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BEFORE THE POSTAL REGULATORY COMMISSION

WASHINGTON, DC 20268

Regulations Establishing System of Ratemaking) **Docket No. RM2007-1**

COMMENTS OF THE PARCEL SHIPPERS ASSOCIATION

(April 6, 2007)

INTRODUCTION AND SUMMARY

In these Comments the Parcel Shippers Association responds to PRC Order No.2 (January 30, 2007). That Order established Docket No. RM2007-1, Advanced Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking ("ANPRM"), through which the Commission will "by regulation establish . . . a modern system for regulating rates and classes for market dominant products."[1] In that Order the Postal Regulatory Commission ("Commission") asks for comments on "regulations to bound Postal Service discretion in setting rates for competitive postal products."[2] Specifically, part III of that Order asks for comments on the regulations required to ensure that revenues from Postal Service market dominant products are not used to

[1] Ibid.

[2] PRC Order No. 2 at 1.

subsidize its competitive products. With some exceptions, PSA confines these comments to those issues related to the provision of competitive products.[3]

PSA urges the Commission, in promulgating its regulations, to take great care to ensure that those regulations afford a meaningful opportunity for the United States Postal Service ("Postal Service" or "USPS') to compete in expedited and package delivery markets. During the course of the more than decade long journey to final postal reform legislation, some argued the Postal Service should be denied that opportunity or even prohibited from offering parcel delivery services.[4] Those arguments were rejected by both the Presidential Commission appointed to make recommendations on postal reform,[5] and by the Congress in passing the Postal Accountability and Enhancement Act ("PAEA" or "Act").[6] The law is clear. "'[P]ostal service' refers to the delivery of letters, printed matter, or *mailable packages*. . ." 39 U.S.C §102(5)(emphasis added). The legislative history is replete with expressions of intent that the Postal Service should be permitted, even encouraged, to compete in these markets. This is

[3] PRC Order No. 2 at 8; "Competitive products" are defined as "priority mail; expedited mail; bulk parcel post; bulk international mail; and mailgrams . . ." and those terms "shall … be considered to have the meaning given to such mail matter under the mail classification schedule." *See* 39 U.S.C. §§101(9), 3631(a) and (c).

[4] **"**UPS strongly agrees that the Postal Service should have a clearly-stated, distinct mission. However, this mission should be the delivery of hard-copy information – *not packages*". *Rebuttal Comments of United Parcel Service* submitted to the President's Commission on the U.S. Postal Service at 8 (emphasis added), available at http://www.treas.gov/offices/domestic-finance/usps/.

[5] The Commission said that the Postal Service should "provide products and services directly relating to the delivery of letters, newspapers, magazines, advertising mail, and *parcels* on a universal basis." *Embracing the Future, Report of the President's Commission on the United States Postal Service*, (2003) page 28 (emphasis added).

[6] Pub. L. No. 109-435, 120 Stat. 3198 (Dec. 20, 2006). The PAEA amends many section of title 39 of the United States Code. Unless otherwise noted, section references in these comments are to title 39, as amended by the PAEA.

because only the Postal Service provides truly universal parcel delivery service: post office boxes; APO's; FPO's; Alaska; and Saturday delivery, just to cite some examples. Under the PAEA it will continue to have this universal service obligation. Some degree of success in the package delivery is necessary to ensure continued universal, affordable parcel *and* mail delivery.

The Postal Service's competitive position in the package delivery market is fragile. At the time of the last comprehensive postal reform, the Postal Reform Act of 1970,[7] the Postal Service and one private carrier each held roughly 50% of the market volume. The USPS share is now 14% and that of other carriers is 86%.

The PAEA strives to ensure "a level playing field" in those markets in which the Postal Service has competed and will continue to compete. In response to concerns expressed by competitors, various "governmental advantages" have been taken away from the Postal Service by the PAEA. At the same time, it is given substantially more "flexibility" to price its competitive products, although, as discussed below, it is subject to numerous constraints that do not apply to its competitors. Only time will tell if Congress struck the appropriate balance in "leveling the playing field" on which the Postal Service competes with private sector enterprises. PSA suggests that there is no reason to fear that the Postal Service will advance significantly in competitive markets to the detriment of private competitors. There is, however, a substantial possibility it could fail if the Commission inadvertently injures its competitive position. This

[7] Public Law 91-375, 84 Stat. 719.

could happen if the Commission's regulations, intended to protect against cross subsidization, excessively and unnecessarily burden the Postal Service.

As explained more fully below, PSA believes the Postal Service will have a fair chance to compete if the following principles are observed. First, the incremental cost test should be applied to prevent cross subsidization. Second, the test to determine whether "competitive products" cover attributable costs should be applied, essentially, at the current subclass level, i.e. Priority Mail, Express Mail, bulk parcel post, and bulk international mail. Third, attributable costs should be determined through reliably identified causal relationships. Fourth, the collective contribution of all competitive products, the "appropriate share," should be no greater than that recommended by the Commission in Docket No. R2006-1. Fifth, while the Commission's implementing regulations should give the Postal Service substantial flexibility to negotiate market dominant rates with customers, the regulations should give the Postal Service even greater flexibility to negotiate competitive product contract rates with customers. Finally, PSA members make substantial use of Standard Mail and First-Class Mail, which are market dominant products . The extraordinarily and exceptionally large rate increases for First-Class Mail parcels and Standard Mail packages proposed by the Postal Service in the most recent omnibus postal rate case, Docket No. R2006-1, are very problematic. To ensure the predictability and stability in the ratemaking system envisioned by the PAEA where annual rate increases are expected to be the norm, the Postal Service should be required to provide the

Commission with written, on the record, justification for any market dominant rate increases that *substantially* exceed inflation.

1. Consistent with the opinion of mainstream economists and as the Commission found in Docket No. R97-1, application of the incremental cost test is the appropriate way to prevent cross subsidization. The Commission's attributable costs are closely related to the economic concept of incremental costs.

Section 3633(a)(1)-(2) requires the Commission to promulgate regulations that "prohibit the subsidization of competitive products by market dominant products" and "ensure that each competitive product covers its costs attributable." To satisfy this statutory requirement, PSA respectfully submits that the Commission should require that revenues for each competitive product cover its incremental cost. As the Commission has previously explained, its definition of attributable costs is most similar to that of incremental costs. Thus, the Commission's attributable costs can serve as a reasonable proxy when testing for subsidies.

In Docket No. R97-1, Dr. Panzar described the incremental cost test as the accepted economic standard for determining the possible presence of subsidy.

> The test accepted by economists to determine whether or not any service (or group of services) is receiving a subsidy is
>
> > *The Incremental Cost Test*. The revenues collected from any service (or group of services) must be at least as large as the additional (or *incremental*) cost of adding that service (or group of services) to the enterprise's offerings.

Docket No. R97-1, USPS-T-11 at 8.

Referencing this testimony approvingly, the Commission identified Dr. Panzar's testimony as reflecting the mainstream approach to cross-subsidy analysis by economists and the Commission's own view:

> The Commission also has no desire to recommend rates that allow cross subsidies. In this respect the Commission agrees completely with the prevailing opinion of the economics profession cited by witness Panzar. The intent of the framers of the Act was to prohibit cross subsidies. The testimony offered by witness Panzar regarding the correct test for cross subsidy is also accepted by the Commission. The incremental cost test he describes in principle is the test that the Commission should attempt to apply.

PRC Op. R97-1, ¶4026.

The Commission goes on to note some technical difficulties with the available measures of incremental costs:

> In 1970, economists had not yet determined that the proper economic test for cross-subsidy also involves considering services more than one at a time. Fortunately, the statutory framework is sufficiently flexible so that it can encompass a reliable measure of incremental costs. Such a measure has not been developed on this record.

Ibid.

However, the Commission notes that its attributable costs come close to being an estimate of incremental costs and can therefore provide reliable guidance about cross-subsidization:

> The Commission's calculation of attributable costs by subclass and service does not precisely conform to witness Panzar's definitions

> of either marginal cost or incremental cost. However, they come closest to being the incremental costs associated with the subclasses and services taken one at a time. Therefore, nonnegative markups are good evidence against the presence of the most elementary cross subsidies.

Id. at ¶4024.

2. The test to determine whether "competitive products" cover attributable costs should be applied, essentially, at the current subclass level, i.e. Priority Mail, Express Mail, bulk parcel post, and bulk international.

PSA submits that the test to determine whether "competitive products" cover attributable costs should be applied individually for Priority Mail, Expedited Mail, bulk parcel post, and bulk international mail for two reasons. (The test need not be applied to mailgrams because the Postal Service no longer offers this product.) First, application of the test at this level is similar to the approach – requiring that revenues from each subclass cover attributable costs – which the Commission has successfully applied under the existing ratemaking system. Second, the subclass level is the level at which USPS Cost and Revenue Analysis (CRA) systems accurately track costs, thus data may not be sufficient to accurately apply the test at a more detailed level. On this point, PSA notes that the Commission has expressed concern about the accuracy of CRA systems for small subclasses. *See, e.g.*, PRC Op. R2005-1, ¶6143 (Media Mail); PRC Op. R2006-1, ¶5796 (Periodicals Within County). Further, application of the incremental cost test to each individual rate would be difficult, if not impossible to administer (e.g., there are hundreds of Parcel Select rates alone). It is more than obvious that it is not possible to ensure that each rate within a subclass meets the test.[8]

3. At current rates, all competitive products clearly cover their attributable costs, thus ensuring that cross-subsidization is not a problem.

The Commission's R2006-1 decision provides information on the costs and revenues associated with the competitive classes for FY 2008, as shown in Table 1.[9] Clearly the revenues are well above the attributable costs. This ensures that attributable costs are covered, that incremental costs are covered, and that cross-subsidization does not exist.

Table 1. Costs, Revenues and Contribution for the Competitive Subclasses (FY 2008) (in Thousands of Dollars)

Subclass	Attributable Cost	Revenue	Contribution
Priority Mail	$3,466,108	$5,192,582	$1,726,474
Express Mail	$467,208	$796,283	$329,075
Parcel Post	$1,278,840	$1,456,748	$177,908
International Mail	$1,505,112	$1,880,630	$375,518
Competitive	**$6,717,268**	**$9,326,243**	**$2,608,975**

PRC Op. R2006-1, Appendix G, Schedule 1.

[8] Under the PAEA, the services that comprise the Priority Mail and expedited mail products are clearly defined since those terms "have the meaning given to such mail matter under the mail classification schedule," 39 U.S.C. §3631(c). It seems clear that "bulk parcel post" refers to the existing Parcel Select service, the Parcel Return Service, and workshared non-destination-entry Parcel Post (e.g., OBMC and BMC Presort parcels). What is intended by "bulk international mail" is not clear. PSA suggests that it would be consistent with the categorization of domestic competitive services, to define the following international services as "bulk international mail": single-piece letters weighing more the 12.5 ounces; EMS/Express International; GXP; Air CP/Priority International; International Priority Airmail; International Surface Air Lift; bulk letters; bulk packages including Global Bulk Economy; Commercial Direct Entry bulk letters and packages; M-bags, Publishers Periodicals; Other Articles; International Money Orders. (Note: the Postal Service's International Mail offerings will be realigned on May 14, 2007 [Fed. Reg. / Vol. 72, No. 64, 16604].

[9] Note that figures in this table and subsequent figures in these comments unavoidably treat single-piece Parcel Post and International Mail as competitive products because separate cost and revenue figures that exclude single-piece are not available. Inclusion of single-piece volumes will affect the exact figures presented, but not the general conclusions drawn.

Even if there is some difference between attributable and incremental costs, there is clearly no concern about having the competitive subclasses cover their full incremental costs at present pricing levels for the competitive subclasses.

Not only is there no cross subsidization of competitive products by market dominant products, but the rates for market dominant products are lower because the Postal Service offers competitive products. In FY 2008, competitive products were estimated to cover their attributable costs and in addition make a contribution of $2.6 billion towards institutional costs. Without this contribution from competitive products, market dominant products would have to cover this $2.6 billion in institutional costs. This would require market dominant rates to increase by more than four percent.[10]

4. Consistent with longstanding Commission practice and as codified in the Postal Accountability and Enhancement Act (PAEA), attributable costs should be determined "through reliably identified causal relationships," not through the application of arbitrary accounting rules.

When determining the attributable or incremental costs of postal products, the Postal Regulatory Commission should continue its appropriate and now statutorily recognized practice of doing so through the analysis of "reliably identified causal relationships." PSA also submits that the Secretary of the Treasury in reporting on accounting practices to be used for competitive products (and the Commission in establishing these accounting rules) is bound by this

[10] $2.6 billion divided by market dominant revenue of $64.1 billion. PRC Op. R2006-1, Appendix G, Schedule 1. Note that the rate increase would have to be greater than the resulting 4 percent to account for reductions of mail volume due to the rate increase.

same method for attributing costs. Section 2011(h)(1). Similarly, costs allocated to competitive products (Section 2011(h)(1)) should be consistent with the "appropriate share" of institutional costs determined by the Commission pursuant to Section 3633(a)(1)). Treasury's role in recommending costing is circumscribed by the Act's requirement that attributable, or non-institutional costs, must be causally related. It is, thus, axiomatic that the equitable share of institutional costs cannot be derived through accounting or non-causal methods. As the Commission noted in Docket No. R97-1, it is not the case that all costs can or should be attributed:

> The sum of all attributable costs always leaves a sizeable institutional remainder for the Commission to assign to classes of mail and types of services in a manner that is "reasonable" in accordance with the criteria stated in the Act.

PRC Op. R97-1, ¶4025.

This, of course, is because not all costs can be causally related back to a particular postal product. In addition to the administrative costs that represent important fixed costs in any business, the Postal Service has substantial network costs that are appropriately treated as institutional. As described by Professor Michael D. Bradley in his 2003 article on "The Postal Service Product Costing System" for the President's Commission:

> These institutional network costs arise from three sources: (1) common fixed cost in network provision, (2) economies of scale or density in network provision and (3) economies of scope in network provision. The lion's share of the institutional cost comes from the carrier and retail networks where these sources are strong.

Professor Bradley's review of the Postal Service Cost Segments and Components Report finds that fully two-thirds of the Postal Service's institutional costs are due to its network responsibilities, particularly its carrier and retail network responsibilities.

This Commission past practice is now codified in sections 3622(c)(2) and 3631(b). These sections specifically states that attributable costs should be determined through reliably identified causal relationships:

> each class of mail or type of mail service bear the direct and indirect postal costs **attributable** to that class or type of mail service **through reliably identified causal relationships.** Section 3622(c)(2)(emphasis added).
>
> For purposes of this subchapter, the term 'costs **attributable**', as used with respect to a product, means the direct and indirect postal costs attributable to such product through **reliably identified causal relationships**. (emphasis added). Section 3631(b)(emphasis added).

5. The minimum markup on competitive products overall should be no greater than that recommended by the Commission in Docket No. R2006-1 and, to enhance social welfare, should be significantly less.

The PAEA requires that the Postal Regulatory Commission (PRC) promulgate regulations to "ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service." 39 U.S.C. §3633(a)(3). Further, one of the objectives of the system for regulating rates for market dominant products is "to allocate the institutional costs of the Postal Service appropriately between market dominant products and competitive products." 39 U.S.C. §3622(b)(9).

PSA respectfully submits that the "appropriate share" requirement for competitive products is satisfied by the markups recommended in Docket No. R2006-1,[11] i.e., the minimum markup requirement should be no greater than recommended in the last case. The recommended markups are presumptively fair to users of market dominant products and, as illustrated by the Postal Service's meager share of the parcel delivery market, presumptively do not provide the Postal Service with an unfair competitive advantage.

Further, PSA urges the Commission to take a light handed approach in establishing a minimum markup on competitive products for several reasons. First, a reduction in the markup on competitive products will significantly increase consumer surplus, thus enhancing social welfare. Second, despite the higher-than-average own-price elasticities of competitive products, USPS has an incentive to increase rates for competitive products (not reduce them). This will improve USPS profits.[12] Thus, the Commission need not be concerned that the Postal Service will try to increase profits by charging "unfairly low" prices.[13]

The Commission is required to revisit its "appropriate share" determination in five years. 39 U.S.C. § 3633(b). If it errs on the side of being overly generous

[11] If the Postal Service files another rate case before implementing the modern ratemaking system, the PRC will again recommend rates that it deems, based upon an evaluation of the non-cost factors of the Postal Reorganization Act (PRA), to be appropriate. *See,* former 39 U.S.C. § 3622(b).

[12] For example, the Commission estimates that the double-digit rate increases recommended in Docket No. R2006-1 for Priority Mail, Express Mail, and Parcel Post will increase the contribution of these products by approximately $700 million in the Test Year. PRC Op. R2006-1, Appendix G, Schedule 1; Docket No. R2006-1, PRC-LR-2.

[13] Given that the Postal Service will now have an incentive to increase its earnings through rate increases, not rate reductions, for competitive products, the more pressing concern should be preventing the Postal Service from charging inappropriately high rates for competitive products, not preventing it from charging too little.

to the USPS competitive position, that can be corrected. If it errs in the other direction, there may be no competitive USPS product line for which to make corrections. The USPS could be effectively out of the competitive product business; its competitive position irreparably harmed.

That would not be a good result, because today the Postal Service is the only universal service provider. As discussed earlier, establishing a minimum markup requirement that prices the Postal Service out of the market jeopardizes universal parcel delivery service at reasonable rates, an outcome that was specifically rejected by the President's Commission on the U.S. Postal Service and the U.S. Congress. Section 5.d notes that greater increases in competitive product rates will affect most adversely those users who are not effectively served by the Postal Service's competitors—a move in the direction of jeopardizing universal parcel delivery service.

a. The current set of markups on competitive products is fair to users of market dominant products.

The Docket No. R2006-1 recommended markups are presumptively fair to users of market dominant products. In Docket No. R2006-1, the Commission recommended rates for market dominant products that, based upon an evaluation of the non-cost pricing factors specified in section 3622(b) were deemed to be appropriate.[14] The modern ratemaking system, which is to include

[14] Note that the factors that the PAEA requires the Commission to take into account when establishing the system for regulating rates and classes for market dominant products are similar to the factors specified in the Postal Reorganization Act of 1970 (PRA). For example, the PAEA adopts, with minimal change, eight of the nine PRA ratemaking factors. .

inflation-based limits on rate increases for market dominant products, will effectively preserve the reasonableness of rates for market dominant products into the future.

b. At current markups, the Postal Service does not have an unfair advantage over its competitors.

The markups recommended by the Commission for competitive products in Docket No. R2006-1 promote competition because they were designed with this specific goal in mind. As the Commission found in Docket No. R2000-1 and reiterated in its Docket No. R2006-1 Opinion:

> That alternatives exist does not require the Commission to recommend rates causing the Postal Service to cede markets to competitors. *See United Parcel Service, Inc. v. United States Postal Service*, 184 F.3d 827, 845 (D.C. Cir. 1999) ("[t]he Commission has consistently, and reasonably, held that [criterion 5] authorizes a reduction in rates to maintain the position of the Postal Service as a competitor in the mail delivery industry.") Nor is it the Commission's role to assure market share for the Postal Service. The Commission's role is to protect competition, not competitors. *Direct Marketing Association, Inc. v. United States Postal Service*, 778 F.2d 96, 106 (2nd Cir. 1985). The recommended rates are designed with that goal in mind.

PRC Op. R2006-1, ¶5094 (citing PRC Op. R2000-1, ¶5788).

Further, characteristics of the parcel delivery market confirm that the Postal Service has no unfair advantage over its competitors. If it had such an advantage, USPS would presumably be the dominant player in the marketplace for competitive products. This is not the case. Measured as a percentage of volume, USPS competitive products comprise only1 4 percent of the parcel delivery market, far less than the 57 percent share held by United Parcel Service (UPS) and Federal Express' 21 percent share. Measured as a percentage of revenue, the Postal Service's share is even smaller.[15]

United Parcel Service – 51 percent

Federal Express – 28 percent

U.S. Postal Service – 11 percent

DHL – 6 percent

Other – 3 percent

The soon-to-be-implemented above-average rate increases proposed by the Postal Service and recommended by the Commission for Priority Mail, Express Mail, and Parcel Post will further erode the Postal Service's share. For example, as the Commission noted in Docket No. R2006-1:

> The above-average rate increase recommended for Priority Mail precipitates nearly a 13 percent decline in Priority Mail volumes in a market which by all accounts is expanding and can not fairly be characterized as protecting the Postal Service's market share.

PRC Op. R2006-1, Footnote 108.

Further, the specific arguments that UPS has advanced in support of its contention that the Postal Service has unfair advantages are incorrect or will no

[15]Source of all market share data: The Colography Group, Inc., *Domestic Quarterly Market Growth And Competitor Share Report;* USPS FY2005 & FY2006 RPW Reports.

longer be relevant as the PAEA is implemented.[16] The two are that (1) the Postal Service subsidizes rates for competitive products; and (2) the Postal Service obtains benefits (e.g., exemption from taxation and other requirements that private competitors must meet) from its status as a government agency.

The former is simply untrue -- the Postal Service does not subsidize its competitive products. In fact, as discussed above, revenues from competitive products cover their attributable costs and contribute about $2.6 billion per year to institutional costs. Further, the per-piece contribution made by competitive products is significantly higher than for market dominant products. For example, as emphasized by the Commission in Docket No. R2006-1:

> At recommended rates, Priority Mail's unit contribution increases to $2.08, an increase of nearly 34 cents over the last litigated case. (footnote omitted) This level represents an historic high and is more than nine times the unit contribution of First-Class letters.

PRC Op. R2006-1, ¶ 5345.

The per-piece contribution to institutional costs ($1.29) across all competitive products is approximately nine times the average per-piece contribution (14 cents) for market dominant products and approximately six times the per-piece contribution (22 cents) of First-Class Mail letters.[17]

[16] See, *e.g.*, Written Statement of Mike Eskew (Chairman and CEO of United Parcel Service) Before the President's Commission on the United States Postal Service. February 20, 2003. pp. 5-8.

[17] These per-piece contribution figures were calculated from PRC Op. R2006-1, Appendix G, Schedule 1. Because contribution figures are provided at the subclass level, Priority Mail, Express Mail, Parcel Post, and International Mail were treated as competitive with the remainder of domestic mail classified as market dominant. These figures thus should be viewed as approximate.

Further, provisions in the PAEA eliminate any advantages that the Postal Service currently derives from its status as a governmental agency.

Section 402 requires the Postal Service to pay tax on the income that it makes from competitive products.

Section 403 prohibits unfair competition.

Section 703 requires the Federal Trade Commission (FTC) to prepare a report on laws that apply differently to the Postal Service and make recommendation for bringing these legal differences to an end. The PRC must take the FTC's recommendations into account then must promulgate regulations

Additionally, as the Commission noted in Docket No. R2000-1, the Postal Service has significant disadvantages compared to its competitors.

> By the same token, the Postal Service, as a governmental agency, may incur costs, *e.g.*, universal service, which disadvantage it compared to competitors.

PRC Op. R2000-1, Footnote 151.

Finally, the Postal Service has to comply with numerous requirements that do not apply to its competitors. For example, under the PAEA, the Postal Service will have to comply with externally-imposed accounting rules (Section 2011); receive external approval before it can introduce new products (Section 3641-3642); and have its contract rates reviewed by the PRC (Section 3632(b)).

c. Reducing the aggregate markup on the competitive category of products would significantly increase consumer surplus. Thus, the Postal Service should be allowed to set rates for competitive products closer to socially-optimal levels.

The Postal Service should be allowed (in fact, encouraged) to reduce the aggregate markup on competitive products because – as the Postal Service has found in past analyses of "Ramsey" prices – doing so provides significant benefit to users of competitive products.

For example, in dockets R97-1, R2000-1, and R2001-1, the Postal Service presented estimates of Ramsey prices – prices that maximize consumer surplus (the net benefit to consumers from purchasing a product) while meeting the Postal Service's revenue needs.[18] In Docket No. R2000-1, Postal Service witness Bernstein estimated that the net loss of value to mailers from the use of non-Ramsey prices was roughly $1.27 billion. Docket No. R2000-1, USPS-T-41 at 98. Further, he found that reducing rates for Priority Mail, Express Mail, and Parcel Post to Ramsey levels would increase consumer surplus by more than $2 billion, an appreciable gain to society.[19]

While the data underlying these calculations have changed, the general findings still hold. In fact, given that the own-price elasticities of Priority Mail, Express Mail, and destination-entered Parcel Post (which comprises the vast

[18] Docket No. R97-1, USPS-T-31; Docket No. R2000-1, USPS-T-41; Docket No. R2001-1, USPS-10.

[19] Note that the inflation-based limitations on rate increases for market dominant classes and the increased elasticities for the competitive products since Docket No. R2001-1 would minimize the impact on those classes of moving towards more optimal rates for the competitive products.

majority of bulk Parcel Post) were estimated to be higher in Docket No. R2006-1 than in Docket No. R2001-1, these findings are even more applicable today.

As witness Bernstein pointed out, the estimate of the loss of consumer surplus reflects a comparison that can be made between any two sets of postal rates. *Id.* at 93, lines 12-13. The procedure for calculating the change in consumer surplus in moving from a higher rate to a lower rate involves combining 1) the effect of the price reduction for the volume that is mailed at the higher rate, and 2) an estimate of the benefit from the mail volume increase using a linear demand function. *Id.* at 94. It is not necessary to go all the way to Ramsey prices to capture some of the consumer surplus that a Ramsey approach produces.

PSA respectfully suggests that the Commission, in determining the "appropriate share" of institutional costs for competitive products, consider the possibility of some movement in the direction suggested by Ramsey prices to increase social welfare.

d. The Postal Service is the only provider of universal service. Thus, any increase in Postal Service rates for competitive products necessitated by an unreasonable minimum markup requirement will be felt most by those consumers (e.g., rural, residential) not effectively served by the Postal Service's competitors.

Finally, PSA urges the Commission to be cautious in determining the "appropriate share" of institutional costs to be borne by competitive products. While there is significant competition in the parcel delivery marketplace overall, the Postal Service remains the only provider of universal parcel delivery service.

The impact of an unreasonably high minimum markup requirement would be felt most by users of USPS who are not effectively served by alternative providers. As PSA explained in its comments to the President's Commission on the U.S. Postal Service:

> Only the Postal Service provides truly universal parcel delivery service: post office boxes; APO's; FPO's; Alaska; and Saturday delivery, just to cite some examples…Unlike some of its competitors, it does not penalize parcel deliveries to your home with a hefty surcharge; it does not hide from, but welcomes at one of forty thousand post offices, the ordinary citizen with one package to send.[20]

6. The Commission should grant the Postal Service substantial flexibility to negotiate contract rates for market dominant products.

Our members will continue to be significant users of market dominant products. We urge substantial flexibility for the Postal Service to enter into Negotiated Service Agreements (NSAs).

The PAEA specifically recognizes the importance of providing the Postal Service with pricing flexibility and empowers the Postal Service to negotiate customized agreements (i.e., contract rates) with individual users of market dominant products. In particular, Factor 7 emphasizes "the importance of pricing flexibility to encourage increased mail volume and operations efficiency" and factor 10 specifically recognizes the desirability of customized agreements to "improve the net financial position of the Postal Service" and "enhance the

[20] Parcel Shippers Association Comments to the Presidential Commission on the United States Postal Service by Timothy J. May. Note that while the PAEA classifies single-piece Parcel Post as a market dominant product, single-piece Priority Mail and Express Mail are competitive. Thus, the impact of a high "appropriate share" requirement would certainly impact some single-piece mailers, i.e. ordinary citizens.

performance of mail preparation, processing, transportation, or other functions." 39 U.S.C. §3622(c)(7),(10).

For the Postal Serviceand its customers to reap the full benefits from contract rates, the PRC should eliminate procedural impediments to the greatest extent possible. We note that while the Postal Service is currently authorized to negotiate such agreements, the length of time and the expense of litigation has significantly hindered the Postal Service's ability to take advantage of such agreements – in the last five years, the Postal Service has only negotiated and implemented five agreements with individual mailers, only two of which were considered "baseline" agreements.

PSA respectfully submits that the Postal Service should be allowed to negotiate and implement contract rates for market dominant products with no hearing or prior Commission approval. Consistent with the modern system for setting rates for market dominant products, the Commission need only review the contract rates if a complaint is filed.

7. The Postal Service Governors should be granted even more authority to negotiate contract rates for competitive products, analogous to the ability of their competitors to do deals.

For two primary reasons, the Postal Service Governors should be granted even more authority for negotiating deals for competitive products than for market dominant products. First, Section 3632(a) makes clear that it is the Governors, not the Commission, that establishes rates and classes for competitive products, subject only to the rules established by the Commission in

Section 3633. Further, Section 3632(b)(3) specifically calls for the establishment of rates and classes not of general applicability, which would include regional and local rates as well as contract rates with individual customers.

Second, as discussed in Section 5.b. above, a goal of the PAEA is to level the playing field between the Postal Service and its competitors. Thus, it is appropriate to allow the Postal Service, to the extent practicable, to have the same ability as its competitors to negotiate deals for competitive products.

Flexibility to negotiate and implement deals must include rules that minimize the amount of information that must be publicly disclosed. Undue disclosure will not only put the Postal Service at a competitive disadvantage by allowing its competitors to undercut the negotiated prices, but also deter private companies from doing deals with the Postal Service out of fear that confidential, commercially sensitive information will be made public.

8. To create predictability and stability in rates, the Postal Service should be required to provide the PRC with written justifications of all rate adjustments for market dominant products that substantially exceed inflation.

One of the objectives – Section 3622(b)(2) – of the modern system for regulating rates and classes for market-dominant products is "[t]o create predictability and stability in rates." The primary way by which this objective will be achieved is through the establishment of an "annual limitation on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index for All Urban Consumers…[which] shall apply to a class of mail." 39 U.S.C. §3622(d)(1)(A).

While this limitation will ensure that the average rate increase for a class of mail increases by a predictable and reasonable amount, the rate increase experienced by individual mailers can deviate significantly from this average.[21] Thus, capping the average rate increase for a market dominant class will not ensure predictability and stability for particular mailers or groups of mailers. More is needed to satisfy this objective.

PSA fully appreciates that "predictability and stability in rates" is only one of nine objectives of the modern ratemaking systems and thus it would be inappropriate, for example, to place an absolute limit on every rate cell. However, the Postal Service should be required to justify increases in particular rates that substantially exceed inflation.

Thus, PSA respectfully submits that the PRC require the Postal Service to provide a written justification (explaining how it appropriately balances the objectives and factors specified in Sections 3622(b) and (c) of the PAEA) of all rate increases that substantially exceed inflation. This justification should be provided at the time that the Postal Service provides public notice of the rate adjustment.

[21] For example, while the average rate increase recommended for the Standard Regular subclass in Docket No. R2006-1 was approximately 9.5 percent, the increase for some mailers was significantly higher. For example, despite the Commission's decision to moderate the rate increase "given the demonstrated uncertainty in the data quality and the potential for rate shock," the average rate increase for Standard Regular parcels was still 33 percent. PRC Op. R2006-1, ¶5494; PRC-LR-15.

CONCLUSION

For the foregoing reasons, PSA respectfully urges the Commission to promulgate new regulations that achieve the following:

- Afford a meaningful opportunity for the Postal Service to compete in expedited and package delivery markets, and in international markets. Both the Presidential Commission and the Congress, in passing the PAEA, rejected arguments that the Postal Service should not be offering parcel delivery services in the competitive markets.

- Reflect the opinion of mainstream economists, as found in Docket No. R97-1, that the incremental cost test is the appropriate way to prevent cross-subsidization; and that attributable costs are closely related to the economic concept of incremental costs.

- The Commission's regulations, to the extent that they use a test to determine whether "competitive products" cover attributable costs, should be applied essentially at the current subclass level, *i.e.* Priority Mail, Express Mail, bulk parcel post and bulk international mail.

- The Commission's regulations, consistent with longstanding Commission practice, and as codified in the PAEA, should provide that attributable costs are determined by “reliably identified causal relationships,” not through the application of arbitrary accounting rules.

- Compliant with the PAEA requirement that the PRC promulgate regulations to “ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service,” and “to allocate the institutional costs of the Postal Service appropriately between market-dominant products,” the Commission should provide that the “appropriate share” is satisfied by the markups recommended in Docket No. R2006-1.

- The Commission’s regulations on the requisite markup on competitive products should recognize that the current markups are fair to users of market-dominant products and the Postal Service does not have an unfair advantage over its competitors through cross-subsidy

- The Commission’s regulations concerning the aggregate markup on the competitive category of products should allow the Postal Service to reduce the aggregate markup and to set rates for competitive products closer to socially-optimal levels in order to increase consumer surplus.

- The Commission’s regulations for competitive products should recognize that the Postal Service is the only provider of universal service and therefore any increase in Postal Service rates for those products that result from an unreasonable minimum markup will be felt most by those consumers not effectively served by the Postal Service's competitors.

- In determining the regulations that govern the Postal Service's attempts to negotiate contract rates, the Commission should grant the Service substantial flexibility for market dominant products and, more importantly, should cede to the Governors even more authority to negotiate contract rates for competitive products, analogous to, if not equal to, the ability of their competitors to do deals.

- The Commission's regulations, in order to achieve the statutory objective of predicable and stable rates for market-dominant products, should require the Postal Service to provide the PRC with written justifications of all rate adjustments for market-dominant products that exceed inflation rates by a substantial percentage.

Respectfully submitted,

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