

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

RESPONSE OF UNITED STATES POSTAL SERVICE TO
NOTICE OF INQUIRY NO. 3
(August 21, 2006)

Introduction

On July 26, 2006 the Commission issued Notice of Inquiry No. 3 (NOI No. 3).¹ In the notice, the Commission solicited comments from participants in Docket No. R2006-1 regarding First-Class Mail rate design in light of the fact that the approach used by the Postal Service in this proceeding differs from past practice. The Commission listed specific issues that could be considered and discussed so that a balanced record would be available to inform the Commission's consideration. The Postal Service respectfully submits the following comments.

The Commission's concerns, as reflected in NOI No. 3, might be summarized as follows:

1. The Postal Service' approach to rate design for First-Class Mail in this proceeding does not reflect the assumptions regarding the composition and behavior of such mail that have shaped the Commission's approach in its most recent decisions.
2. The Postal Service's approach suggests or implies a subclass treatment for single-piece and presort.

¹ Docket No. R2006-1, Notice of Inquiry No. 3, issued July 26, 2006.

3. The Postal Service's approach abandons or qualifies the objectives of Efficient Component Pricing (ECP) that have played a central role in the Commission's most recent approach.

In the comments below, the Postal Service discusses these observations in the context of the major conclusions that have shaped its current views on the Commission's inquiries. These conclusions might be summarized as follows:

1. Old assumptions regarding First-Class Mail no longer reflect current realities. Both the single-piece and workshared categories have evolved significantly, making the traditional approach of applying recognition of clearly defined worksharing practices to a single benchmark less appropriate than the Postal Service's proposals in this case.
2. The Postal Service is not proposing subclass treatment. Its approach, however, is not inconsistent with the conventional subclass analysis. Its approach is to delink the mechanics of pricing, but not to propose separate cost coverages or markups for single-piece and presort.
3. The economic and policy objectives of ECP or other measures of economic efficiency are not undermined by the Postal Service's approach. Rather, the Postal Service's proposal retains the merits of ECP, while respecting other important goals mandated under the Postal Reorganization Act and effective pricing principles.

In accordance with the above, the Postal Service respectfully submits the following comments.

I. Postal Rate Design Proposals Must Balance All Relevant Pricing Criteria

Postal ratemaking is governed primarily by the pricing criteria in 39 U.S.C. section 3622(b). Economic efficiency is only one factor that must be considered in evaluating the reasonableness of postal pricing proposals. In fact, as the Commission has noted, "[e]conomic efficiency is neither the exclusive nor even the paramount

ratemaking objective under the Act.” PRC Op. R2000-1 at 210. Efficiency considerations must be balanced by non-economic policy factors to reach an appropriate pricing recommendation. The Efficient Component Pricing rule is an example of one tool that could be applied to achieve efficiency goals. However, the application of theoretical rules to postal pricing must be tempered by consideration of the section 3622(b) pricing criteria and involve an assessment of a variety of factors including the reasonableness of rates, rate changes, rate relationships, and non-economic public policy goals.

II. First-Class Mail Single-Piece Is A Heterogeneous Grouping In Which Presort Mail Has Matured.

A. The heterogeneity of single-piece First-Class Mail makes it difficult to isolate a specific type of piece that would migrate to the presort category in the event of expanded discounts.

As witness Thress notes:

First-Class Mail is a heterogeneous class of mail which includes a wide variety of mail sent by a wide variety of mailers for a wide variety of purposes. This mail can be divided into various substreams of mail based on several possible criteria, including the content of the mail-piece (e.g., bills, statements, advertising, personal, and government), or the recipient of the mail-piece (e.g., households versus business versus government).

First-Class Mail can be broadly divided into two categories of mail: Individual Correspondence, consisting of household-generated mail and non-household generated mail sent a few pieces at a time; and bulk transactions, consisting of nonhousehold-generated mail sent in bulk. Relating these two categories of First-Class Mail to rate categories, Individual Correspondence mail may be thought of as being approximately equivalent to First-Class Single-Piece Mail, while Bulk Transactions could be viewed comparable to First-Class Workshared Mail. Of course, these correspondences are only approximate. USPS-T-7 at 42.

This heterogeneity² makes it difficult to pinpoint the type of piece, on average, that will migrate to worksharing. Single-piece mail from growing businesses, with the characteristics of what has been termed Bulk Metered Mail, is a possible candidate for migration. Another one of the many possible candidates is non-uniform mail originating from small businesses that previously did not presort, but which is now consolidated by presort bureaus. Choosing either end of the spectrum as the sole benchmark could understate or overstate cost avoidances, thereby leading to the types of inefficiencies discussed in the economics literature.

B. The maturation of the presort category limits the potential migration from single piece, and has changed the characteristics of the candidate pieces.

Since the establishment of the initial First-Class Mail presort discount in 1976, there has been substantial growth in the presort market. USPS-LR-L-74. However, as the Household Diary Study illustrates, the presort industry has matured.

| Total Percentage of First-Class Mail Received by Households | | | | | | |
|--|-------|-------|-------|-------|-------|-------|
| Which is Sent Presort by Industry Sector | | | | | | |
| Postal Fiscal Years 1987 and 2001-2005 | | | | | | |
| | 1987 | 2001 | 2002 | 2003 | 2004 | 2005 |
| Financial | 58.9% | 84.2% | 84.9% | 84.7% | 84.9% | 86.4% |
| Merchants | 55.0% | 78.2% | 75.6% | 75.6% | 76.5% | 77.9% |
| Services | 56.7% | 68.7% | 66.5% | 67.6% | 68.4% | 67.8% |
| Federal Government | N/A | 76.9% | 72.8% | 73.7% | 74.3% | 80.4% |
| State & Local Government | 54.0% | 69.8% | 66.9% | 67.6% | 70.1% | 67.6% |
| Social/Charitable/Political/Nonprofit | 16.5% | 41.7% | 35.0% | 36.3% | 38.2% | 39.6% |
| Source: Household Diary Data, Table A2-20 | | | | | | |
| | | | | | | |

² Professor John Panzar recently presented a paper on this subject: "Clean" Mail and "Dirty" Mail: Efficient Work-Sharing Discounts with Mail Heterogeneity. 14th CRRRI Conference on Postal and Delivery Economics, Bern, Switzerland, June 1, 2006.

As can be seen in the table, presort growth has leveled off this decade in all industry sectors. It is likely that today's workshare candidate mail may be quite different from the candidate mail of 1987. Shifts from single-piece to presort that were observed in the initial periods of worksharing and its expansion, in terms of both volume and discounts, are not expected in the future. See generally, USPS-T-7 at 43-46. The Postal Rate Commission has previously acknowledged that the maturity of the presort category can be a factor in the choice of a worksharing cost-differential methodology. For instance, in its Docket No. MC95-1 Recommended Decision, the Commission noted that maturity of a category could have implications regarding the methodology for workshare rate design.

This more liberal standard better reflects the impact of a discount on a mature category such as presort First-Class Mail. As a mature workshare category whose volumes have stabilized, additional volume is considered less likely to come from low-cost nonpresort mail that requires few changes to convert, and more likely to come either from average cost nonpresort mail that requires more extensive change to convert, or from new mail.

PRC Op. MC95-1, at IV-102. While the presort market may have matured, all conversion of single-piece mail to presorted mail may not have occurred. However, we may not see the same types of mail being converted to presort as in the past. For example, recently there has been growth in mail converted from single piece mail (often generated by small businesses and office buildings) into presorted mailings by intermediaries. The Postal Service expects mail service providers and their customers to continue to develop innovative ways to increase the use of presorted mail, although it

is likely that the characteristics of this mail will differ from those of the mail that shifted to presort years ago.

C. It is possible that a decrease in the price differential could lead to reversion to single piece.

Certainly, if the effective discount for worksharing were lowered, one would expect some workshared letters could revert to single-piece. It depends on how much cost the mailer incurs to achieve the “workshare.” It is not possible to assess how different the Postal Service’s processing costs are for these “reverting” pieces versus the average cost, though it is likely these reverting pieces would be those for which the customers’ cost of presorting are higher. For example, it is less likely that list-generated mailings that can be sorted during the production of the mail would revert, as compared to mail pieces that receive a more costly physical sortation.

III. The Choice of Any Benchmark Is Controversial Given The Heterogeneous Nature of First-Class Mail And The Maturity of Presort

While it may appear obvious that the characteristics of today’s candidate mail should inform benchmark issues, it is less obvious that we can identify the characteristics of this candidate mail in such a heterogeneous market. The selection of the benchmark serves two purposes: first, to identify the mail most likely to convert from single-piece to presort; and second, to consider the differences in the cost-driving characteristics of the mail most likely to convert relative to those characteristics of the mail already in the presort category. The intention is to identify and quantify the cost savings associated with making the, perhaps incremental, changes to the candidate

mail's cost-driving characteristics such that it would qualify as presort mail. In past dockets, the Postal Service and intervenors have debated this issue extensively.³ The Bulk Meter Mail (BMM)⁴ benchmark has been described as follows:

BMM letters are generally considered to be machinable, homogenous, non-barcode mail pieces with machine printed addresses that are properly faced and entered in trays.

Docket No. R2005-1, response to APWU/USPS-T21-8 (Tr. 4/952).

BMM letters are machinable mail pieces that are entered in full trays and weighted into the entry facility as "meter bypass", meaning that they bypass the 020 meter belt operations. They are routed to MLOCR-ISS operation. Other metered letters are typically entered as bundles. Those mail pieces arrive at the entry facility mixed with other collection mail pieces. They incur costs related to dock operations and would also incur the costs required to cull them from the residual collection mail. The mail could be culled manually by the mail handlers or by postal equipment such as the Dual Pass Rough Cull system. Once culled, the bundles are routed to 020 operation where they are unbundled, faced and trayed. If the mail is machinable, it would be routed to the MLOCR-ISS operation. If the mail is determined to be non-machinable, it would be routed to manual operations.

Docket No. R2005-1, response to APWU/USPS-T21-6 (Tr. 4/950).

The precise measurement of mail processing cost avoidances is made difficult when the basis for comparison is a mailstream with characteristics as diverse as First-Class Mail. In such an environment, any opinion on the benchmark could be simultaneously right and wrong.⁵ These diverse opinions have led to extensive controversy over the history of First-Class Mail rate design.

³ See PRC Op. R97-1 at 292-94 and PRC Op. R2000-1 at 238-239 and 241.

⁴ Our cost systems cannot isolate BMM costs. Rather the cost of First-Class Mail single-piece metered mail is used as a proxy in the model that derives BMM costs.

⁵ There has been considerable disagreement among the parties regarding the benchmark and appropriate levels of discounts. Please see PRC Op. R2001-1 at 61-76; PRC Op. R2000-1 at 235-244; PRC Op. R97-1 at 281-292; PRC Op. R90-1 at V-36-50; PRC Op. R87-1 at 469-474.

IV. The Postal Service Recognizes The Difficulty In Determining Benchmarks And The Need To Balance Economic Efficiency And Other Ratemaking Goals.

A. Ideally, one would identify the sole candidate mailpiece and use the ECP tool to design rates

In an extremely simplified situation, there would be a single identifiable, homogeneous mail stream that was the sole source for conversion to the presort category from single-piece. Absent considerations other than efficiency, in this simplified situation, strictly passing through 100 percent of the cost avoidance from this benchmark could be the proper rate design approach. In a more realistic situation, the heterogeneity of the single-piece mail stream and the maturity of the presort category requires a broader consideration of the relevant costs, including cost avoidances and cost differences.

B. The nature of First Class Mail makes strict adherence to ECP inappropriate

While the use of cost avoidance is appropriate as the basis for establishing discounts for each workshare rate category, use of it as the starting point for establishing the difference between single-piece and presort rates may fail to incorporate the full range of cost information available from the CRA for single-piece and workshare mail and may not necessarily be the best basis for establishing the overall relationship between the two major categories within First-Class Mail. Instead, a mechanism that incorporates a greater recognition of the cost differences may be more appropriate, so that the price signal does not only reflect one component of the single piece category. This approach also would achieve a fair result in that pieces from each

subset of First-Class Mail would make similar contributions to covering institutional costs.

C. Separate subclasses are not the solution, and the Postal Service’s proposal does not advance this approach

In this docket, the Postal Service is not proposing to establish separate subclasses for Single-Piece and Presort Letters in First-Class Mail. The Postal Rate Commission has traditionally required evidence of “distinct differences in demand” for the formation of a subclass.⁶ Because it is not proposing a separate subclass, the Postal Service has not provided any evidence or studies in this docket to support the proposition that there are distinct differences in demand between workshare and single-piece First-Class Mail categories. In addition, while the Postal Service is proposing a “de-linking” of single-piece and workshare cost and benchmarking in the mechanics of rate design, a strong link between rates is maintained in the proposal as a result of requiring approximately equal unit contributions between single-piece and presort. The latter link underscores the Postal Service’s continued treatment of single-piece and presort as separate categories within a subclass, not as two separate subclasses, which would require independently selected cost coverages for the two categories.

⁶ Docket No. MC95-1, Op. & Rec. Decision, page V-14, para. [5030]

D. The Postal Service proposal balances all of the concerns

1. The proposal is similar to former approaches such as “Appendix F”

The Postal Service’s proposed approach for First-Class Mail worksharing is not inconsistent in nature with previous Commission approaches. For example, the Commission’s Appendix F approach relied on a hybrid cost difference and cost avoidance approach between single-piece and presort. In describing the Appendix F approach, the Commission noted:

Because it assumes that a broad range of cost characteristics will be avoided as a result of the discount, the Commission’s Appendix F approach to calculating discounts for presort First-Class Mail yields results that are closer to ‘full cost difference’ calculations than to calculations based on ‘clearly capturable’ cost avoidance analysis.

PRC Op. MC95-1, para. 4226.

Among other things, the Commission in Docket No. R84-1 was initially “motivated by the absence of a sufficiently reliable cost avoidance methodology.” PRC Op. R87-1, para. 5189. In Docket No. R87-1, the Commission cited the maturity of the presort category (“3/5 has been in existence for twelve years and it appears that its existence is not merely the result of conversions from the nonpresort category”). Another reason given for the use of the hybrid approach was the heterogeneity of the nonpresort category compared to the five-digit presort category (e.g., “the wide range of costs exhibited by the mail from which it (the presort category) is derived”). PRC Op. R87-1, para. 5191; and PRC Op. MC95-1, para. 4223.

Today we also find ourselves facing similar circumstances: First-Class Mail is characterized by (1) the difficulty of fixing on a reliable worksharing cost avoidance methodology, (2) a mature presort category, and (3) a heterogenous single-piece category — perhaps more so than ever before. Thus, applying an approach that relies on the cost of presort mail as a starting point and then uses cost avoidances for the various presort levels is appropriate.

2. The Postal Service’s proposal creates a reproducible and transparent mechanism for the pricing of First-Class Mail

The cost difference approach for establishing the relationship between the two major categories of First-Class Mail is transparent and easily reproducible from one rate case to the next. Cost differences can be calculated and documented with relative certitude, in stark contrast to the uncertainty and controversy associated with past benchmark specifications and cost avoidance calculations derived from modeled cost pools. The transparency and relative certitude should lead to more consistency from rate case to rate case. This should have the benefit of greater rate predictability.

3. The Postal Service’s proposal is consistent with Efficient Component Pricing with acknowledgement of its limitations and the need to balance all rate design objectives

In a theoretical world with nothing to consider but Efficient Component Pricing, this rule would require the Postal Service to set its discount no more or less than the cost that the Postal Service would incur in converting the non-workshared mail to presorted mail. However, the Postal Service does not operate within a theoretical construct and the pricing structure established in the Act does not support the narrow

application of any single theoretical economic model. The Postal Service's current proposals and the Commission's prior recommendations have carefully weighed the often contradictory policy objectives embodied in the pricing criteria.

While the Postal Service recognizes the need to send efficient signals to mailers regarding worksharing decisions, with a mature market for First-Class Mail presort mail this process has become more complicated. Rather than rigidly following a single theory we have looked at the totality of the situation and at both rate categories and their cost causing characteristics and believe that the goal of economic efficiency can still be achieved by establishing the target of equal per-unit contribution from both categories. To the extent that Efficient Component Pricing offers guidance on pricing that promotes economic efficiency, it may be useful in postal ratemaking. However, the pricing criteria and other policies of the Act also require the consideration of a wide range of non-economic policy factors. In constructing First-Class Mail rates, the Postal Service has carefully weighed all factors and developed rates that are reasonable and consistent with the Act.

Respectfully submitted,

UNITED STATES POSTAL SERVICE
Respectfully submitted

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Michael T. Tidwell
Nan K. McKenzie
Attorneys

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-2998; Fax -5402
August 21, 2006