

**BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON DC 20268-0001**

REGULATIONS ESTABLISHING SYSTEM)
OF RATEMAKING)

Docket No. RM2007-1

**COMMENTS OF NATIONAL POSTAL POLICY COUNCIL
IN RESPONSE TO
FURTHER ADVANCE NOTICE OF PROPOSED RULEMAKING
(ORDER NO. 15)**

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The National Postal Policy Council (“NPPC”) respectfully submits these comments in response to Order No. 15, the further Advanced Notice of Proposed Rulemaking (“ANPR”) issued by the Commission on May 17, 2007, and published in the Federal Register at 72 Fed. Reg. 29284 (May 25, 2007). These comments respond to Questions 3 and 9(a) posed by the Commission.

These questions relate to one of the most important issues facing the Commission under the Postal Accountability and Enhancement Act, Pub. L. No. 109-435 (“PAEA”): how should the Commission best promote competition for the products that the Postal Service offers? Question 3 solicits comments on what “information and/or data are needed to allow the Commission to evaluate whether . . . workshare discounts” comply with 39 U.S.C. § 3622(e), which requires that “workshare discounts,” subject to a certain exceptions, “do not exceed the cost that the Postal Service avoids as result of the workshare activity.” Question 9(b) seeks comments on whether “each Negotiated Service Agreement is a product” under 39 U.S.C. § 3633(a)(2), which requires that “each competitive product must cover its attributable costs.”

In answering these questions, the Commission should balance two central goals of PAEA. First, the Postal Service should be given sufficient pricing flexibility to offer innovative prices and services, with the least possible regulatory oversight and burdens. Second, however, the Commission should establish safeguards to ensure that the Postal Service does not leverage its remaining market power to impair competition for products, services or elements where competition from other suppliers is feasible.

**I. QUESTION 3: WORKSHARING DISCOUNTS AND AVOIDED COSTS
(39 U.S.C. § 3622(e))**

39 U.S.C. § 3622(e) establishes a general requirement that that “workshare discounts” “do not exceed the cost that the Postal Service avoids as result of the workshare activity.” “Workshare discounts” are defined as “rate discounts provided to mailers for the presorting, prebarcoding, handling, or transportation of mail,” as those activities are defined by the Commission in its implementing rules under Section 3622(a). *Id.*, § 3622(e)(1).

The “avoided cost” ceiling on “workshare discounts” is subject to five broad exceptions:

1. ***Exception for new or changed services or initiatives:*** The discount is “associated with a new postal service, a change to an existing postal service, or with a new workshare initiative related to an existing postal service;” *and* “necessary to induce mailer behavior that furthers the economically efficient operation of the Postal Service and the portion of the discount in excess of the cost that the Postal Service avoids as a result of the workshare activity will be phased out over a limited period of time.” *Id.*, § 3622(e)(2)(A).

2. **Rate shock exception:** The amount by which the discount exceeds avoided costs (a) “is necessary to avoid rate shock” and (b) “will be phased out over time.” *Id.*, § 3622(e)(2)(B).
3. **ECSI exception:** The discount “is provided in connection with subclasses of mail consisting exclusively of mail matter of educational, cultural, scientific, or informational value.” *Id.*, § 3622(e)(2)(C).
4. **Efficiency exception:** Reducing or eliminating the discount would “impede the efficient operation of the Postal Service.” *Id.*, § 3622(e)(2)(D).
5. **Net contribution exception:** Reducing or eliminating the discount would cause a loss of volume sufficient to reduce the aggregate contribution to institutional costs from the subclass or category subject to the discount, or result in a further increase in the rates paid by mailers not able to take advantage of the discount. *Id.*, § 3622(e)(3).

The Commission should define work sharing cost avoidance under § 3622(e)(2), and interpret § 3622(e) generally, in a manner that best promotes pricing flexibility while promoting effective competition for the mail sorting, handling, and transportation services offered by the Postal Service. This outcome requires full pass-through of worksharing-related cost avoidances.

As several parties have noted in this proceeding, “worksharing” is a form of competition. Worksharing enables competition to develop for the sorting, handling and transportation of mail—even for those mail classes whose delivery is a legal monopoly under the Private Express Statutes.¹ Worksharing discounts have been the primary

¹ See John C. Panzar, “The Economics of Mail Delivery,” in J.G. Sidak, ed., *Governing the Postal Service* 3-4 (1994).

means of promoting this competition since the 1970s.² Promoting this potential competition is of paramount importance, for services other than delivery represent a large share of the total cost of end-to-end postal service, and competition is a more stringent and effective constraint on price and quality than the most omniscient and powerful of regulators.³

As NPPC and others have noted, economists generally agree that the price relationships for bundled services and their unbundled components must satisfy the Efficient Component Pricing Rule (“ECPR”) to allow effective competition.⁴ ECPR requires that mailers should receive a discount equal to the costs they save the Postal Service by bypassing portions of its network. Stated otherwise, the *difference* between the prices charged by the carrier for (1) bundles of monopoly services and competitive services vs. (2) the carrier’s unbundled monopoly services alone (i.e., delivery), must be great enough to cover the incremental costs of the competitive services (e.g., sorting and transportation), or the costs that the Postal Service avoids by not supplying those services itself.⁵

² Mary S. Elcano *et al.*, “Hiding in Plain Sight: The Quiet Liberalization of the United States Postal System,” in M. Crew and P. Kleindorfer, eds., *Current Directions in Postal Reform* 336-52 (2000); *see also* ANM-NAPM-NPPC Comments (April 6, 2007) at 16-18.

³ *See, e.g.*, ANM-NAPM-NPPC Comments (April 6, 2007) at 17 (discussing economic evidence).

⁴ *See, e.g.*, ANM-NAPM-NPPC Comments (April 6, 2007) at 16-26; Comments of John C. Panzar on behalf of Pitney Bowes (Apr. 6, 2007); *see also* Valpak Comments (Apr. 6, 2007) at 11 (second full bullet paragraph); John C. Panzar, “Competition, Efficiency, and the Vertical Structure of Postal Services,” in M. Crew and P. Kleindorfer, eds., *Regulation and the Nature of Postal and Delivery Services* 91-105 (1993).

⁵ *Accord*, R2006-1 PRC Op. & Rec. Decis. ¶ 4016; Panzar, *supra*, in *Governing the Postal Service* at 1, 8-9; William J. Baumol and J. Gregory Sidak, “The Pricing of Inputs Sold to Competitors,” 11 *Yale J. on Reg.* 171, 178 (1994); Alfred E. Kahn and William E.

Unbundling and ECPR pricing promote competition and economic efficiency by encouraging “the competitive segment of the service [to] be performed only by efficient suppliers—that is, by those suppliers whose incremental costs incurred to supply the service are the lowest available.”⁶ ECPR-compliant rates “reflect cost differences fully,” and thus “send proper price signals,” thereby resulting in “more efficient processing and transportation practices, which in turn reduce costs, thereby allowing smaller rate increases, and less volume losses.” R2006-1 PRC Op. & Rec. Decis. (Feb. 26, 2007) at ii.

Many regulatory bodies have adopted ECPR as a regulatory standard for worksharing and access prices by other vertically integrated firms. Rate differentials that fail to cover 100 percent of the costs avoided by bypassing competitive segments of a network with market power are subject to challenge as vertical price squeezes. As Professor Kahn has explained,

what efficient competition requires is that the non-integrated rival not be subject to a vertical squeeze, such as was one basis for the condemnation of the Aluminum Company of America (Alcoa) under the antitrust laws. The source of the squeeze was not the absolute height of the price at which Alcoa sold ingot to competing manufacturers of sheet but the margin between its respective prices for ingot and sheet. It was the failure of that margin to cover Alcoa’s own fabricating costs that made it impossible for equally efficient independent fabricators to compete.⁷

Taylor, “The Pricing of Inputs Sold to Competitors: A Comment,” 11 Yale J. on Reg. 225, 226, 227-28 (1994).

⁶ William J. Baumol and J. Gregory Sidak, “The Pricing of Inputs Sold to Competitors,” 11 Yale J. on Reg. 171, 184-89 (1994).

⁷ Kahn and Taylor, *supra*, 11 Yale J. on Reg. at 228-29; see also Docket No. R83-1, *E-COM Rate and Classification Changes*, 1983, PRC Op. & Rec. Decis. (Feb. 24, 1984) at 36-37; J. Ordober, A. Sykes, and R. Willig, “Nonprice Anticompetitive Behavior By Dominant Firms Toward The Producers of Complementary Products,” in Franklin M. Fisher, ed., *Antitrust and Regulation* 123-27 (1985); Baumol and Sidak, *supra*, 11 Yale J. on Reg. at 180 & nn. 9-11 (citing decisions); William J. Baumol and J. Gregory Sidak,

Until about a decade ago, the Commission did not adhere closely to ECPR in setting worksharing rate differentials. While the Commission professed to support worksharing, in practice worksharing rate differentials were often set at less than 100 percent of the attributable costs of the bypassed services. The Commission repeatedly approved as “conservative” rate relationships that antitrust economists would characterize as predatory price squeezes.⁸

During the past ten years, however, the Commission has embraced ECPR principles—and therefore full pass-through of worksharing-related cost differences—with increasing consistency and rigor. “Indeed, in every subclass that has worksharing discount rates, both the Postal Service and the Commission strive to obtain an ECP outcome, i.e., a one-hundred percent passthrough of the applicable cost savings.” R2006-1 PRC Op. & Rec. Decis. (Feb. 26, 2007) ¶ 4005. As the Commission recently stated in connection with letter/flat rate differentials for Standard Mail, ECPR has become a “bedrock principle” of postal ratemaking. R2006-1 Second PRC Op. & Rec. Decis. (May 25, 2007) at 15.

To reconcile ECPR pricing principles with the limited cap on “workshare discounts” established by 39 U.S.C. § 3622(e)(2), the Commission should prescribe the following guidelines for case-by-case determination of workshare rate differentials:

“The Pricing of Inputs Sold to Competitors: Rejoinder and Epilogue,” 12 Yale J. on Reg. 177, 179-85 (1995) (describing decision of highest court in the British Commonwealth to approve ECPR as standard for telecom access pricing in New Zealand).

⁸ See R90-1, PRC Op. & Rec. Decis. at V-143, V-154, V-229-V-230, V-239 (setting worksharing rate differentials below 100 percent of cost differentials); *id.* at V-143 (defending resulting as “conservative”); R84-1 Op. & Rec. Decis. at 432 (same).

(1) The term “workshare discounts,” as defined in 39 U.S.C. § 3622(e)(1), covers only a subset of the potential competitive alternatives to services provided by the Postal Service. For example, the following activities by mailers or third-party vendors, while properly subject to ECPR pricing, do not constitute “presorting, barcoding, handling, or transportation of mail” within the meaning of Section 3622(e)(1):

- More efficient methods of purchasing and applying postage and evidencing of postage.
- More efficient methods of mail acceptance.
- Use of more efficient mailpiece shapes (e.g., letters vs. flats).

The proper pricing of these and similar activities should be governed by the judgment of the Postal Service and the Commission under ECPR principles, rather than the Section 3622(e)(2) statutory cap.

(2) The exceptions set forth in 39 U.S.C. § 3622(e)(2) and (3) to the statutory cap on workshare discounts serve important ratemaking policies, and should be given full effect. Of particular importance to NPPC’s members are the exceptions for new or changed services or initiatives (§ 3622(e)(2)(A)), and passthroughs in excess of 100 percent of cost differentials that promote “the efficient operation of the Postal Service” (§ 3622(e)(2)(D)) or increase the Postal Service’s net contribution to institutional costs (§ 3622(e)(3)). These exceptions recognize circumstances in which the interests of the Postal Services and its customers may be benefited by workshare discounts that exceed the direct cost savings from the “workshare” activity—e.g., by promoting a new product, enabling the Postal Service to induce a mailer (or group of mailers) to serve as

a pilot test for new technology or processes, or stimulating an increased volume of mail with characteristics that increase the Postal Service's net contribution.

Whether a worksharing initiative promotes falls within these exceptions should be resolved case-by-case, rather than through the establishment of rules in the abstract. For example, the term "limited period of time" (39 U.S.C. § 3622(e)(2)(A)(ii)) is likely to depend on the nature of the initiative and the reasons for setting discounts in excess of estimated avoided costs (e.g., to promote a new service or to provide a sufficient time for mailers to recover investment needed to engage in the worksharing). While a "limited period of time" in these circumstances is certainly likely to be longer than a week or a month, the outer bounds of the permitted period almost certainly will depend on the particular circumstances of the initiative.

(3) The Commission should reject any presumption that setting worksharing rate differentials below 100 percent of cost differentials is "conservative" or otherwise desirable. As noted above, rate differentials that fail to cover attributable costs of postal services with potential competition from private competitors (including self-provisioning by mailers) are tantamount to vertical price squeezes.

(4) The sources of cost data that were used to determine worksharing cost avoidances under the Postal Reorganization Act can also be used to set rate differentials under PAEA. When worksharing cost differentials are determined through a top-down ("discount") rather than bottom-up method of cost analysis, however, the Commission should rule out any presumption that cost pools not modeled by the Postal Service do not vary with worksharing. Treating non-modeled cost pools as unaffected by worksharing is anticompetitive. It allows the Postal Service to block potential

competition by setting rate differentials that are less than actual avoided costs, and thus violate ECPR. See R2006-1 PRC Op. & Rec. Decis. ¶¶ 5160-5161 (rejecting Postal Service assumption that non-modeled operations are unaffected by worksharing).

(5) Section 3622(e)(2)(D) and (3) require modification of the Commission's previous benchmark methodology for determining cost avoidances when significant cost variation or heterogeneity exists within the mail class or category from which cost avoidances are determined has significant cost heterogeneity. (This cost heterogeneity is typically symptomatic of a rate structure for the mail class or category that lacks separate rate elements for one or more significant cost causing characteristics, resulting in significant cost averaging.) For the reasons explained by NPPC and others in Docket No. R2006-1, and elsewhere by Professor John Panzar, *cite?* economically efficient rate differentials in these circumstances must reflect the cost differences between the workshared mail and the mail that is at the *margin* of converting to worksharing, not the cost characteristics of the *average* workshared mail, or the mail that would be "most likely to revert" to non-workshared status if the workshare discounts were eliminated.⁹

Whatever the merits of the "most likely to revert" standard before PAEA, it is inconsistent with the new law. Rate differences smaller than cost differentials for mailpieces at the margin of conversion to the worksharing at issue would, for the reasons noted by Prof. Panzar, "impede the efficient operation of the Postal Service." 39 U.S.C. § 3622(e)(2)(D). Moreover, regardless of whether the entire cost differential between "workshare" and non-"workshare" mail is caused by the particular mail

⁹ Compare John C. Panzar, "Efficient Worksharing Discounts With Mail Heterogeneity," in M. Crew and P. Kleindorfer, eds., *Liberalization of the Postal and Delivery Sector* 121-34 (2006), with R2006-1 PRC Op. & Rec. Decis. ¶ 5109.

characteristic for which the discount is offered, the associated costs savings resulting from other differences in mail characteristics also affect the Postal Service's contribution. Hence, establishing smaller worksharing rate differentials, by reducing incentives for such worksharing, will tend to "reduce the aggregate contribution of the Postal Service from the category or subclass subject to the discount below what it otherwise would have been," *id.*, § 3622(e)(3)(A).

II. QUESTION 9(b): IS EACH NEGOTIATED SERVICE AGREEMENT A SEPARATE "PRODUCT" UNDER 39 U.S.C. § 3633(a)(2)?

Question 9(a) asks whether each Negotiated Service Agreement ("NSA") for a competitive product is a separate "product" within the meaning of 39 U.S.C. § 3633(a)(2), and thus must separately cover its attributable costs. It is unclear whether this issue has much practical significance. Given the low coverage ratio of the products defined by PAEA as competitive (priority mail, expedited mail, bulk parcel mail, bulk international mail, and mailgrams), the Postal Service understandably has focused its NSA efforts on presort First-Class and Standard Mail, both of which have relatively high coverages. The likelihood that the rates established in any NSA will fail to cover the costs attributable to the mail at issue is remote.

It may be useful, however, to define NSAs (for both competitive and market dominant products) as separate products for purposes of implementing the Section 3622(d) rate index. Doing so would eliminate any possible claim that proposed NSAs could lead to greater rate burdens on other mailers by reducing the Postal Service's net contribution from the mail covered by the NSA. If mail service under an NSA is treated as a separate product from non-NSA mail, it will be impossible for rate reductions for

NSAs to provide any basis for rate increases for other products. Establishing a firewall in the CPI index between the profitability of NSAs and maximum allowed rates for other postal services would be consistent with the greater pricing flexibility for NSAs that PAEA allows the Postal Service to exercise. See 39 U.S.C. §§ 3622(c)(10), 3622(d)(1)(C).

CONCLUSION

NPPC respectfully requests that the Commission adopt the standards and procedures proposed herein.

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