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**Regulations Establishing System
Of Ratemaking**

Docket No. RM2007-1

**COMMENTS OF POSTCOM IN RESPONSE TO
SECOND ADVANCE NOTICE OF PROPOSED RULEMAKING
ON REGULATIONS ESTABLISHING A SYSTEM OF RATEMAKING**

The Association for Postal Commerce ("PostCom") offers these initial comments on the Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking issued by the Commission on May 17, 2007 ("Second Advance Notice").

INTRODUCTION

These comments address the issues the Commission raised in its Second Advanced Notice only with respect to the Market Dominant classes. PostCom may reply to comments submitted with respect to the Competitive categories to the extent that those comments implicate matters affecting Market Dominant services.

With respect to the Market Dominant classes, in its Second Advance Notice, the Commission specifically asks for comments regarding (1) the Postal Service's proposal to use a monthly point-to-point method of calculating the CPI cap limitation as opposed to a 12-month average; (2) the Postal Service's method of calculating the annual change in rates; and (3) how the Commission should evaluate workshare discounts. In brief, there is no justification as either a practical or policy matter for the Commission to accept the Postal Service's proposal to use a monthly point-to-point method of calculating the CPI cap limitation, and the Commission should mandate the use of an annual average because that approach better serves the basic purposes of the PAEA. In contrast to its method for calculating changes in the CPI, the Postal Service's method for applying the CPI cap, using

historical volume weights to compute changes in revenue per piece at the class level is basically sound; the Commission has, however, unnecessarily complicated the proposed methodology by suggesting that the historic, fixed weight methods will not work in cases where the annual rate adjustment is accompanied by “altered rate designs.” PostCom strenuously maintains that the impact of a change in rate design is to be considered only in the context of an annual compliance audit or a complaint in the year following the change, at which time billing determinants for the new or altered rate design will be available. Similarly, PostCom contends, and the statute makes quite clear, that evaluation of the workshare discounts should occur in, and only in, the context of the annual compliance audit or upon complaint.

- 1. The Commission should require the Postal Service to use the annual average as a reference period from which changes in the CPI over the previous year will be measured.**

The Postal Service proposes to use a single month as a reference point from which changes in the CPI over the previous year will be measured, rather than an annual average. *See Reply Comments of Postal Service, Appendix C* at p. 10. Exactly why the Postal Service thinks that this approach should be adopted is unclear, and its adoption is not only at odds with other methods of measurement recognized by the very authority the Postal Service involves, but would defeat the objectives of the modern rate system mandated by the PAEA.

The Postal Service apparently bases its proposal on an example provided by the Bureau of Labor Statistics (“BLS”). It is true that monthly single point technique is illustrated by the lone example the BLS sets forth on its website, but this approach is not exclusively endorsed by BLS. Rather, the BLS instructs the reader to “SPECIFY a reference period from which changes in the CPI will be measured. This is usually a single month...*or an annual average.* [emphasis added.]” Thus, BLS’s instructions also suggest that the annual average

method is commonly used as a reference period.¹ Cf. 47 C.F.R. § 76.922(e) (describing the annual rate adjustment method for cable television programming services). The annual average method compares the current year average over the previous year's average, and, thus, mitigates the effects of short term changes in the CPI.² Further, as Figures 1 and 2 in the Second Advance Notice illustrate, the single month point-to-point method exhibits a greater variation based on the month that is selected.

Accordingly, even assuming that the language of the statute -- which contemplates an "annual limitation on the percentage change" in rates -- would allow the single month reference approach proposed by the Postal Service, the results of such a method plainly cannot be reconciled with the objectives of the modern rate regulation system Congress has mandated. Congress has made it abundantly clear that an important objective of the system of regulation to be established by the Commission is to "create predictability and stability in rates." 39 U.S.C. § 3622(b)(2). That objective will be difficult, if not impossible, to achieve if the computation method fails to mitigate the effects of short term changes in the CPI and is highly dependent on the month that is selected as the reference point. Mail users and mail service providers would have no reliable means of estimating even the order of magnitude of anticipated rate increases in advance of the month selected as the reference point. In contrast, since the BLS issues CPI figures on a monthly basis (usually in the third week after the close of the month), the use of the annual average method will enable mailers and their mail service providers to track the order of magnitude (and direction) of CPI changes throughout the year in order to arrive at a reasoned judgment as to the likely increase in rates, at the class level, well in advance of the Postal Service's filing of its Notice of Rate Change for

¹ Indeed BLS's Canadian counterpart publishes a similar document which offers a few additional examples of calculations, including one that selects an annual average reference point. <http://www.statcan.ca/cgi-bin/downpub/listpub.cgi?catno=62-557-XIB1996001>

² See, e.g., Treasury Board of Canada, *Pension Benefits Inflation Protection – Questions and Answers* at question 3, http://www.tbs-sct.gc.ca/hr-rh/bp-rasp/pensions/faq_e.asp.

the upcoming year. This, in turn, will enable mailers to more effectively develop their budgets and forecasts of mail volume. It will minimize the disruptive effects of rate changes, not only on the business activities of the Postal Service's customers, but upon Postal Service operations themselves. The use of the annual average method thus not only benefits mail users through greater predictability and stability in rates, but will better enable the Postal Service to manage its own costs and thereby assure adequate revenues, including retained earnings, to maintain financial stability, as contemplated by Section 3622(b)(5). No such claims can be made for the monthly reference approach proposed by the Postal Service. It should be rejected.

2. The Postal Service's proposed method of calculating the annual change in rates is largely reasonable, although available historic data should be more recent; the Commission should refrain from prospective review of "altered rate designs."

PostCom accepts the Postal Service's view that using historical volume weights to compute a revenue per piece, and comparing the historically weighted revenue per piece to the CPI-U cap is the best practical method of assessing compliance with the rate cap. PostCom further anticipates that it will be reasonable for the Postal Service to use the most recent 12 months of available data to establish the volume weights. As the Postal Service also acknowledges, every effort must be made to expedite the compilation of data needed to support the price change. *See Postal Service Reply Comments, Appendix C* at n. 2 (p. 6). However, PostCom submits that the Commission should demand some acceleration of its current processes over time, such that, in time, the data available is more recent than that the Postal Service indicates would be currently available.

In its Second Advance Notice (at p. 5), the Commission specifically asks for comments concerning how to deal with changes in rate design "for example, one for which billing determinants do not exist ...". The question correctly contemplates that the Postal Service may very well make changes in rate design in the context of a Notice of Rate Change

based upon the CPI price cap method mandated by the PAEA. Where the Commission seems to have gone astray, however, is in the implicit notion that the effects of an altered rate design must be considered in the context of the Commission's review of proposed CPI rate increases under Section 3622(d). At the time a new rate design is proposed, there is obviously no volume data to determine the effects of the new rate design on historic volumes or average revenue per piece at the class level. Thus, any attempt by the Commission to assess the effects of a change in rate design at the time that the change is proposed will entail a re-introduction of the old cost of service methods that the Commission has used under the Postal Reorganization Act, including the attempt to establish a test year, the reintroduction of roll-forwards and volume and revenue forecasts, and all of the uncertainty, controversy and confusion that these methods entail. That is manifestly a result that Congress did not intend. *See*, PAEA Section 201(a) (striking old Section 3621 and 3622 of Title 39).

Thus, under the historic fixed volume weights method, the question of whether and if so, to what extent, altered rate designs affect compliance with the CPI cap must be addressed retrospectively, once billing determinant information becomes available, in the annual compliance audit or in response to complaints that may be filed. This approach is entirely consistent with traditional utility ratemaking principles where the regulator affords the utility the "opportunity" to recover its costs, but where actual over-or under-recovery within a particular rate category is not illegal, provided that the filed rate is the rate actually charged. If after billing determinants are available, it is observed that a change in rate design does produce effects at the class level (where the cap applies) which result in non-compliance with the CPI cap, the rates may then be subject to adjustment in the annual compliance review or upon complaint.

As PostCom stated in its Initial Comments (at pp. 5-6), the Postal Service is clearly authorized to redesign and price its products and services in accordance with the evolving

marketplace (*see* 39 U.S.C. § 3622(b)(4) and (c)(7)), and the Commission's role is to provide a check against monopoly abuse and predation (*see* 39 U.S.C. § 3622(b)(8), (b)(9) and (c)(3)). In the absence of abuse, which, in the market-dominant area cannot be evidenced without historic data, the Commission should not restrict Postal Service pricing flexibility. Therefore, the Commission should not propose any mechanism to address an “altered rate design” in its rules governing Postal Service filings under Section 3622(d)(1)(C).

3. The Commission should evaluate workshare discounts only in the context of the review of the Postal Service’s annual reports and the Commission’s determination of compliance.

As PostCom explained in its Initial Comments (at p. 13), the review of the rate changes contained in the Notice must focus exclusively upon any non-compliance of the adjustment within the CPI cap. Plainly, the issue of workshare discounts does not arise in this context. Section 3622(e) does provides that workshare discounts will be reviewed by the Commission, but this section must be read together with Section 3652(b), which specifies that information relating to workshare discounts for market-dominant products be included in the compliance report the Postal Service files pursuant to Section 3652(c). The Act must be read as a whole: had Congress intended for the review of workshare discounts to be included in the Commission’s price-cap review, it would have instead required the Postal Service to file the worksharing information in the Notice of Rate Adjustments required by § 3622(d). Thus, the questions the Commission poses (at p. 5 of the Second Advanced Notice) inquiring what information and/or data are needed “in the context of a Notice of Rate Adjustment” overlook the terms of the statute.

Although not raised in the Second Advance Notice, there are certain important issues that the Commission will have to deal with in relation to workshare discount rules with respect to the annual compliance report the Postal Service must file pursuant to Section 3652(b).

First, the Commission will need to address the question of exactly what constitutes a “workshare discount” for purposes of the reporting requirement. Section 3622(e) explains that workshare discounts “refer to rate discounts provided to mailers for the presorting, prebarcoding, handling or transportation of mail,” but otherwise leaves it to the Commission to further define the term. A superficial reading of Section 3652(b) might suggest that if the Postal Service is required to report the “per-item cost avoided,” “the percentage of such per-item cost avoided that the per-item workshare discount represents,” and the “per-item contribution made to institutional costs” that the Commission’s review of workshare discounts must be performed at each rate cell. But when review is based on annual historic volumes, rates and cost data (as Section 3652(a) requires), per-item costs avoided, per-item discounts, and per-item contributions are as readily reported and reviewed at the level of rate category.

Second, as a practical matter, evaluating workshare discounts at the rate category level is compelled by how “*workshare activity*” is performed. Few mailers that enter workshared mail enter mail exclusively at a single rate cell within a category. For example, targeted direct mail mailings rarely consist exclusively of pieces sorted to the automation 5-digit level mail. Rather, mail that cannot qualify for the deepest level of sort is often required to be sorted to the next highest level. Thus, the rate cells are hierarchical. Indeed, there is even a hierarchy between subclasses—for example, pieces in a mailing that lacks the density for Standard Mail ECR Basic presort may be presorted to and entered at the Standard Regular, 5-digit level. Residual pieces in a mailing may be presorted to and entered at a still higher level. Because mailers’ performance of a worksharing activity inevitably intertwines presort, containerization, and drop entry,³ in evaluating compliance with 3622(e)(2) the Commission

³ See Testimony of Anita Pursley on behalf of the Association for Postal Commerce and the Mailing and Fulfillment Service Association, PRC Docket No. R2006-1 (September 6, 2006) at p. 7.

should consider the extent to which the workshared rate category, taken as a whole, does or does not exceed avoided cost.

Indeed, in Standard Mail, all rate categories are worksharing categories,⁴ so evaluating whether workshare discounts exceed avoided costs at the rate cell level would, at least in Standard Mail, effectively return this Commission to a cost-of-service regime. Given the overarching statutory theme of pricing flexibility, and the common knowledge that Standard Mail has become the mainstay of the Postal Service, surely that is not a result Congress intended.

Further, one of the most important exceptions to the general rule quoted above is that discounts are allowed to exceed the cost the Postal Service avoids as a result of the workshare activity if “reduction or elimination of the discount would impede the efficient operation of the Postal Services”. 39 U.S.C. §3622(e)(2)(D). It is the differentials between rate cells that provide incentives for mail service providers to perform incremental worksharing steps. For example, if the difference between drop-entering mail at the SCF and drop-entering mail at the BMC is too small, mailers will not go the extra mile (figuratively and literally) to drop-enter mail at the SCF because the additional sortation and transportation cost do not warrant the incremental postage savings. But elimination of SCF drop entry or reduction of the rate differential between the destination BMC and destination SCF rate cells would certainly “impede the efficient operation of the Postal Service.” As PostCom witness Anita Pursley stated her direct testimony in PRC Docket No. R2006-1 (at p. 5), “[a] decline in drop shipped mail would result in added Postal Service costs and unplanned for changes in its mail flows.” The differentials between automation presort rates are similarly significant; the existing incentives enable mailers or their service providers to combine mailings to achieve the density

⁴ *Opinion and Recommended Decision*, PRC Docket No. R2006-1, ¶ 4015 (February 26, 2007).

required to produce more automation 5-digit pallets. Evaluating workshare discounts at the level of rate category would be less likely to result in limitations that “impede the efficient operation of the Postal Service” than examination at each rate cell, because this approach would not necessarily require adjustments to the differentials between rate cells.

Finally, while PostCom strongly discourages backtracking to a cost-of-service regime, it is worth observing that evaluating the worksharing discounts at the level of rate category is consistent with the Postal Service’s historic rate design methodology:

In describing the rate design methodology for Standard Mail in R97-1, the Commission explained that “each rate is comprised of both volume variable and institutional cost; but the difference between the rates of any pair of rate categories equals the difference in the avoided cost between the categories, assuming 100 percent passthrough of avoided cost. PRC R97-1, ¶ 5373.⁵

In sum, in the context of the development of reporting rules under Section 3652(b) -- but not in the context of the implementation of Section 3622(d) -- the Commission must address issues as to how to best address the so-called workshare “discount” issue. In that setting, the Commission must recognize the primary goals of pricing flexibility and efficient Postal Service operations that Congress had in mind in its enactment of the PAEA.

Respectfully submitted,

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⁵ *Opinion and Recommended Decision*, PRC Docket No. R2006-1, ¶ 4015 (February 26, 2007).