

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

POSTAL RATE AND FEE CHANGES, 2006

DOCKET NO. R2006-1

**INITIAL COMMENTS OF POSTCOM ON
THE BOARD OF GOVERNORS REQUEST FOR RECONSIDERATION OF
STANDARD MAIL FLAT RATES**

The Association for Postal Commerce (PostCom) hereby files these initial comments regarding the Postal Service's request for reconsideration of Standard Mail flat rates. An examination of the basis upon which the Board of Governors has remanded the Standard Mail Regular flats rate to the Commission for further consideration and the existing record compels two conclusions:

First, there is abundant evidence in this record upon which the Commission can, and, in the exercise of its expertise should, mitigate the rates it has proposed for Standard Mail regular and Nonprofit flats. This must be accomplished by an across-the-board reduction of each of the rate cells in the Regular and Nonprofit subclasses.

Second, there is absolutely no support in the record for the Postal Service's proposal to "rebalance" the Standard Mail Regular and Nonprofit subclass revenues by offsetting reduced flats rates by a corresponding increase in the rates for letters. The Postal Service's proposal to "rob Peter in order to pay Paul" is not only unsupported, but utterly irrational and unnecessary.

In sum, PostCom urges the Commission to reject the Postal Service's mechanistic "rebalancing" proposal. Instead, the Commission should exercise its judgment, as the statute plainly empowers it to do, in order to reach a result that mitigates the harm that will be caused to flats mailers under the current rates in a way that does not cause harm to any other type of mailer or to the Postal Service.

A. There is Abundant Evidence to Support A Reduction of the Flats Rates

There is no question that mitigation of the proposed flats rates is necessary. That result is required whether the issue is characterized as "rate shock" or – in our view, more accurately – an overly optimistic assessment of the ability of mailers of catalogs and other flat-shaped pieces to avoid substantial rate increases by converting their flats into letters. The Board of Governors has concluded that at the rates set forth in the Commission's Recommended Decision, there will be substantial adverse effects on mailers of catalogs and other pieces that meet the definition of a flat in both the short run and in the longer term, and that this, in turn, will result in harm to the Postal Service. In large part, the Board of Governors reached this conclusion because of its realization – belated, but nonetheless accurate – that the conversion of flats into letters is unlikely to happen, at least to the degree that the Commission assumed in setting the flats rates and in particular, the rates for flats weighing 3.3 ounces or less. *Decision of the Governors on Docket No. R2006-1* at 10.

In fact, the Commission itself recognized, albeit in a slightly different context, that the shape of a mail piece is driven by considerations other than, or in addition to, postage rates. In dealing with NFM's, witness McCrery repeatedly insisted that the solution to the sharp difference between NFM and flats rates is for mailers is to

simply reconfigure their packages. See, e.g., USPS-RT-14 at 11 et seq. The Commission plainly did not credit that testimony. Cf. Opin. and Rec. Dec. Vol. 1 at ¶¶ 5515-17. It did mitigate the Postal Service's proposed NFM rates. *Id.*

The exact same considerations apply here. The Commission has the inherent power to take official notice of the Board of Governors assessment – or more aptly, reassessment – of the extent to which mailers and the Postal Service will be harmed if flat-shaped pieces do not convert to letters. As it did in the case of NFMs, the PRC can and should judgmentally adjust the rates for flats in light of the Board of Governors' uncontested reassessment.

It is of critical importance that the adjustment be made at each rate cell and in a way that does not disturb rate relationships within or between the flats categories. The attempt to moderate certain rate cells by shifting revenues to others (e.g., by shifting revenues from piece rated to pound rated flats or by moving revenues from the automation category to other non-automation category) threatens to “solve” one problem by creating worse problems particularly in regard to the incentives for presortation and drop entry. The issue raised by the Board of Governors remand affects all flat-shaped rates and must be dealt with accordingly.

B. There Is No Justification For An Increase in the Letter Rates

However, it does not follow as a legal or factual matter that the Postal Service's solution to the problem created by the flats rates should be adopted. In its decision, the Board of Governors spoke of the desirability of “rebalancing” without specifying exactly what that meant. The Postal Service, presumably with the approval of the Board of Governors, states explicitly that “rebalancing” means that

the Commission should increase Standard Mail letter rates by a “modest” but otherwise unspecified amount in order to offset the decrease in flats rates and *presumed* corresponding decrease in revenues. The Postal Service points to no evidence in the record to justify this result; its use of the word “modest” is not particularly informative and certainly is not quantitative. What the Postal Service seems to be implying is that its demand models that are used by it and the Commission to estimate volumes and revenues by subclass cannot be uncritically applied in the determination of flats rates, but should be rigidly adhered to in the Commission’s development of rates for letter-shaped pieces. The Postal Service’s “rebalancing” theory is hopelessly flawed.

In the first place, there is absolutely no evidence in the record to suggest that the elasticity of letters and flats influence Postal Service volumes and revenues in any way that would justify offsetting a downward adjustment in Standard Mail flats at the expense of rates for letters. No one – including the Board of Governors – has called into question the Commission’s estimates of costs and volumes of Standard Mail letters at the rate levels contained in the Recommended Decision. There is, therefore, no reason for the Commission to reconsider that analysis.

More importantly, the Commission in this case as in others has explicitly observed that the Postal Service’s demand models are far from perfect. See *generally*, Opinion and Recommended Decision, Vol. 2, App. I; *id.* at ¶ 64 *et seq.* The Postal Service’s demand model that is used to estimate Standard Mail volumes operates at the subclass level (including a demand equation for each of Regular, ECR, NonProfit and Nonprofit ECR), not by shape of mailpiece. USPS-

T-7 at 103. The Commission recognized that the forecasts of test year volumes and revenues made with the Postal Service models and forecasting methodologies are reasonably accurate in the aggregate, but that the reliability of these forecasts deteriorates rapidly as the subclasses are broken down into rate categories. Opin. and Rec. Dec. Vol. 2, App. I at ¶ 15 *et seq.*

Indeed, witness Thress acknowledges that the level of detail of his demand equations is not sufficiently fine as to be satisfactory for projecting USPS revenues and costs. USPS-T-7 at 365. To address this problem in Standard Mail Regular and Nonprofit, he merely develops a share equation that takes into account the differences in historic growth rates between letters and non-letters. *Id.* The Commission unequivocally concluded that forecasts that depend on witness Thress's share models are the least reliable of the volume forecasts. Opinion and Rec. Dec. Vol. 2, App. I at ¶ 18. It is entirely reasonable, therefore, to conclude that the Postal Service's volume forecasts are least reliable in rate categories (such as flats) that represent a relatively smaller percentage of the subclass.

Accordingly, shape-based volume projections, and the resulting revenue and cost projections, are based, to a great extent, on qualitative judgments. The fundamental flaw in the Postal Service's rebalancing approach is that it has offered no valid reason and points to no probative evidence to support its judgment that "rebalancing" of Standard Mail Letter rates is necessary.

Lurking just beneath the surface of the Postal Service's "rebalancing" proposal is the Postal Service's desire for PRC assurance that the Postal Service

achieves the revenue requirement (and presumably cost coverage) for the Standard Mail subclasses as a whole. This unstated assertion is unstable in exactly the same way and exactly to the same degree that the rebalancing proposal itself founders. It relies upon a highly selective and mechanical application of the demand models. Nor is there any reason to conclude that mitigation of the flats rates without a corresponding adjustment of letters would put the subclass revenues or flats rates levels below reasonably attributable cost. The issue here is not an inter- or intra-class subsidy.

Most importantly, the Postal Service completely ignores volume and revenue effects that may ensue if the flat rates are moderated. As Mr. O'Brien has aptly put it in his letter of April 11, 2007 to the Commission, the elasticity assumptions "are subject to reasonable adjustment and the PRC can reasonably assume that with a lower Standard flat rate and higher volume levels, the same amount of revenue would be generated." Conversely, if the letter rates are increased, no matter how modestly, that may well have an adverse effect on volumes, revenues (and contributions) from letter mail, depriving the Postal Service of the very assurance of a specific revenue target for Standard Regular mail that it seeks. The Postal Service ignores these possible outcomes because of its slavish adherence to a selective and formulaic approach to volume and revenue forecasts, an approach which this Commission has never accepted and should not now ratify.

Indeed, the whole notion that the Commission should "rebalance" the letter-flat rates in order to guarantee the Postal Service the subclass revenues it seeks is untenable. It is not now, and it has never been, the Commission's

responsibility to guarantee the Postal Service a particular revenue result; in that respect, postal rate cases are utterly no different than any other cost of service ratemaking process. This is particularly true in the context of a forward looking test year which necessarily entails the exercise of judgment not only as to the robustness of demand models, but as to a myriad of other uncertainties which cannot be reduced to a formula or applied mechanically.

The contingency reserve exists as a cushion against the unavoidable uncertainty in the ratemaking process; and, in this case, the Commission has accepted the Postal Service's proposed contingency reserve without modification. The Postal Service's argument that it not only needs the contingency reserve, but needs to offset the anticipated reduction in flats revenues by a corresponding increase in Standard Letter mail revenues thus is not merely analytically and legally indefensible. It is unconscionable. It should be rejected.

CONCLUSION

For the reasons set forth above, the Commission cannot recommend downward adjustment of Standard Mail flat rates at the expense of Standard Mail

letters. It should reduce the rates for flats at each rate cell and otherwise leave its proposed rates for Standard Mail undisturbed.

Respectfully submitted,

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