

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268 0001

Regulations Establishing System
Of Ratemaking

DOCKET No. RM2007-1

REPLY COMMENTS
OF
PARCEL SHIPPERS ASSOCIATION
TO
COMMENTS OF UNITED PARCEL SERVICE

- 1. Just as it did in Docket No. R87-1, the Commission should reject UPS' proposal (UPS Initial Comments at 5-7) to set the markup for competitive products to generate the maximum possible contribution from these products.**

In its Initial Comments, United Parcel Service (UPS) argues that competitive products should be required to “make the maximum possible contribution to institutional costs.” UPS Initial Comments at 5. In support of this position, UPS argues that this approach will (1) “produce the same results as would be produced by effective competition”; and (2) offer protection to users of market dominant products. UPS Initial Comments at 3, 5. Both positions are wrong.

This is not the first time that UPS has made this argument. In Docket No. R87-1, UPS witness Hall advocated the “Maximum Competitive Contribution

Methodology” [MCCM] according to which “a regulated entity should price so as to maximize the net revenue from its sales in competitive markets.” UPS-T-4 at 32 (Hall). In that docket, the PRC appropriately rejected UPS’ proposal. It should do so again in the instant proceeding.

First, in Docket No. R87-1, the Commission found that the MCCM approach to pricing competitive products would have significant negative consequences for the Postal Service in the long run.

Witness Hall claims that MCCM will provide maximum benefits to users of postal monopoly services but it also seems likely to skew the markets in which private businesses compete with the Postal Service. Raising prices disproportionately where competition exists may have serious long run effects on the Postal Service’s market position to its eventual detriment. We note that under cross-examination witness Hall could not identify any instances where such pricing techniques had been used successfully for an extended period of time. Tr. 16/11682.

PRC Op. R87-1, Para. 4108.

Not only would this harm competition and users of competitive products, the inevitable erosion of the Postal Service’s competitive position due to MCCM would increase (not decrease) the share of institutional costs borne by market dominant products. As discussed in PSA’s Initial Comments, competitive products will make a \$2.6 billion contribution to institutional costs in FY08. PSA Initial Comments at 9. A pricing method that “ha[s] serious long run effects on

the Postal Service's market position, to its eventual detriment" would seriously jeopardize this significant contribution. R87-1 Op., Para. 4108.¹

Further, the MCCM approach would not, as suggested by UPS, emulate the pricing policies of a private company in a competitive market. Rather, it would prevent the Postal Service from competing on equal terms with its private sector counterparts. As the Commission found in R87-1, private firms must, at times, abandon their profit-maximizing policy to effectively compete. MCCM, on the other hand, would require the Postal Service to cede markets to its competitors, rather than reduce its prices to competitive levels.

It seems likely that to the extent pricing policies resembling MCCM may have been followed successfully for a time it has been possible because in the particular competitive market demand materially outran supply. If a seller, e.g., is the first to offer an innovative service which catches on so rapidly that he cannot supply nearly all the demand it will be rational for him to seek extraordinary profits on the sales he can make. In a truly competitive market however this state of affairs is bound to be temporary for reasons outlined by witness Baumol in his discussion of stand alone cost (USPS-T-3 at 24-25). Supernormal profits will attract entry some of it at lower prices and with new entry the capacity of the industry also will expand. Under these conditions the innovator soon will have to abandon his profit-maximizing policy.

Thus, while witness Hall may be right that in some cases a seller in a competitive market may set prices to maximize his profit it does not follow that such a policy would be rational either for a

¹This is particularly true given the fragility of the Postal Service's position in the competitive products. For example, even without any increase in Parcel Select rates, the introduction of a niche product by UPS -- UPS Basic -- resulted in a noticeable decline in FY 2004 Parcel Select volume per adult. Docket No. R2006-1, USPS-T-7 at 180; "UPS to Test Cheap, No-Frills Service." *Direct Magazine*. November 7, 2003. http://www.directmag.com/news/marketing_ups_test_cheap_2/index.html

competitive seller in the long run or for a regulatory agency making basic policy choices to implement a ratemaking status.

R87-1 Op., Para. 4109-4110.

Finally, PSA notes that the PAEA's rate cap mechanism -- which limits the average rate increase for each class of market-dominant products to inflation except in truly "extraordinary or exceptional circumstances"² -- provides significant protection to users of market-dominant products. Contrary to UPS' position, no additional protection is necessary.

2. PSA agrees with UPS that the Postal Service should strive to accurately measure and report costs. However, this does not mean that attributable costs should necessarily increase.

In its Initial Comments (at 3-5), UPS argues that the "accuracy of postal [cost] data must improve, and so too must cost attribution." Further, it attempts (at 4) to equate improved accuracy of cost data with higher cost attribution levels.

While PSA certainly supports efforts to improve the accuracy of data used to measure and report USPS costs,³ PSA strongly disagrees with UPS' correlation of improved accuracy of cost data and higher attribution levels. As PSA explained in its Initial Comments:

² As explained in the April 6, 2007 letter of Senators Collins and Carper, the co-authors in the Senate of the Postal Accountability and Enhancement Act, to the Chairman of the Postal Regulatory Commission, "extraordinary or exceptional circumstances" was intended to include only "terrorist attacks, natural disasters, and other events that may cause significant and substantial declines in mail volume or increases in operating costs that the Postal Service cannot reasonably be expected to adjust to in the normal course of business."

³ PSA, however, does not agree with UPS' implication that current USPS costing systems are insufficient.

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.

PSA Initial Comments at 10.

Consistent with the Commission's longstanding and now-codified approach of determining attributable costs "through reliably identified causal relationships" as well as generally accepted marginal costing principles (see ValPak Initial Comments at 15-22), these network costs are accurately classified as institutional. Increasing attribution levels by allocating these costs to mail subclasses would decrease the accuracy of cost reporting, not increase it.

Finally, UPS' position (at 9) that prior period retiree health benefit costs should be treated as attributable costs is incorrect. As the Magazine Publishers of America (MPA) and Alliance of Nonprofit Mailers (ANM) explained in Docket No. R2006-1, this is because there is no reliably identifiable causal relationship between prior period retiree health benefit costs and current year mail volume.

The cause of the [retiree health benefit] obligation ... was mail volume that the retirees serviced in *past* years in exchange for the future health care benefits promised by the Postal Service... [The] payment therefore represents costs that are not only fixed but sunk.

Docket No. R2006-1, MPA-ANM Reply Brief at 32.

It would be wholly inappropriate to attribute fixed and sunk costs to classes of mail. As Alfred Kahn, the same regulatory economist cited by UPS in

its Initial Comments (at 3) in this proceeding, has stated, sunk costs are “bygones, unchangeable past history, and best forgotten.”⁴

3. OCA’s proposal (at 36) to define each “rate cell” as a “product” is contrary to the clear intent and objectives of PAEA. As PSA explained in its Initial Comments, “product” should be those itemized as competitive products in § 3631 (a).

In its Initial Comments (at 36), OCA argues that PAEA “seems to” define every “rate cell” – which OCA asserts refers to unique combinations of weight and zone – as a separate and distinct product. The heart of OCA’s argument is that the Act makes a distinction between “classes” and “products” when it comes to the coverage of attributable costs. Notably, the OCA does not claim that there is any statutory distinction in the definition of “products” between market-dominant and competitive products. They cannot because the statute treats them as equivalent: it defines and itemizes what are “market-dominant products” in § 3621(a) and what are “competitive products” in § 3631(a). In fact, those definitions closely track what were previously called classes and subclasses.⁵

OCA argues that, when it comes to cost attribution, there is a “much more stringent” test for competitive products than there is for market-dominant products. OCA Initial Comments at 35. OCA is falsely led to this position

⁴ Docket No. R2006-1, MPA-ANM Reply Brief at 32, footnote 14 (citing Alfred E. Kahn, *The Economics of Regulation* 118 (1970)).

⁵ Under the PAEA, there is no practical difference between classes of competitive products and subclasses of competitive products. The named “competitive products” listed in § 3631(a) include classes (i.e., Express Mail), subclasses (i.e., Priority Mail) and significant portions of subclasses (i.e., bulk parcel post). Each individually listed “competitive product,” however, maps neatly to an existing class.

because the cost coverage factor – § 3622(b)(2) – for market-dominant products refers to “classes” while the requirement that each competitive product – § 3633(a)(2) – cover attributable costs refers to “products”.

As OCA acknowledges (at 35), the cost coverage factor for market-dominant products remains essentially the same as the old § 3622 (b)(3). That is, there simply was no change in the language except to codify the Commission’s longstanding practice of determining attributable costs “through reliably identified causal relationships.” To impute a different intention to Congress because it did not use the same language (which would have been inappropriate, because there will be no classes, only products) for competitive products is without justification. There is not a scintilla of evidence in the legislative history of the PAEA that Congress intended cost coverage to be assessed at a different level of detail for market-dominant and for competitive products. What is clear is that Congress used the same definitions for market-dominant and competitive products throughout the statute. Nowhere is there any distinction between what might be referred to as the classes within market-dominant and the “products” within competitive products. It is clear that Congress viewed “products” as the preexisting classes of mail, and that is what Congress used in defining the different groups.

In another very strange argument (at 36), the OCA attempts to deal with the fact that “product” is defined in §101(6) as a “postal service with a distinct

cost or market characteristic for which a rate or rates are, or may reasonably be, applied.” OCA concedes that, contrary to its argument that each rate-cell is a separate product is the statute’s use of the phrase “rate or rates.” If a single product can have multiple “rates” associated with it, the rate-cell interpretation could be ruled out.

OCA’s tortured argument, to get out of the trap that they concede, is that a single rate-cell could have more than one rate associated with it, specifically noting that the “same weight/zone in Express Mail has different rates depending whether a piece is Post Office to Post Office or Post Office to Addressee.” OCA Initial Comments at 36. This simply is not the case: every rate cell contains just a single rate. OCA’s counterexample does not contradict this because an Express Mail Post Office to Post Office rate is, of course, a separate rate cell than is the Express Mail Post Office to Addressee rate even for the same zone/weight combination. Thus, if each rate cell is a product, that “product” could not have more than one rate

Finally, OCA reasons (at 36) that each rate-cell is a separate product because the underlying costs differ by rate cell. What OCA neglects to recognize is that USPS costs for handling a mailpiece are affected by many factors that are not reflected in existing rates. Thus, defining pieces for which the Postal Service incurs different costs as separate products would result in tens of thousands of different competitive products.

Parcels delivered by rural carriers would be different products than those delivered by city carriers because rural and city delivery costs are different. Further, both would be distinct from those sent to P.O. Boxes.

Parcels entered at high-productivity facilities would be distinct from those entered at low-productivity facilities.

Sacked, palletized, and bedloaded parcels would each be different products.

Low-density parcels and high-density parcels would be different products.

The *reductio ad absurdum* of OCA's reasoning is that every single piece of mail in the competitive products would be a separate "product" and thus would need to meet the attributable cost test. Clearly, this was not the intent of the PAEA. As PSA explained in its Initial Comments, practical considerations also support defining "products" as the five types of mail listed in § 3631(a).⁶ Further, defining Express Mail, Priority Mail, and bulk Parcel Post as distinct products is consistent with the primary cost and market characteristic that differentiates domestic parcel delivery products – speed of delivery.

⁶ Note that the Postal Service no longer offers one of the competitive products – mailgrams – listed in § 3631(a).

Other provisions in the PAEA make it evident that Congress did not make a distinction in terms of “cost attribution” between classes and products. For example, in the report provided by the Postal Service under § 3652, the Commission can take action when it appears that “(A) the attribution of costs or revenues to products has become significantly inaccurate or can be significantly improved;” (§ 3652 (e)(2)(A)). This section applies to market-dominant products, again evidencing the fact that the Congress did not make the kind of distinction between classes and products that OCA argues.

Again, the PAEA provides that the PRC shall make a written determination as to “(1) whether any rates or fees in effect during such year (for products individually or collectively) were not in compliance” § 3653 (b) (1)

One could go on citing different provisions of the PAEA which demonstrate that Congress had in mind an idea of “products” that assimilated the previous definitions of classes under the old Domestic Mail Classification Schedule, with the important changes that Congress made. (For example, the separation of Bulk Parcel Post from single piece parcels into the two categories.)

Because of the consistent use of the term “product” throughout the rest of the statute, both for market-dominant and competitive, there is no evidence that Congress intended a different interpretation for a product depending upon

whether it was market-dominant or competitive, and consequently the attributable costs to be borne by the product.

Respectfully submitted

Timothy J. May
Patton Boggs, LLP
2550 M Street, NW
Washington, DC 20037
Tel: 202 457 6050
Email: tmay@pattonboggs.com
Counsel, PSA

Dated this 7th day of May, 2007