Postal Rate Commission
Submitted 8/17/2006 4:08 pm
Filing ID: 52559
Accepted 8/17/2006

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

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

COMMENTS OF
VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC. IN
RESPONSE TO NOTICE OF INQUIRY NOS. 2 AND 3
(August 17, 2006)

The Postal Rate Commission issued Notice of Inquiry ("NOI") No. 2 (requesting participants to submit comments regarding the method that should be used to design Standard Mail rates) on July 21, 2006, and issued Notice of Inquiry No. 3 (requesting participants to submit comments regarding the method that should be used to design First-Class Letters and Sealed Parcels rates) on July 26, 2006. NOI No. 3 instructed that combined responses to the two NOIs may be filed by August 10, 2006, and Presiding Officer's Ruling No. R2006-1/40 extended the deadline to August 17, 2006. Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (referred to collectively as "Valpak") hereby submit the following comments regarding the Commission's two NOIs.

In NOI Nos. 2 and 3, the Commission raises a number of issues that are fundamental to ratesetting. Valpak, as a heavy user of Standard ECR Mail, believes that NOI No. 2 has particular importance in the instant docket, but probably well beyond it as well. Valpak appreciates the opportunity to address these issues, all of which are important to mailers and to the long-term effectiveness of the Postal Service. If the Postal Service and the Postal Rate Commission do not honor sound ratesetting principles in establishing rates, then the Postal

Service's success in meeting mailer needs will be impaired, frustrating the purposes of the Postal Reorganizaiton Act, and it will fail to deliver on its responsibility to contribute to the efficiency of the nation's economy.

As the Commission has recognized, many issues raised in the two NOIs are matters that can be addressed better in rate design testimony by expert witnesses than in comments such as these. Even if consensus were reached on a list of principles, rates do not then pop out automatically. Judgment is required to decide which principles apply when, and how much weight each should be given. For this reason, Valpak will discuss general ratesetting principles in these comments, and in subsequently-filed testimony on rates will apply ratesetting principles to specific issues in this docket.

Valpak has endeavored to identify all issues raised by the Commission which bear on Standard Mail, and has addressed each in turn. Comments on First-Class Mail are also included herein.

1. The Importance of Costs

Many questions raised in the two NOIs relate to the importance of costs and to how they should be recognized. Valpak believes that costs, properly defined, are critically important to ratesetting. They should be the first step and first reference point in all ratesetting exercises. Costs should be developed, presented, and examined, even though doing so can require significant Postal Service investment. Attaching this level of importance to costs is in line with prescriptions of economics for ratesetting and with the finest traditions of regulatory practice; it is also a necessity to achieve rates that are fair, by almost any definition of fairness.

Questions frequently arise about what it means for rates to be "cost-based." Valpak takes "cost-based" to mean that the costs are known and acknowledged, and that decisions as to how far rates should be set above costs are made on clearly articulated bases. Therefore, rates being cost-based is completely consistent with the important Commission role in considering factors other than costs in recommending rates.

In this docket, the Postal Service has been unusually candid about various problems with its cost estimates. For example, in response to UPS/USPS-T37-9, Postal Service witness Kiefer states that:

> the Postal Service does not have cost information that is designed to adequately calculate unit costs and contributions below the subclass level.

In response to PSA/USPS-T32-4 (revised July 24, 2006), Postal Service witness Taufique makes this statement with respect to First-Class Mail:

> It is my understanding that there are a number of issues related to cost estimates by weight increment and shape.

Yet, despite Postal Service awareness of known problems with respect to costs by shape, a Postal Service institutional response states:

> The Postal Service has not performed studies or analyses to evaluate the reliability of CRA costs by shape. [Postal Service response to PostCom/USPS-1.]

An example of one such weight-shape issue is the estimated cost of **First-Class parcels** by weight increment. In response to OCA/USPS-25, the Postal Service indicates that the cost of First-Class parcels by weight increment is as reproduced in Table 1, *infra*. The cost of First-Class Presort parcels that weigh in excess of 4 ounces, $13 to $14, is clearly anomalous.

A similar situation arises with respect to **Standard parcels**. According to library reference USPS-LR-L-135, Standard Regular parcels have a unit cost of $0.99, while ECR parcels, which involve less handling because they are more presorted, have a unit cost of $24.90, which is also anomalous. Fortunately, such parcels constitute a minor portion of the mail stream.

Table 1
Cost of First-Class Parcels, by Weight Increment

Weight (oz.)	Single Piece	Presort
0-4	$1.45	$1.72
4-8	$1.60	$13.29
8-12	$1.94	$14.42
12-13	$1.92	$14.14

In response to VP/USPS-T30-26(e), Postal Service witness Kelley states that his Segment 7 unit costs constitute valid base-year marginal costs only **at the subclass level:**

> I have not done an analysis of the costs calculated at the rate category level, by shape, by mail preparation or characteristic, to determine if these disaggregated costs are valid estimates of the marginal street time costs to handle one more Saturation flat/DAL. I do not know of any location where such a marginal cost analysis can be found.

In response to ADVO/USPS-T27-5, Postal Service witness Talmo states:

> Estimated costs by shape for High Density ECR demonstrate considerable sample variation. Combined with sample variation in Saturation ECR costs, the estimated cost difference by shape between High Density and Saturation costs also shows considerable variation. Due to the uncertainty in the estimated difference in costs, High Density and Saturation cost by shape are treated as having the same mail processing costs.

The weight of an item (along with zone) is a significant factor in rates for Priority Mail and Parcel Post, and the Postal Service does prepare an estimate of the transportation cost in each weight-zone cell for these products. Although transportation cost is an important portion of the unit cost for parcels, rates also must cover mail processing and delivery costs. With respect to delivery costs, Postal Service witness Coombs, responding to UPS/USPS-T44-1(a), states that:

> It is my understanding that no studies or analyses have been conducted that examine the effect of weight or density on city delivery costs or rural costs for Priority Mail or Parcel Post.

The above-cited testimony of Postal Service witnesses Kiefer, Taufique, Kelley, Talmo, and Coombs contrasts with the testimony of Postal Service witness Bradley, USPS-RT-3, in Docket No. R2005-1, which sought to explain how the Postal Service's costing system provides reliable estimates of marginal costs. In a world created from imperfect cost information, the Commission must continue to soldier on and do the best it can, while also continuing to exhort the Postal Service to improve its cost studies substantially.

2. Cost-causing Characteristics of Mail and Worksharing

Notions of worksharing, which are associated generally with rates designed to result in the lowest-cost entity doing the work, and therefore with maximizing productive efficiency, are mentioned in both NOIs and have been important in postal ratemaking for some years. The application of these notions, however, does not extend to all rate differences or to all cost-causing characteristics, as some of them are not matters of worksharing.

Cost-causing characteristics of mail receive explicit mention at several points in NOI 2. Here follows a brief list of such cost-causing characteristics, together with a brief discussion of each as it relates to worksharing and other mailer behavior.

Postal Service Costs Caused By	**Mitigated by Mailer Activity**
Sortation	Pre-sortation
Barcoding	Pre-barcoding
Transportation	Destination entry
Shape	Design of mailpiece
Weight	Design of mailpiece
Other (*see* NOI No. 2, p. 7):	
Density (applicable to parcels)	Design of mailpiece
Preparation/packaging	Palletization, shrink-wrapped bundles, sacks, trays, etc.

Sortation and Barcoding. Beyond minimum requirements, pre-sortation and pre-barcoding are activities undertaken at a mailer's option. Non-required pre-sortation and pre-barcoding both are classified properly as worksharing activities.

Transportation. Transportation, including transportation-related activity such as cross-docking, generally should not be classified as a workshared activity, because often it is not. Mail may be for delivery within the local area where it is prepared. When such locally-prepared mail is entered into the mailer's local postal facility, which also happens to be the destination facility, such mail requires long-haul transportation by neither the Postal Service nor the mailer. Hence, such destination entry does not enable the Postal Service to "avoid" any transportation or associated handling costs. In general, the Postal Service does not know where mail is prepared, nor should it care. When mail is to be delivered within the area served by the office of entry, the rates for it should be based on the costs it incurs.

Admittedly, when mail is dropshipped to destination facilities outside of the area where it originates, the Postal Service is able to avoid transportation costs. The Postal Service should not, however, be in the position of speculating about how far the mailer may have driven its truck.

Shape, weight, density. Shape and weight are cost-causing characteristics of mail that arise from design of the mail piece; they clearly are not workshare activities. Density of mail is another characteristic that can cause additional costs to be incurred (*e.g.*, with lightweight parcels), but likewise should not be considered as a workshare activity.

Mail preparation and packaging. Mailers can prepare and submit mail using a number of **optional** methods. Each method has its own cost-causing characteristics, and different methods often can impact the Postal Service's costs significantly.[1] Rate differences can be established to recognize the different costs that the Postal Service incurs. When acted upon by mailers, such rate differences encourage mail to be prepared in ways that make it less costly for the Postal Service to handle. Establishing rate differences such as those described here (whether they be in the form of discounts or surcharges) is simply an appropriate exercise in rate de-averaging to improve recognition of cost incurrence.

---

[1] *See* Docket No. C2004-1, Complaint of Time Warner, Inc. concerning Periodicals Rates, for specific examples.

3. Costs Avoided and Incurred

NOI No. 2 refers (at p. 1) to having rate differences which reflect fully costs that the Postal Service "would avoid (or incur)."

- Costs **avoided** usually pertains to costs that the Postal Service need not incur when mail does not require specified processing activities, such as sorting, barcoding, or transporting.

- Costs **incurred** usually refers to ordinary operating costs caused either by mail that has **not** been workshared, or by other cost-causing characteristics such as those discussed above.

Estimating the aggregate amount of **costs avoided** by the Postal Service is usually difficult, and perhaps very difficult. This is due, at least in part, to the fact that when a block of workshared volume bypasses part, or even all, of the postal network upstream of delivery, no cost is being incurred by the Postal Service and, therefore, no costs exist to be measured or recorded. Also, difficulty can attach to defining whatever characteristics all such mail would have if the worksharing were not being done. **Costs incurred**, by contrast, are contained in the Postal Service's accounting records and, in principle, are measurable. Cost estimates are matters that must be addressed in specific expert testimony relating to specific situations.

In First-Class, the Postal Service has proposed using Cost and Revenue Analysis ("CRA") costs incurred as a benchmark for presort mail. This approach recognizes **all cost differences** between single-piece and presort mail, rather than just the **cost avoidance** associated with recognized workshare activity. In the past, differences in costs **incurred** by mail remaining in the system have been larger than the cost avoidances, and NOI No. 3 invites comments on the proper approach.

Valpak is not a major user of First Class. It is concerned, however, with the declining volume of First-Class Mail and the consequent reduction in contribution to the Postal Service's overhead costs. Should the trend in First-Class Mail of the last few years continue, both subclasses of Standard Mail could be called upon to make even larger contributions to overhead.

Failure to give presort First-Class Mail subclass treatment limits the ability of the Postal Service to establish prices that would encourage a more efficient mailstream. Permitting destination entry discounts for presort First-Class Mail is an example of one fairly obvious efficiency that could be encouraged. Eliminating free return of undeliverable mail would be another possible way to reduce costs and rates for presort First-Class Mail. By encouraging various efficiencies that help keep costs and rates down, the Postal Service may be able to slow, and then stabilize, the declining usage of First-Class Mail. Valpak would urge the Commission to consider the Postal Service's proposal in view of this objective.

4. Transparency

NOI No. 2, p. 2, presents the Commission's belief that rates should be developed in a "transparent manner." Valpak agrees. The costs that underlie rates need to be developed, presented, and discussed fully. All factors considered in going from the costs to the rates should be identified and discussed, and the weight given to each should be made clear. Also, any factors often thought to be important or relevant that are not given weight should be discussed. One way in which to have transparency in rate setting is to maintain the presort tree, as discussed *infra*.

5. What is the Role of the Presort Tree?

The presort tree is a graphical, layout-type of framework, possibly characterized as a schematic, and can be a useful way to display costs, passthroughs, rates, and their relationships. The presort tree is meant to be helpful in facing a situation where any ordinary mind likely would be taxed by the complexity, which grows with each case. It does not provide constraints or limitations on rate design. All rate and cost relationships normally shown in the tree exist, regardless of whether they are shown in a tree. Therefore, since the cost and rate relationships should be dealt with, regardless of whether they are shown in a tree, it really makes no difference whether the tree is actually drawn.[2] However, Valpak finds the tree to be helpful in focusing attention on important relationships, especially relationships within the letter, flat, and parcel shapes.

It appears clear that the Commission needs some method by which it can organize, analyze, and display costs and cost differences which underlie rates and rate differences. At the same time, the expanding number of cost differentials with corresponding rate differentials increases the size and complexity of whatever method the Commission selects to organize and display the situation. The Commission will have to judge for itself whether and when a single tree becomes too large and complex to facilitate its work. Should that occur, however, then perhaps multiple, less complex trees could be substituted.

If multiple trees are to be used, they should be selected on the basis of mail characteristics not properly associated with worksharing, but often associated with product

---

[2] Rates and costs in Priority Mail and the parcels subclasses customarily have been displayed in a series of tables, rather than "trees."

definition, such as shape (*e.g.*, letters, flats, and parcels), which also tend to determine operational handling methods. Each shape then would have its own presort tree, reflecting those "worksharable" activities available to each shape. But unless separate **subclasses** are created, cost and rate differences between different shapes would still exist, and they would have to be analyzed.

What costs should be reflected in such tree, or trees? Currently, presort trees reflect volume variable (marginal) costs. However, **if** Efficient Component Pricing ("ECP") is to be the guiding principle, then the focus should be on cost avoidances, and the type of costs displayed would more logically be **average attributable costs,** which corresponds more closely to **incremental costs**, as recommended by Baumol and Sidak.

6. Can a Sensible Presort Tree Be Constructed for Standard Regular Today?

As the Commission notes, in this docket, the Postal Service appears to have established not one but eight separate and relatively independent benchmarks in Standard Regular mail. Also, the Postal Service argues that the categories do not relate to each other in a sensible way. Valpak disagrees with the Postal Service position. These categories can be related in sensible ways.

- **Machinable letters** and **machinable flats** are key categories just as much as ever. Letter and flat sorting machinery has been a key focus of Postal Service mechanization and automation. Short of considering them separate subclasses (which would make costs even more important, not less), we know of no better and no more relevant way of establishing their relative rates than to give considerable attention and weight to their costs.

- **Non-machinable letters** are machinable letters with a surcharge due to non-machinability.

- **Automation letters** are a workshare variant of machinable letters.

- Similarly, **automation flats** are a workshare variant of machinable flats.

- **Machinable parcels** are nonletters that are too large for the flats machinery that has been designed and developed, but can run on parcel sorting equipment. They are processed on different equipment and their additional costs should be recognized.

- **Non-machinable parcels** are a variant of machinable parcels, that also can be related either to machinable parcels or machinable flats.

- The **hybrid** category is a temporary one attached to machinable parcels. Presort levels can be displayed vertically in all of these categories, just as has been done before the instant docket.

The cost and rate differences among these eight categories can be displayed easily in a tree. They do not present difficulties. Simply put, the Postal Service has not adequately supported its proposal to view each of these eight categories as separate and relatively independent benchmarks. For each of the eight categories, costs have been developed. All the Postal Service approach has done is to neglect them, or obscure them. Whether the rate relationships between the various categories should be viewed as matters of worksharing or some other kind of de-averaging, many of which are discussed above, is a matter for a rate design witness to address. In this case, the Postal Service simply has not done so. Nevertheless, these relationships can and should be examined by the Commission, and an examination likely will show that some improvement is needed.

7. Applying the Principle of Efficient Component Pricing ("ECP")

We begin with the general observation that, whenever various groupings of mail within a class or subclass exhibit systematic cost differences, the Commission must decide whether to **recognize the characteristics** that give rise to such cost differences in the rate structure. If a decision is made to recommend rate differences, the Commission must decide whether to focus on **cost avoidances**, or **cost differences**. The Commission then must determine whether rate differences also should reflect a **markup**.

Within this general framework, NOI Nos. 2 and 3 both inquire about the application of ECP to cost differences arising from (a) worksharing; (b) shape; and (c) other cost-causing characteristics, such as transportation cost and weight. Initially, we would mention that, in a narrow, technical sense, ECP applies only to cost-causing characteristics associated with worksharing. For other cost-causing characteristics, including shape, transportation and weight, the Commission needs to rely on other principles. Although not mentioned explicitly in either NOI No. 2 or NOI No. 3, one could also ask how ECP would apply to a variety of other cost causing characteristics not currently recognized in the rate schedule, should the Commission at some point in the future decide to recognize them.[3] Accordingly, we interpret the Commission's query about ECP broadly.

We note that Section 3622(b)(3) of the Postal Reorganization Act of 1970 **requires** each class and subclass bear all of its attributable costs. It has been determined that the Act does not

---

[3] Two specific other characteristics are: (i) **density**, which the Postal Service now proposes to recognize explicitly in Priority Mail, with an additional charge for low-density packages; and (ii) **containerization**, which the Postal Service now proposes to recognize explicitly in Periodicals.

stipulate that (b)(3) applies below the subclass level — *i.e.*, to individual rate categories, or to cost differences between rate categories. However, the principle that all recognized rate differences should reflect at least 100 percent of differences in attributable costs is a sound one. It helps assure that attributable costs which the Postal Service incurs on account of the cost-causing characteristic will be recovered by incremental revenues from the corresponding rate differential.[4]

With respect to current practice, the picture is somewhat mixed. For cost differentials associated with **worksharing** (pre-sortation and pre-barcoding), the Commission has recommended rates that reflect 100 percent of the difference in attributable cost, sometimes limited to workshare-related costs. Within the Standard subclasses, the Commission has recommended destination entry discounts that nominally reflect about 85 percent of the transportation and associated handling costs, applied at 3.3 ounces for piece-rated letters and flats, but for lower weights the recognition is a higher percentage. By contrast, in Priority Mail and the parcel subclasses, the Commission applies a full subclass markup to transportation costs in each rate cell, and mail that travels to more distant zones thus pays a substantial markup over the actual transportation cost.

---

[4] When incremental costs incurred on account of a cost-causing characteristic are **not** recovered by the rate differential for that characteristic, the revenue shortfall must be made up from other mail within the subclass (assuming the subclass achieves its target coverage). In competitive markets, when cost-causing factors are recognized in the price structure, a price differential typically reflects the cost difference **plus a markup.** Consequently, when a rate difference associated with a cost-causing characteristic produces revenues that **cover only 100 percent** of attributable costs incurred, with no markup, any such rate difference is less than what a competitive market would charge, and in this sense certainly cannot be considered unfair. Recognizing the full amount of cost differences also would be in accord with the way that the Commission has interpreted and implemented ECP.

With respect to **weight**, in all subclasses, the Commission sets a rate that presumably exceeds incremental cost, sometimes by a significant amount. In First-Class, for example, the current rate is $3.84 per pound (24 cents per ounce) and the proposed rate is $3.20 per pound (20 cents per ounce). No explicit markup can be computed for weight, however, because the Postal Service has no reliable estimate of the cost of additional weight (not for any class of mail, nor for any presort condition, nor for any entry point).

With respect to extra costs caused by **shape**, within Standard Mail, the Commission has recognized varying percentages, ranging from zero to something not far above 50 percent of the letter-flat cost differential. Only recently has the Commission begun to recognize the extra costs of parcels in the rate structure for Standard Mail.

In Docket No. R2005-1, Valpak recommended that the Commission recognize **shape-based cost differentials** by applying the subclass markup to them. The Commission responded favorably to this recommendation (*Op. & Rec. Dec.*, Docket No. R2005-1, p. 135, ¶¶ 6074-75), and Valpak continues to recommend this treatment for shape-based cost differentials. With respect to the costs and cost differentials caused by additional **weight**, Valpak recommends that such costs should be subject to a subclass average markup.[5]

With respect to actual transportation costs (cost segment 14) and cost differentials related to worksharing mail processing activities within Standard Mail, the Commission

---

[5] Valpak recognizes that the Postal Service has no reliable estimate of additional mail processing costs imposed by additional weight. The Commission should continue to urge the Postal Service to conduct a reliable study of this issue.

generally has limited rate recognition to 100 percent of such differentials, and it may wish to continue doing so.[6]

8. Prices That Are Economically Efficient

NOI No. 2 (p. 3) mentions the importance of sending "economically efficient price signals to mailers," but it does not address specifically the importance of notions about economic efficiency generally. Valpak urges that these subjects both receive attention.

For rates to be economically efficient, given that breakeven is required, rates must bear a certain relation to costs and to the associated elasticities, both own-price and cross. The required relationships, which are quantified in the Ramsey formulas, focus in one way or another on the distance of rates from marginal costs, whether the rate is for a separate subclass, a category within a subclass, a rate cell, or the rates and costs for specific pieces of mail. Thus, although the costs and difficulties associated with ease of use and administration might suggest varying degrees of aggregation and rate averaging, the relation of rates to costs, as well as to elasticities, is of fundamental importance. One occasion on which these issues do receive consideration is when a proposal is made to deaverage a subclass into two or more separate subclasses, as was done in Docket No. MC95-1. That is, separate subclass treatment

---

[6] Transportation-related **handling** costs, which are a part of processing costs, are considered to be weight-related. Valpak sees no distinction between these weight-related costs and other weight-related costs, which should be subject to a markup equal to that applied to the entire subclass. Accordingly, Valpak recommends that these weight-related costs be considered when establishing rates for destination entry.

can be desirable when reasonable application of existing subclass arrangements leads to rate-cost relationships that are too far from being economically efficient.[7]

Short of new subclasses for categories like letters and flats, which are not worksharing variants of each other, Valpak believes the appropriate way to recognize costs is for rate cells within a subclass to be based on **cost times the subclass coverage**, except that rate differences between cells that relate to worksharing should be at least 100 percent of a relevant cost avoidance based on average attributable cost.[8] This would be normal and appropriate ratesetting, and might be called the default relationship. Using this approach also would be relatively in line with notions of economic efficiency.

One additional dimension of efficient ratesetting should be noted, particularly if one is interested in the signals sent to mailers and whether they are designed to lead to a low-cost mailstream. That dimension relates to how broadly categories are defined, an issue discussed at great length in Docket No. C2004-1. Suppose, for example, that a cost is developed for 3-digit flats in Standard Mail. It is possible to develop a refined cost estimate and to recognize that estimate in ratesetting, but the category nevertheless may represent a non-homogeneous

---

[7] *See* comments, *supra*, regarding NOI No. 3 and First-Class Mail.

[8] This would not be called discrimination under the **first definition** by Professor Stigler in his book, *The Theory of Price*. In the footnote referenced with specificity by the Commission (fn. 10 on p. 209), Professor Stigler says: "**Our definition** of discrimination turns upon" the ratio of price to marginal cost not being the same for two or more products. (Emphasis added.) Then he points out that "**[s]ome economists** prefer the slightly different definition: prices are discriminatory if the difference in price is not equal to the difference in marginal cost," which, as the Commission notes, means that the per-piece contributions are not the same. (Emphasis added.) This latter definition would appear to have its greatest applicability in situations involving worksharing.

mixture of sacks and pallets, containers with few and many pieces, an array of bundle characteristics, and several different kinds of non-destination entry points (such as a local office, a local SCF, or a local ADC). If the various cost drivers associated with these kinds of mixtures are recognized in rates, mailers can react to those price signals, and the result can be a much more efficient mail system. When large cost differences exist, the benefits and efficiency gains available from such recognition are large. For all classes of mail, significant cost drivers should be recognized.

Lastly, with respect to setting rates for existing categories within Standard Mail, it needs to be recognized that Standard Mail is used almost exclusively by businesses (and nonprofit organizations), both large and small, for advertising purposes. Accordingly, Valpak believes that public policy reasons for overriding sound ratemaking principles to favor one category of Standard Mail over another do not generally exist.

Respectfully submitted,

_____

William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.