

BEFORE THE POSTAL REGULATORY COMMISSION

WASHINGTON, DC 20268

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

RESPONSE OF THE PARCEL SHIPPERS ASSOCIATION
TO
SECOND ADVANCE NOTICE OF PROPOSED RULEMAKING
(Issued May 17, 2007)

In this Response, the Parcel Shippers Association (PSA) responds to PRC Order No. 15 (May 17, 2007). PSA confines its Response to Part III of the Notice: Regulations concerning Competitive Products.

III. Regulations Concerning Competitive Products

4. Subchapter II of title 39, 39 U.S.C. §§ 3631-3634, sets forth the provisions applicable to competitive products, which initially are to consist of priority mail, expedited mail, bulk parcel post, bulk international mail, and mailgrams. § 3631(a).¹ A procedure must be established to allow for amending this list of competitive products.

Regarding section 3631 —

- a. What current mail matter is “priority mail”?
- b. What current mail matter is “expedited mail”?
- c. What current mail matter is “bulk parcel post”?

¹ Pursuant to section 3642, the Commission may change the list of competitive products under section 3631 and market dominant products under section 3621 by adding new products to or removing products from the lists, or transferring products between the lists.

- d. What current mail matter is “bulk international mail”?
- e. What, if any, current mail matter is “mailgrams”?
- f. To what does “mail classification schedule,” as used in section 3631(c), refer?

RESPONSE

For domestic competitive products, “mail classification schedule” as used in section 3631(c) of the PAEA appears to generally refer to the current Domestic Mail Classification Schedule (DMCS) and its successor, which presumably will be maintained by the Postal Service for competitive products.

The DMCS generally supports the classification of products that PSA provided in its Initial Comments (at 8, footnote 8). Section 100 of the DMCS states that Expedited Mail is “mail matter entered as Express Mail.” When Section 223 discusses Priority Mail, it refers to the current Priority Mail subclass.

PSA notes that the definition of Bulk Parcel Post in Section 521.3 of the DMCS is an anachronism, because the definition does not currently have any rate implications, i.e., there is no specific subclass or rate category entitled “Bulk Parcel Post.” For example, while the minimum number of pieces in a Parcel Select mailing is fifty (DMCS 521.2), the minimum number of pieces/minimum weight in a Bulk Parcel Post mailing is 300 pieces or 2000 pounds (DMCS 521.3). Obviously, this definition of Bulk Parcel Post needs to be updated for consistency with current mail preparation requirements. This DMCS provision pre-existed all of the current Parcel Select rate categories, and, apparently through an oversight, was never deleted from the schedule. It never had any rate consequences, nor has it any relevance to the PAEA use of the term “bulk parcel post.”

As we explained in our Initial Comments, bulk parcel post includes Parcel Select, Parcel Return Service, and workshared non-destination-entry Parcel Post parcels. Additionally, we note that DMCS sections 521.27 and 28 describe Parcel Return Service as “Parcel Select Return Service,” and provide that it will be “retrieved in bulk.”

Finally, as we noted in our Initial Comments, mailgrams are no longer being offered by the Postal Service. Thus, the DMCS no longer includes any reference to mailgrams.

5. Section 3632 authorizes the Governors to establish rates and classes of mail for competitive products in accordance with Subchapter II of Chapter 36 and regulations promulgated by the Commission under section 3633. The rates and classes shall be established in writing, accompanied by a statement of explanation and justification and the effective date of each rate or class. § 3632(b)(1).

Regarding section 3632 —

- a. What information is needed to support new rates of general applicability?
- b. What information is needed to support new rates not of general applicability?
- c. Is the information needed to support a rate decrease different from that needed to support a rate increase? Please elaborate.
- d. What information is needed to support new classes of general applicability?
- e. What information is needed to support new classes not of general applicability?
- f. What criteria should be used to determine whether a rate or class is of general applicability or is not of general applicability in the Nation as a whole?

- g. How should “any substantial region of the Nation” be defined?

RESPONSE

(a)-(e) As the question notes, Section 3632 of the PAEA provides the Governors with the authority to establish rates and classes of mail for competitive products. Consistent with this authority, PSA respectfully submits that the Postal Service need only provide, in the Federal Register, a 30-day notice of the rate or classification “decision” and “record of the Governors’ proceedings in connection with [its] decision” when establishing rates and classes of general applicability for competitive products. For rates and classes not of general applicability, this information need be provided only to the Commission and only 15 days in advance. In no event, should commercially sensitive information be disclosed or need it even be reported with the required notice. As discussed in response to Question 6 below, the filing of CRA-type information with the required annual report is sufficient to allow the Commission to ensure the PAEA’s cross subsidization protections are met.

(f)-(g) PSA has not yet developed a position on how the Commission should define a “substantial region of the Nation” for determining whether Section 3632(b)(2) or (3) applies. It, however, is clear that contract rates that are negotiated between the Postal Service and individual mailers for the provision of competitive products are rates that are “not of general applicability.” Thus, Section 3632(b)(3) applies to such agreements.

6. Pursuant to section 3633(a), the Commission is required to promulgate regulations applicable to rates for competitive products to:

- “(1) prohibit the subsidization of competitive products by market-dominant products;
- (2) ensure that each competitive product covers its costs attributable; and
- (3) ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.”

Regarding section 3633 —

- a. What data should be filed periodically with the Commission to enable it to assess the Postal Service’s compliance with subsection:
 - i. (a)(1),
 - ii. (a)(2), and
 - iii. (a)(3)?
- b. How frequently, *e.g.*, quarterly, annually, should such data be filed with the Commission?
- c. Are existing data systems adequate to enable the Commission to assess the Postal Service’s compliance with section 3633(a)? If not, what modifications would be necessary?
- d. What is the appropriate standard for determining whether competitive products are being subsidized by market dominant products?
- e. What standard should be applied to determine the appropriate share of institutional costs to be recovered collectively from competitive products?
- f. Over what period of time should the standard identified in (e) be deemed valid?
- g. Should the standard identified in (e) raise a rebuttable presumption of validity?
- h. If return on investment (or assets) is used, what capital structure (assumed or otherwise) should be used for the Postal Service?

RESPONSE

In our Initial Comments (at 5-7), PSA explained that the Commission should apply the incremental cost test to prevent the subsidization of competitive products by market dominant products. In those comments (at 6-7), we noted that the definition of attributable costs is similar to that of incremental costs, thus the attributable costs of competitive products are reasonable proxies for their incremental costs. Further, we explained that this test should be applied at the class/subclass level.

The Postal Service's current Cost and Revenue Analysis (CRA) systems are sufficient to enable the Commission to assess compliance with the section 3633(a) requirements. The CRA systems were designed to estimate and report cost and revenue data by class and subclass on an annual basis, which is the level at which the incremental cost test should be applied and well below the level at which the "appropriate share" analysis needs to be performed. The only required change to CRA systems related to domestic products would be modest – modifying them to identify bulk Parcel Post costs and revenues separately from other Parcel Post. The systems would also need to be able to specifically identify costs for bulk international mail.

To allow the Commission to assess compliance with section 3633(a), the Postal Service should file a CRA at the end of each fiscal year. This report would be similar in format to that filed as USPS-LR-L-2 in Docket No. R2006-1 although the categories of mail for which cost and revenue data are reported would need to change modestly (as discussed above). The CRA should be accompanied by the workpapers the Commission deems necessary to verify the accuracy of the CRA report.

Consistent with the annual reporting requirements specified in sections 3652 and 3653 of the PAEA, the Postal Service should provide CRA data to the Commission on an annual basis. Given the annual cycle established by the PAEA, requiring the Postal Service to make a CRA-type report on a more frequent basis would add little value while significantly increasing administrative costs. Further, given the Postal Service's significant use of statistical sampling techniques to develop CRA data, the number of samples taken (and thus cost of sampling) would need to increase significantly to ensure that more frequent reports are as reliable as the annual CRA data that the Postal Service currently produces, with little regulatory purpose.

Finally, in our Initial Comments, we explained that the "appropriate share" requirement – section 3633(a)(3) – can be satisfied by ensuring that the combined markup on competitive products meets a minimum threshold. Further, this threshold should be no greater than recommended by the Commission in Docket No. R2006-1 and, to enhance social welfare, should be significantly less. PSA Initial Comments at 11-20. This standard – a collective markup on competitive products that is no higher than recommended in Docket No. R2006-1 – should be deemed valid until the Commission undertakes its review of minimum contribution requirements – per section 3633(b) – five years after the date of enactment of the PAEA.

7. Section 3634 provides for an annual, assumed Federal income tax on the competitive products income. The amount of the assumed tax is to be transferred from the Competitive Products Fund to the Postal Service Fund.²

² Pursuant to section 2011(h) the Secretary of the Treasury is charged with developing recommendations regarding, *inter alia*, rules for determining the assumed Federal income tax on competitive products income for any year. Following receipt of those recommendations, which are due not earlier than June 20, 2007 or later than December 19, 2007, the Commission will provide interested persons an opportunity to comment on the recommendations.

Regarding section 3634 —

- a. Is the assumed Federal income tax amount appropriately classified as an attributable cost?
- b. On what basis should the assumed Federal income tax amount be reasonably assigned among competitive products?

RESPONSE

PSA submits that the assumed Federal income tax is not appropriately considered an attributable cost. Specifically, the Federal income tax to be applied to the “income” from competitive products is determined with no consideration of “the direct and indirect postal costs attributable to such product through reliably identified causal relationships.” § 3631(b). Indeed, the Federal income tax rate is determined with effectively no consideration of any postal issues at all, but rather is determined entirely by the Federal government’s consideration of desired spending levels on a vast array of Federal programs and the tradeoffs inherent with raising Federal revenues from a variety of sources.

Furthermore, the income tax is not even a cost to the Postal Service, but is instead simply a transfer between its competitive and market dominant operations. This transfer acts simply as a mechanism for sharing some portion of any income generated by the competitive side of the Postal Service with the market dominant side. Since the income tax is neither a cost nor the result of a causal attribution process, it cannot be considered to be an attributable cost.

Furthermore, in the event that the Commission decides (erroneously) that the income tax should be treated as an attributable cost, assigning the income tax among competitive products according to the income that each generates would ensure that the imposition of the tax has no effect on whether competitive products collectively or individually “pass” the cross-subsidy tests established by sections 3633(a).

8. Section 3633(a)(2) requires each competitive product to cover its “costs attributable,” which are defined as “the direct and indirect postal costs attributable to such product through reliably identified causal relationships.” § 3631(b). The Commission has historically used attributable costs to develop recommended rates under the Postal Reorganization Act. Enactment of the PAEA raises issues concerning the need, if any, to modify the Commission’s historic approach as well as the classification of costs arising under the PAEA.

Regarding the term “costs attributable” —

- a. Identify any costs currently classified as attributable that, in light of PAEA, should be classified as institutional. The rationale for the proposed change should be explained.
- b. Identify any costs currently classified as institutional that, in light of PAEA, should be classified as attributable. The rationale for the proposed change should be explained.
- c. How should Retiree Health Benefit costs be classified?

RESPONSE

(a)-(b) As PSA explained in its Initial Comments (at 9-11), the PAEA does not change the definition of an attributable cost. Rather, it codifies the longstanding practice of the Commission and the Postal Service of determining attributable costs “through reliably identified causal relationships.”

While the Commission, the Postal Service, and intervenors have disagreed in the past and will likely continue to disagree in the future on the exact methodology for determining attributable costs, estimating these costs based upon principles of cost causation has been a bedrock principle of postal ratemaking for the last 35 years. Given this, the PAEA’s definition of “costs attributable” should have no impact on which costs are classified as attributable and institutional.

(c) As PSA explained in its Reply Comments (at 5-6),³ prior period retiree health benefit costs – i.e, those that were earned by postal employees through their service in prior years – are sunk and fixed costs that should be classified as fixed. Since the fixed annual payments that section 803 of the PAEA requires USPS to make into the Postal Retiree Health Benefits Fund are essentially “catch-up” payments to cover the Postal Service’s unfunded obligation for retiree health benefits that have already been earned,⁴ these payments should be treated largely as institutional costs.

The costs for retiree health benefits that postal employees earn based upon their service in the current year, however, are caused by current year mail volumes. Since these current year retiree health benefit costs can be related to postal products through reliably identified causal relationships, they should largely be

³ Also, see ANM-MPA Reply Comments at 9-10 and USPS Reply Comments at 28-29.

⁴ ANM-MPA Reply Comments at 9.

attributed. The attribution and distribution of these costs should follow that of labor costs.

9. The PAEA establishes a rate floor for each competitive product, *i.e.*, each competitive product must cover its attributable costs. § 3633(a)(2). Product is defined as “a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied[.]” § 102(6).

Regarding the term “product” —

- a. Is each International Customized Agreement a competitive product?
- b. Is each Negotiated Service Agreement a product?
- c. Is each special classification a product?
- d. Is each class not of general applicability a product?

RESPONSE

In our Initial Comments (at 7-8) and Reply Comments (at 6-11), PSA explained why “product” should be defined essentially at the class/subclass level, rather than at the rate cell level, for the purpose of § 3633(a)(2). As we stated in those comments, defining “product” at the rate cell would be administratively unworkable. Doing so would also be inconsistent with the PAEA’s statutory language. For the same reasons, International Customized Agreements, Negotiated Service Agreements, special classifications, and classes not of general applicability are not products. After all, these customized agreements and classifications are effectively rate cells of an existing subclass that have been tailored to meet the needs of individual mailers or groups of mailers.

Also, defining customized agreements and classifications as products and thus requiring that each be shown to cover its costs would tilt the playing field towards the Postal Service’s competitors. As is widely known, USPS competitors

negotiate customized agreements with essentially all, if not all, of their large customers and these competitors, of course, are not subject to any externally-imposed floors on each and every contract rate they offer or any reporting requirements. The goal of these competitors is to make sure they make a profit on an overall deal, even if they lose money on some of its elements, because that's a negotiated condition to get the deal.

Further, while the Postal Service has no incentive to negotiate a deal that loses money (particularly since the PAEA allows it to retain earnings), we are concerned that the imposition of significant administrative requirements on customized agreements and classifications will limit the Postal Service's ability to innovate. As we noted in our Initial Comments (at 21), the history of NSAs provides a cautionary tale. In the last five years, the Postal Service has been able to negotiate and implement only five agreements with individual mailers. PSA submits that burdensome administrative requirements and high transaction costs required to pursue NSAs are primary reasons for this meager number. For competitive products, it is our view that rates and costs for contract rates or customized agreements are product elements and should be averaged with the other rates and costs of the appropriate product (class/subclass) for purposes of cross-subsidy considerations.

In any event, requiring that every NSA, contract rate, or customized agreement and classification cover its attributable costs is an unnecessary safeguard. First, the PAEA's inflation-based limit on rate increases already safeguards users of market-dominant products. Second, the requirements that (1) competitive products collectively cover an "appropriate share" of institutional costs; and (2) as PSA suggests, that each class/subclass of competitive products be required to cover its attributable costs already provides significant protection against unfair competition. Third, other users of competitive products are safeguarded by the availability of alternatives.

Pre-reform, the Commission had little choice but to ensure each NSA made a profit. That is no longer necessary; as noted, there are other protections under the PAEA for mailers, and for competitors. If USPS is to be a competitor, it must be allowed to behave as one, without requiring its partners to divulge confidential data, and to run a gauntlet of challenge and delay before getting a deal done.

CONCLUSION

It is of paramount importance that the PRC, in devising the regulatory scheme for competitive products, allow the Postal Service the maximum flexibility to compete in expedited and package delivery markets, and in international markets, and not inhibit those efforts by regulations that would slow down, constrain, and disable the Postal Service from effectively competing with very powerful and efficient competitors in the free market.

We hope our responses will aid the PRC in achieving a truly competitive marketplace.

Respectfully submitted,

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