
REGULATIONS ESTABLISHING
SYSTEM OF RATEMAKING

Docket No. RM2007-1

COMMENTS OF ADVO, INC. IN RESPONSE TO SECOND
ADVANCE NOTICE OF PROPOSED RULEMAKING ON
REGULATIONS ESTABLISHING A SYSTEM OF RATEMAKING

ADVO, Inc., a wholly owned subsidiary of Valassis, Inc., hereby submits its comments in response to the Commission's Second Advance Notice Of Proposed Rulemaking On Regulations Establishing A System Of Ratemaking (Order No. 15), issued on May 17, 2007. Our comments are presented in the order listed in the Commission's notice.

I. ISSUES RELATING TO MARKET-DOMINANT PRODUCTS

In our initial and reply comments to the Commission's first notice, we emphasized the importance of construing the Postal Accountability and Enhancement Act (PAEA) -- and adopting implementing regulations -- in a manner that preserves true pricing flexibility for the Postal Service under the rate cap regime. We would urge the Commission to keep that objective in the forefront in assessing the specific issues raised in its second notice.

Issue 1 – Moving Average v. Point-to-Point CPI Methods

In Appendix C of its earlier reply comments, the Postal Service proposed that the annual change in CPI-U be calculated by comparing the most recent monthly CPI value with that from the corresponding month of the prior year. As an alternative to this "point-

to-point” approach, the Commission has suggested comparing the 12-month running averages, which it characterizes as a “moving average” approach. Advo believes that the Commission’s suggested alternative is preferable.

Either method would be compatible with the language of the statute, which requires that the rate cap be equal to the “change” in the CPI-U “over the most recently available 12-month period preceding the date the Postal Service files notice of its intention to increase rates.” Section 3622(d)(1)(A). Over the long run, if the Postal Service implements annual increases the same month each year, either approach will “even out” over time, producing much the same overall result, although the point-to-point approach would have greater year-to-year variations, up and down.

The moving-average approach better comports with the statutory objective of rate predictability and stability in section 3622(b)(2), both for mailers and the Postal Service. If, as it has suggested, the Postal Service opts for annual increases every January 15th, with notices filed September 15th, mailers by following the moving average will know by the middle of the summer, within a half-percentage-point, what the final CPI percentage will be. This will be beneficial to the Postal Service, as well, in its advance planning and preparation for the upcoming rate cycle. It, too, will know within a month or two of the filing what the final moving average will be – within a likely margin of error of only a tenth of a percentage point or so – avoiding the potentially large last-month surprises under the point-to-point method.

Issue 2 – Calculation of Compliance With Rate Caps

(a) Use Of Historic Vs. Projected Volume Data

We agree with the Postal Service that historic volume data should be used to develop the class average rates – both at current rates and at new rates. Valpak and NAA seem to suggest that the volume data be projected, but projected data, though consistent with postal breakeven ratemaking, are inconsistent with the rate-cap incentivizing process contemplated by the PAEA.

First, correctly forecasting all volumes based on proposed rates under the capped rate constraint would be very difficult, if not impossible, and would require various ad hoc adjustments to force-fit the volumes to the rates and potentially restraining Postal Service pricing flexibility. Second, with the complexity and judgmental nature of volume forecasting, projected volumes would be subject to both manipulation and litigation. Third, the use of historic data to develop rates under a rate cap regime has been shown to lead to greater economic welfare than the use of volume projections.¹ For these reasons, historic data should be used to develop postal rates under the PAEA rate cap regime.

(b) Treatment Of New Rate Elements

The Postal Service may propose new rate elements within a class when it makes its annual rate change filing. In its reply comments to the original notice, the Postal Service discusses the examples of peak-load and seasonal rates, but other new rate elements may also be proposed, such as new worksharing discounts. As the Postal Service states, it will likely be able to develop an estimate of the historic volumes that would be subject to such rates if they were in effect. These estimates could then be used to calculate the average class rates used to first implement these new rate

¹ See, e.g., Vogelsang, “Incentive Regulation and Competition in Public Utility Markets: A 20 Year Perspective,” *Journal of Regulatory Economics*, July 2002.

elements. Thereafter, their actual annual billing determinant and rate data can be recognized in the class average rates.

(c) Inclusion Of Volumes From New Products

The Postal Service should be allowed to price new product offerings flexibly without linkage to existing product prices during their experimental periods, as long as such products are priced above incremental costs. The rates for other mailers subject to the CPI cap will not be affected by the presence of new products until assignment to specific classes (and therefore inclusion in class level rate calculations) after experimental periods are completed. This approach is consistent with Section 3641(g) that specifies that annual increases for “experimental” products must not exceed the annual CPI index.

(d) Treatment Of NSA Rates

The Postal Service notes that customer-specific or NSA rates could be implemented at any time during the annual rate cycle. In such a case, the NSA billing determinants for the remainder of that rate cycle will not be included within the class average rates for that cycle. This is not a problem since it will not affect the rates of any other mailers except those that agreed to the NSA.

However, in its reply comments to the original notice, the Postal Service then assumes that the NSA billing determinants for the subsequent rate cycle must be recognized in the class averages. This approach is questionable, however, and even the Postal Service has no proposal as to how it should be performed.

First, the class rate cap is designed to protect mailers that have no alternatives to using the Postal Service’s class rates. The class average rates should be based on the

data from mailers that need such protection. NSA mailers, however, by negotiating an acceptable alternative, do not need to be “protected” by the rate cap, and their NSA volumes and rates should, therefore, not be included in the class average rates.

Second, assuming that NSAs will almost always reduce the specific mailer’s rates (and increase its volumes), any inclusion of NSA billing determinants in class average rates will tend to reduce the apparent level of the proposed class-wide increase and thereby allow the Postal Service to justify higher rate increases for other mailers in the class within the CPI cap. Moreover, as more NSAs are implemented, this negative impact on non-NSA mailers could grow. Eliminating NSA volumes and rates from the class average rate will avoid this negative impact while permitting the Postal Service full flexibility to pursue beneficial NSAs, knowing that any losses on NSAs cannot be recovered from other mailers. Finally, including NSA data in the class average rate calculation will complicate that calculation. Therefore, contrary to what the Postal Service proposes, it is more appropriate to exclude all NSA data from class average rate computations.

(e) Matching Of Time Period For Both CPI-U And Average Rate

The Postal Service proposal to use CPI-U and billing determinant data for development of the capped average class rate involves a mismatch between (a) the period over which the CPI is averaged (September Year 0 through August Year 1) and (b) the period over which the volumes are collected (July Year 0 through June Year 1). Its example indicates that the period over which volumes are collected lags by two months the period over which the CPI is averaged. We believe this short two-month lag is acceptable because (a) it relies on the latest full-year data from both sources, and (b)

the 12-month volumes shares within a class should not change much over that two-month lag period. It is more important to use the latest CPI-U data for the current inflation rate in order to calculate allowed price increases than to worry about the short lag between the two data sets.

Issue 3 – Compliance of Worksharing Discounts

Workshare discounts have become extremely important to postal economics. Over time, they have generated huge postal cost savings and, due to lower combined mailing costs, have also stimulated the growth of mail volumes.² Section 3622(e) requires that workshare discounts not exceed their avoided postal costs, subject to certain exceptions. Clearly, Congress intended that when there are benefits to higher-level workshare discounts, they should be permitted.

The Commission should take care that the rules implementing this section not freeze, or perhaps even reverse, some of the long-term progress that has been made due to worksharing programs. The effort involved for the Postal Service to estimate workshare and non-workshare volumes and costs is considerable and, as the Commission well knows, can be highly contentious. Under the PAEA, this effort will have to be undertaken every year – a tremendous increase in the amount of work required by the Postal Service compared to the PRA regime. However, if the Commission's rules require extreme precision in volume and cost estimates, are implemented rigidly, and/or permit extensive litigation, the Postal Service may be

² See, e.g., "Postal Regulation and Worksharing in the U.S.," in *Proceedings of the Wissenschaftliches Institut für Kommunikationsdienste GmbH on the Management of Public Services*. 8th Königswinter Seminar on "Regulating Postal Markets – Harmonized Versus Country Specific Approaches," Dorint, Siebengebirge, Germany, February 16-18, 2004.

reluctant to offer worksharing discounts that come near to passing-through 100% or more of workshare avoidable cost – even in instances where it believes such discounts would be extremely beneficial.³

Thus, we believe that the Commission, in its rules, should attempt to minimize the workshare discount support requirements and encourage the Postal Service to maximize the benefits from worksharing programs.

(a) Workshare Avoided Costs

Section 3622(e) requires that the avoided costs of worksharing be compared to the relevant workshare discounts. However, this determination is not required prior to implementation of annual rate changes rates, but only when (1) new workshare discounts are proposed [Section 3622(e)(4)]; and (2) the annual compliance review is performed [Section 3652(b)].

There are several ways in which these workshare cost estimates may be developed. For existing workshare discounts, if there have been no substantive operational changes, the avoided costs from the last relevant PRA rate case or cost study (adjusted for inflation) may be presumed to be compliant. Or, the Postal Service can simply estimate the previous rate-year's avoided cost and adjust for inflation. For new discounts, the USPS could provide an estimate of the previous rate-year's avoidable costs, adjusted for inflation, if no substantive operational changes are expected in the next rate year. Or, it could provide projected rate-year avoided cost support for its new discounts.

³ This is precisely what has occurred with the Commission's implementation of its comprehensive and rigid NSA rules, the high regulatory cost and litigation risk deterring the Postal Service and all but a small handful of mailers from pursuing NSAs.

Regardless of the cost estimation method chosen, the PRC's annual compliance review should recognize that there will likely be (1) differences between the Postal Service's pre-implementation expectation and the estimate of actual results after the end of the rate-year; and (2) differences in opinions regarding how those avoided costs should be estimated. These differences should not be presumed to be evidence of non-compliance. With respect to the former, there will inevitably be differences between expected and actual results no matter how rigorously estimated. With respect to the latter, it must be recognized that there is often no single "perfect" costing approach, and that any of several alternative approaches may produce reasonable results.

If not allowed a margin of leeway in its estimates, the Postal Service, in order to ensure compliance, may become reluctant to attempt avoided-cost passthroughs anywhere close to 100%. The PRC should therefore provide some flexibility in how workshare avoided costs are estimated and reviewed for compliance. For example, the Commission may be to deem a result that is within $\pm 10\%$ of the Postal Service's pre-implementation estimate as in compliance with the spirit of the statute.

(b) Support For Workshare Discounts Greater Than Avoided Cost

As recognized in the PAEA, there are sound economic reasons for having workshare discounts that are greater than avoided cost. These include discounts greater than avoided cost when such pricing will improve Postal Service operational efficiency, save Postal Service costs, and/or increase Postal Service contribution to institutional cost (profit).

When such discount pricing is either proposed (before-the-fact) or reported (after-the-fact), the Postal Service should explain its reasons for the pricing and provide

an estimate of how much additional operational efficiency, cost savings, and/or contribution/profit it generates as compared to discounts based on avoided cost alone. Data to support the estimate could include: postal unit (marginal) costs and (current/proposed) unit revenues for workshared and non-workshared volume, any one-time and recurring fixed costs required to implement the discounts, estimates of the workshared and non-workshared volumes (at the relevant rate levels), and support for the volume estimates.

We believe the Commission should not apply a rigorous standard to these data but instead rely heavily on Postal Service expertise in this matter because it now has a strong incentive to “get it right.” In particular, the Commission should grant the Postal Service the requisite flexibility so that the incentive to pursue beneficial worksharing remains fully in place.

II. ISSUES RELATING TO COMPETITIVE PRODUCTS

Our earlier comments explained that all mailers, even those in the market-dominant category, have a stake in the success of the Postal Service’s competitive products. Even if given ample regulatory leeway, the Postal Service faces daunting challenges in the competitive-product arena, not the least of which are to upgrade its technology and infrastructure as well as its service performance to meet the standards of the dominant competitors in the marketplace. Pricing flexibility is critical; without it, the Postal Service faces the prospect of being driven out of the market – to the detriment of all mailers.

Before addressing the specific issues raised by the Commission in Order No. 15, we would note that the development of specific rules for pricing and classification of

competitive products is complicated by the interplay with two other sections of the PAEA – Section 2011(h) concerning accounting practices and principles, and Section 3634 concerning imputed income tax – both of which involve input from the Department of the Treasury. Depending on how interpreted and applied, those sections could allocate additional costs to competitive products that are in excess of their true attributable and incremental costs, and thereby have an adverse impact on the amount of “contribution to institutional cost” those products make. For this reason, we believe that most of the final rules concerning pricing of competitive products should await Commission interpretation of Sections 2011 and 3634. The following are the comments we can make absent those interpretations.

Issue 5 – Justification for Competitive Rate Changes

(a) Information Needed To Support New Rates

We do not see that the Commission needs any information at the time rates for competitive products are changed by the Postal Service, as the authority to set such rates is delegated to the Postal Service under Section 3632. Obviously, however, the Postal Service, in its annual report to the Commission, will have to provide sufficient volume, cost, and revenue information to the Commission so that the Commission can ensure that Market Dominant Products are not subsidizing Competitive Products.

(b) Information Needed To Support New Classes

With respect to establishing new classes, the PRC appears to have no authority other than to determine whether new products within those new classes are considered “Competitive” or “Market Dominant.” The criteria for determining “Competitive” vs. “Market Dominant” will have to be worked out per Section 3642.

Obviously, however, if the Governors establish new classes within the five categories under Section 3631(a) but none of the “products” within those classes are new, then the Commission should quickly determine those to be “Competitive” under its Section 3642 authority.

Issue 6 -- Information Needed To Support Rates Under Section 3633(a)

(a) Standard For Determining Subsidy From Market Dominant Products

If Competitive products cover their combined incremental costs, they are not being subsidized as a group by the Market Dominant products. This is a standard upon which virtually all economists would agree. The key problem here is how Section 2011(h) is interpreted and implemented. Rules implementing that section could allocate additional costs to competitive products that are neither caused by nor incremental to those products but are simply “imputed” to them in order to satisfy some notion of competitive “parity,” resulting in a rate floor that is well in excess of the “cross subsidy” threshold.

(b) Required Cost Data On Competitive Products

Clearly, the attributable/incremental cost for each competitive product should be identified, with “products” defined in logical groupings such as “Priority Mail” rather than at the rate element level. For the present, Postal Service cost data is adequate and appropriate for use in determining the attributable and incremental costs of Competitive Products individually and in total. They have been adequate for rate development prior to the PAEA enactment and are also adequate for evaluations under the PAEA regime. This is not to say that the Postal Service cost data are perfect. Continued improvement in those data should be pursued and encouraged.

(c) Standard For Determining Appropriate Share Of Institutional Costs

In our reply comments to the Commission's first notice, we explained the many reasons why the initial institutional cost contribution for competitive products under section 3633(a)(3) must be set low, certainly well below their current collective cost coverage. Among other things, (1) the competitive cost coverage under the PAEA serves a different purpose than under the old PRA, acting as a "floor" rather than a defining rate target; (2) the PAEA's separation of competitive from market dominant products will prevent cross-subsidization; (3) use of the current "average" competitive cost coverage would expose the Postal Service to great risk of loss of its higher-contribution products which would force further rate increases that could well lead to a downward spiral; and (4) the Postal Service will need a margin of freedom below the current average coverage if it is to have any flexibility to respond to changing competitive marketplace conditions, particularly in light of its well-known need to invest in enhancement of its service offerings. See Advo Reply Comments, May 7, 2007, at 15-19.

As has been well-recognized over the course of postal ratemaking, institutional costs cannot be allocated on the basis of cost causation, and should not be based on artificial benchmarks or targets. The most economically efficient way to allocate them is on the basis of market characteristics, with the most price-elastic products making the smallest contributions (percentage cost mark-ups) to institutional cost. From an economic viewpoint, the "appropriate" share of Postal Service institutional costs to be covered by Competitive Products is simply the amount of institutional cost/profit the Postal Service could extract if it had the flexibility to maximize its long-term profit from

those products. This, of course, would depend upon what the product markets would permit it to charge such that those products would retain their long-term competitiveness. Further, as markets change, that long-term profit could vary over time. Thus, the determination of “appropriate share” will require in-depth knowledge and monitoring of product markets and, as the markets themselves change, will require changes over time.

The Postal Service is in the best position and has the greatest incentive to understand and monitor market conditions and to develop market plans. The Commission does not now and will not in the future have sufficient market knowledge to make a determination on how to “maximize” long-term contributions from Competitive Products. Even if it were to frequently revisit its “contribution” decisions to track market changes, its changes may disrupt Postal Service plans for those markets. Thus, the Commission should keep its required contribution from competitive products low so that the Postal Service has sufficient flexibility to actively compete, as it sees fit, in those constantly changing product markets. We suggest that the “appropriate share” be a small percentage over the incremental cost of all Competitive Products – perhaps only a percentage sufficient to cover the upper end of the confidence interval for that cost.

Although Section 3633 specifies that the Commission identify the “appropriate share of institutional costs” to be covered by Competitive Products, this share does not necessarily have to be based on attributable cost markups or category revenue shares. For example, one way to determine the “appropriate share” could be to inflate the total competitive product Test Year 2008 institutional cost the PRC determined appropriate in R2006-1 by an index comprising CPI-U and delivery point changes for the rate year.

Finally, the Section 2011(h) requirements have not been completed. These could have a significant impact on the total costs that Competitive Product revenues may have to cover. There is the risk that certain costs could be double-counted as “attributable/incremental” and again as “associated” with Competitive Product balance-sheet items. And, as the Commission appears to anticipate, capital costs and imputed income tax on Competitive Product revenues will also depend upon the capital structure imputed to the Competitive Product balance sheet. At this time, the extent to which the 2011(h) rules will affect the computed “institutional cost” generated by Competitive Products is unknown.

This is all the more reason for the Commission to exercise caution in its final decision on the “appropriate share” of institutional costs from competitive products. An error on the high side which burdens the Postal Service’s ability to remain competitive would be the death knell of its competitive services.

Respectfully submitted,

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