complexity of the underlying equations were a ground for ignoring relevant costs, the entire edifice of neoclassical economics, with its multiple differential equations, would have to be jettisoned. Moreover, most goods and services sold in actual markets are bundles of individual components, and thus have “compound” marginal costs. Ordinary producers and consumers nonetheless manage to respond appropriately to these costs. Like the bumblebee, which can fly despite being unable to recite the equations of Newtonian physics, the performance of competitive markets tends to converge on the predictions of the neoclassical market model, even though no individual producer or consumer may be able to define, or even articulate, its equations.

Finally, a comprehensive analysis must also consider the long run, or “dynamic,” effects of price signals on productive efficiency. See MC95-1 Op. & Rec. Decis. ¶ 4255. Recognizing all cost differentials, not just narrowly defined presort cost avoidances, in rate differentials will (1) encourage the Postal Service to recognize more of the cost drivers of First-Class Mail by devising separate rate elements for those attributes (which will narrow the gap between cost differences and cost avoidances by reducing the pool of residual costs left unrecognized in the rate structure); and (2) increase the competitive pressure on the Postal Service to reduce its own sorting costs (to reduce presort rate differentials). By contrast, limiting presort rate differentials to narrowly defined cost avoidances will dampen both of these dynamic effects.

**III. THE POSTAL SERVICE’S DE-LINKING OF PRESORTED AND SINGLE-PIECE FIRST-CLASS RATES IS A REASONABLE AND PRACTICAL SOLUTION TO THESE PROBLEMS.**

With de-linking, rates for Presort First-Class Mail would no longer be set by subtracting narrowly defined “cost avoidances” from a an arbitrarily constructed make-believe “benchmark” category of Single-Piece Mail. Instead, First-Class rates would be set so that each category will make the same per piece contribution to institutional costs. Stated otherwise, rate differentials between individual categories of First-Class Mail will recognize a much larger share of *all* differences in the attributable costs of the services demanded by mailers, not just “cost avoidance.” For the reasons explained above, de-linking will give mailers more accurate signals about the marginal costs to society of the postal, substitute and complementary services that the mailers demand, and thus encourage greater allocative efficiency. See pp. 11-20, *supra*.

De-linking also avoids the need to hypothesize about the particular category or categories of mail from which workshared letters “converted”—or the category to which the letters would “revert” if presort discounts were somehow eliminated. *Cf.* NOI #3 at 4-5; *id.* at 6 (questions 1.a and 1.b). If inter-category cost differences are fully recognized in rate differentials, the proper rate relationships and incentives result regardless of from where the workshared mail is presumed to have “converted,” or to where it hypothetically might “revert.”

The concern that de-linking, by leading to rate recognition of the entire cost differential between Presort and Single-Piece Mail, could cause “inequitable” results by “reflecting the lower costs” produced by non-presort cost drivers “in the presort mailings’ rates, but not in those for mailings similar except for presorting,” is unfounded. *Cf.* NOI #3 at 3 (citing R84-1 Op. & Rec. Decis. ¶ 5132). The average piece of Single-Piece Mail is *not* “similar” to Presort Mail “except for presorting”: that is the very reason why the average per piece cost difference between the two categories exceeds the presort cost avoidance.

Perhaps what concerns the Commission is the prospect that the costs of individual pieces of mail will deviate from the average, and that some relatively low-cost pieces of Single-Piece Mail may be as inexpensive to process as the average piece of First-Class Presort Mail. That outcome, however, is inherent in averaging, “an integral part of postal ratemaking.” MC95-1 Op. & Rec. Decis. ¶ 3063. The “essence of a classification” is a “*grouping* of mail for which a certain rate is charged.” *National Easter Seal Society v. USPS*, 656 F.2d 754, 762-63 (D.C. Cir. 1981) (emphasis added). A “separate rate for every group of mailers with special cost savings, no matter how small the group, would produce

a hopelessly complicated rate schedule.” *Id.* (quoted in *United Parcel Service, Inc. v. USPS*, 184 F.3d 827, 845 (D.C. Cir. 1999); accord, *Mail Order Ass’n of America v. USPS*, 2 F.3d 408, 426 (D.C. Cir. 1993). Accordingly, the Commission must balance the potential efficiency gains of greater rate deaveraging against the additional transaction costs. See MC95-1 Tr. 33/15011, 15023 (Schmalensee).

If economic efficiency would be improved by dividing an existing mail category into multiple categories, or to specifying rate elements for additional cost drivers, the Commission should establish those additional mail categories or rate elements. At whatever level of aggregation the Commission finds optimal, however, it would be inappropriate to base rates and rate differentials on the costs of the outliers rather than the average values, or to seize upon the impracticality of “set[ting] individual prices for every customer” as a pretext to ignore material differences in average cost. See MC95-1 Tr. 33/15023 (Schmalensee).

Finally, the Commission asserts in its NOI that de-linking “implicitly treats Single-Piece Mail and workshared mail as separate subclasses.” *Cf.* NOI #3 at 2. This statement is incorrect. The creation of separate subclasses would entail the prescription of separate coverage ratios or contributions to institutional cost for each grouping of mail, based on a separate analysis of the demand for each grouping. See pp. 5-6, *supra*. None of the undersigned parties or the Postal Service seek this more far-reaching relief here. Absent these additional steps, the de-linking proposal does not amount to the creation of a separate subclass. As the Commission held in R87-1:

From the outset, *we reject the Postal Service's implication that a choice of a cost methodology other than its cost avoidance methodology to design the First-Class Mail 5-digit presort discount is tantamount to a designation of the presort rate as a subclass or "de facto subclass."* From our reading of the statutory criteria and history and of the presort discount, nothing suggests that a restrictive view such as that advanced by the Service is mandated or desirable. On the contrary, these sources and the record in this proceeding support the view that there should be flexibility in the design of any given discount rate and the development of the discount should not be bound by one exclusive cost methodology which must be used throughout the history of the discount.

R87-1 Op. & Rec. Decis. ¶ 5188 (emphasis added). De-linking likewise avoids the need to determine the "market boundaries" of Presort and Single-Piece Mail, or to worry about whether the two categories of service serve, or do not serve, "overlapping markets." *Cf.* NOI #3 at 5; *id.* at 6 (question 1).

### **CONCLUSION**

For the foregoing reasons, and the reasons to be set forth in the evidentiary record, Association for Mail Electronic Enhancement, Financial Services Roundtable, National Association of Presort Mailers, National Postal Policy Council, and Pitney Bowes Inc. urge the Commission to recommend the

de-linking of Presort and Single-Piece First-Class rates as proposed by the Postal Service.

Respectfully submitted,

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August 17, 2006