

BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON, D.C. 20268-0001

REGULATIONS ESTABLISHING SYSTEM  
OF RATEMAKING

Docket No. RM2007-1

INITIAL COMMENTS OF THE UNITED STATES POSTAL SERVICE ON THE  
SECOND ADVANCE NOTICE OF PROPOSED RULEMAKING  
(June 18, 2007)

On May 17, 2007, the Commission issued a Second Advance Notice of Proposed Rulemaking in this docket (Order No. 15). In that Notice, the Commission solicited responses to nine sets of questions. The Postal Service hereby provides its initial responses.

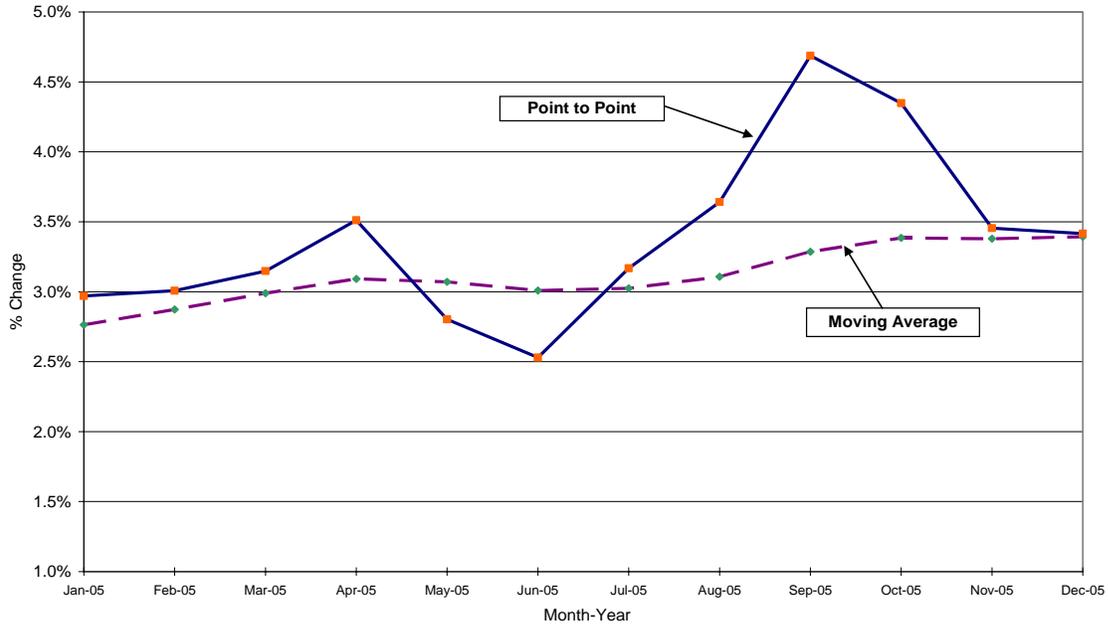
Each question is reproduced below and is followed by the response.

**QUESTION 1**

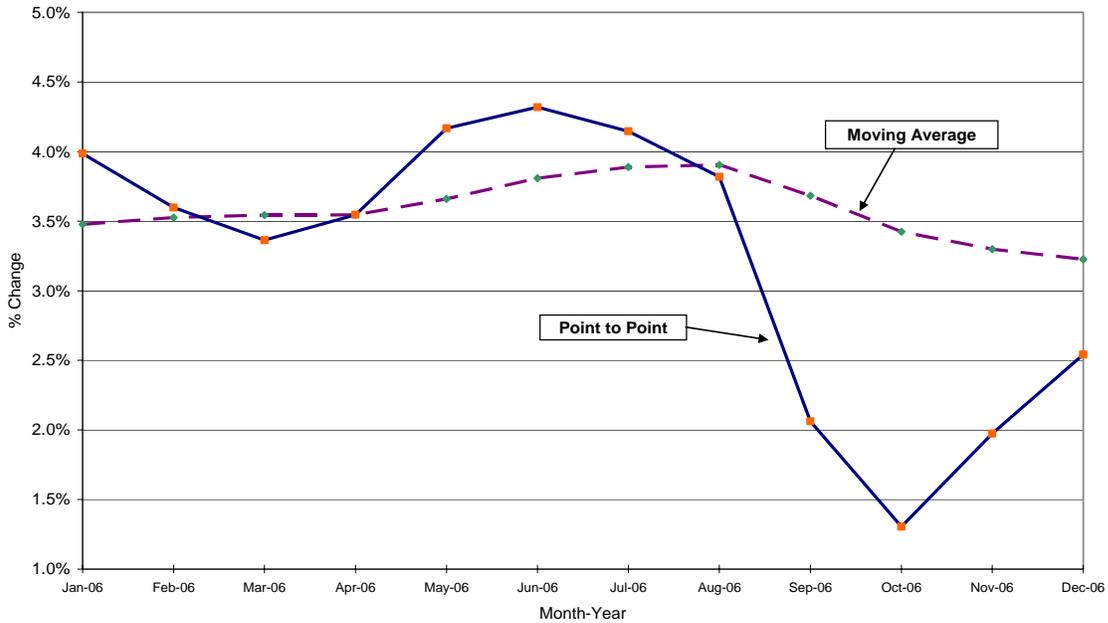
1. In Appendix C of its reply comments, the Postal Service provides a series of examples to illustrate its proposal for calculations that would ensure compliance with the price cap defined in sections 3622(d)(1)(A) and (2)(A). In part C of the appendix, the Postal Service describes its proposed method of calculating the CPI cap limitation. The cap would be equal to the difference between the most recently available monthly CPI and the monthly CPI for the same month of the previous year, divided by the monthly CPI for the previous year. The same result is reached by dividing the most recently available monthly CPI by the monthly CPI for the same month of the previous year and then subtracting one from the quotient.

This point-to-point approach may be contrasted with an alternative that would compare aggregated monthly CPI figures instead of those of a single month. For example, the most recently available monthly CPI could be averaged with the previous 11 monthly CPI values. This 12-month average could then be compared to the average for the previous 12 months in the same way that the single-month figures are in the Postal Service's proposal. Figures 1 and 2 show the cap as it would be calculated under both methods for each month in 2005 and 2006, respectively.

**Figure 1**  
**Comparison of 12-month Moving Average and Point to Point**  
**Percent Change in CPI-U (2005)**



**Figure 2**  
**Comparison of 12-month Moving Average and Point to Point**  
**Percent Change in CPI-U (2006)**



As the graphs show, the results of the point-to-point method exhibit a greater variation based on the month that is selected. The parties are requested to comment on

the merits of each method and may offer additional alternatives. Please discuss how each method conforms to the language in section 3622(d), as well as how each method comports with the objectives in section 3622(b) and the factors in section 3622(c).

**RESPONSE:**

As the Commission notes, the “moving average” approach set forth in this question contrasts with the point-to-point approach discussed in the Postal Service’s Reply Comments in that it exhibits less month-to-month variability. Because of this, using the “moving average” method would appear to reduce the risk of large, short term variations in the unadjusted CPI-U. In addition, because over a period of several years the cumulative effect of the two methods tends to equalize, such that no long-term advantage or disadvantage to the Postal Service would result from either alternative, the objective that the new pricing system assure the Postal Service “adequate revenues” does not appear to favor one method over the other.<sup>1</sup>

The Postal Service is concerned, however, that the “moving average” method does not appear consistent with the language of § 3622(d)(1)(A). That provision defines the price cap as:

an annual limitation on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index for All Urban Consumers unadjusted for seasonal variation over the most recent available 12-month period preceding the date the Postal Service files notice of its intention to increase rates

The point-to-point approach would calculate the change in CPI-U by reference to the percentage increase in the index over the preceding year. The “moving average” approach, on the other hand, would compute the price cap by reference to the percentage change between the most recent 12-month average CPI-U and the average CPI-U for the twelve months before that. It is arguable that calculating the price cap by

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<sup>1</sup> See 39 U.S.C. § 3622(b)(5).

reference to CPI-U data over a 24-month period is counter to the statutory requirement that the CPI calculation be “equal to” the change in CPI-U “over the most recent available 12-month period.”

In conclusion, while there may be business reasons to prefer the “moving average” approach, in order to adopt that approach the Commission would have to reconcile it with the requirement in § 3622(d)(1)(A) that the price cap calculation be based on the change in the CPI-U “over the most recent available 12-month period preceding the date the Postal Service files notice of its intention to increase rates.”

## **QUESTION 2**

2. Appendix C of the Postal Service reply comments provides a series of examples to illustrate its proposal for calculations that would ensure compliance with the price cap defined in sections 3622(d)(1)(A) and (2)(A). Part B of the appendix describes the Postal Service’s proposed method of calculating the annual change in rates to which the CPI cap shall be applied.

The discussion begins by proposing principles (“Standards 1 and 2”) that the measure of the change in rates should satisfy. It concludes that any fixed volume weighting system will satisfy those principles. After explaining the practical impediment to the use of the ideal weights, it describes the weaknesses of two potential methods of measuring the base rates.

The Postal Service proposes to use the most recent 12 months of available data to establish the volume weights and to recalculate average revenue per piece by applying those weights to the current rates. The result would be considered the average base rate. The average new rate would then be calculated by applying the same weights to the new set of rates. The percentage difference between the average base (current) rate and the average new rate would be compared to the percentage change in CPI.

Parties are requested to comment on the method of calculating the annual change in rates under section 3622(d). Please discuss the strengths and weaknesses of the methods described by the Postal Service in Appendix C of its reply comments (and alternative methods, if desired) and how each method comports with the objectives in section 3622(b) and the factors in section 3622(c). Please include a discussion of how to treat an altered rate design, for example, one for which billing determinants do not exist, such as the new rates to be applied to Periodicals.

## RESPONSE:

Some in the mailing community have suggested that the simple “actual revenue per piece” could be calculated for each class subject to the cap by dividing the total actual revenue for the class by the number of pieces mailed in that class for the most recent twelve months of data. Then, this actual revenue per piece would be used as the benchmark against which the noticed price change would be compared to determine if the change was in compliance with the cap. This method would not be simpler for the Postal Service to administer. The primary burden in the cap compliance calculation will be the construction of the fixed volume weights. Because revenue per piece must always be calculated for the new prices by multiplying new prices by some set of fixed volume weights, the Postal Service must still compute fixed volume weights even if actual revenue per piece were the compliance benchmark.

More fundamentally, the use of an actual revenue per piece would not implement the requirement that the § 3622(d)(1)(A) cap be an “an annual limitation on the percentage change in *rates*.”<sup>2</sup> In a simple example, such as a one-price rate class, the role of weighting is not an issue in determining whether prices are in compliance with the cap. However, in the more realistic example of a multiple-price class, the weighting mechanism serves as a tool to facilitate the management of the limitation; it does not change the substance of the limitation. For example, any new price schedule that does not change any price by more than the annual percentage change in the CPI-U should by definition be acceptable. By definition, use of an annual average revenue per piece that includes prices outside the one year period prior to the noticed implementation date will either result in a greater limitation if prices were previously increased (the example

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<sup>2</sup> Emphasis added.

in Appendix C to the Postal Service's Reply Comments) or a lesser limitation if prices were previously decreased.<sup>3</sup> This is of particular concern if the Postal Service (or the Commission, in the case of the Docket No. R2006-1 price structure) had designed prices that would encourage more efficient preparation (and generally lower-than-otherwise revenue per piece) than a previous price structure. Because the revenue per piece would be, in part, "locked in" by the previous (e.g., pre-R2006) price structure, pricing decisions and movements to more preferable rate structures would be further delayed.<sup>4</sup> This situation relates to the final portion of this question, which seeks discussion of how to treat a proposed alteration in the rate design, such that historical billing determinants do not exist.

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<sup>3</sup> Recall the discussion on pages 6-7 of Appendix C to the Reply Comments. The import of that discussion can be summarized as follows. Suppose the previous rate for a class was 20 cents, and a 5 percent increase in CPI-U allowed an increase to the current rate of 21 cents. Assuming another subsequent annual CPI-U increase of 5 percent, the logical allowed ceiling on the next rate increase would be 22.05 (21 times 1.05) cents. However, further assume that the previous increase had come very late (e.g. 10 months) into the 12-month period over which someone proposes to calculate base average revenue per piece, creating a base period with an overlap of rate regimes. Over the 12-month period, the average revenue per piece (with 10 months at a rate of 20 cents and 2 months at a rate of 21 cents) would be 20.17 cents. If average revenue per piece over the 12-month period of 20.17 cents were used to calculate the next rate ceiling, instead of using the actual current rate of 21 cents, the result would be 21.18 (20.17 times 1.05) cents. Consequently, a new rate of 22.05 cents would appear to exceed the allowable cap, when the true price would actually be rising by no more than at the same rate as CPI-U. As concluded in Appendix C to the Reply Comments, using average revenue per piece over a period with an overlap between rate regimes necessarily distorts the allowed rate ceiling, relative to using actual current rates (with appropriate fixed weights).

<sup>4</sup> Using the "actual" revenue per piece as a basis would also undo much of the cost coverage changes being implemented this year (i.e. FY 07) as a result of Docket No. R2006-1. Effectively speaking, only roughly one-quarter of the Periodicals and one-third of the Media and Library rate increases would be built into calculations if FY07 average revenue per piece were used as the base to which a cap were to be applied. Therefore, those classifications could perpetually remain below costs. In fact, because of the relatively large percentage increases coming relatively late in the fiscal year, using FY07 actual revenue per piece as a base for rate adjustments in FY08 would mean that most customers would get rate reductions. For instance, assume the pre-R2006 average revenue per piece for a class was 20 cents and it received an 8 percent increase to 21.8 cents. However, at two-thirds pre-R2006 rates and one-third post-R2006 rates, the FY07 average revenue per piece would be roughly 20.6 cents. If CPI-U inflation is running at about 2 percent, and the Postal Service were only allowed to raise that 20.6 cents by 2 percent under the new ratemaking system, the result would be a maximum rate of roughly 21 (20.6 times 1.02) cents. Comparing that ceiling with our assumed current post-R2006 rate of 21.8 cents, employing the "actual" revenue per piece over the fiscal year as the base would require a rate *decrease*, which would clearly make no sense.

Conceptually, there appear to be two types of mail characteristics for which historical billing determinants would not exist. First, there could be mail characteristics which appear in the mailstream, but for which billing determinants are not available because those characteristics previously were not associated with distinct rate treatment. For example, if historical rates by weight were the same across shapes, then billing determinant information, *per se*, would not exist for mail of different shapes. Thus, a new proposal to charge separate rates for letter-shaped, flat-shaped, and other pieces could not rely on billing determinants to calculate volume shares for the new shape categories, as those characteristics historically were not associated with separate rates. Nonetheless, it may be possible to obtain historical shape-based information from other data sources, either internal to the Postal Service, or external. For example, mailers could be surveyed to develop estimates of shape proportions within the existing mailstream.

The other potential type of mail characteristic for which billing determinant information could be lacking, however, would consist of those characteristics which do not appear at all within the existing mailstream. Using the shape hypothetical, imagine (contrary to fact) that pieces in the shape of tubes historically were categorically prohibited from being mailed, but that the Postal Service now intended to allow tubes and, in fact, to charge a separate rate for them. Under circumstances such as these, the lack of billing determinant information would be due not to a gap in data collection, but rather to the fact that no data exist to be captured. This type of situation could occur any time a truly new product or service is introduced, when no customers for that

product or service were served previously, regardless of their willingness to pay a separate charge.

These two types of circumstances should be treated differently for purposes of calculating the average price change. In the first instance, if the mail characteristic proposed to be introduced as a new rate element currently exists in the mailstream, then the historical billing determinant information should be augmented with the best available estimate of the proportion of the existing mailstream which manifests that characteristic. To maintain consistency with historical billing determinants, of course, the focus must remain on the volume proportions as they exist without any rate distinction.<sup>5</sup>

Returning to our original hypothetical regarding de-averaging based on shape categories defined as letters, flats, and others, the first step would be to estimate existing volume portions for letters, flats, and others, using the best source of data available. Then, to estimate before-rates revenue per piece, all of those volume portions are multiplied by the existing (averaged) rate, while for estimating after-rates revenue, each (of the same) volume portions is multiplied by the corresponding (de-averaged) rate for that shape. In this fashion, the price change calculation for the class can accommodate the rate design change and still provide an appropriate measuring stick for cap compliance purposes.

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<sup>5</sup> For other purposes, it may be useful to estimate what the volume proportions might be after rate distinctions are introduced and mailers respond to the new price incentives, but that exercise should not be confused with the augmentation of historical billing determinants, based on mail characteristics from the same period as all other billing determinants are obtained, for purposes of calculating compliance with the cap.

In contrast, for the second type of situation, potential volumes relating to the totally new mail characteristic should not be a factor in the price change calculation. There simply is no price change or volume for a new service that did not exist before the price under consideration. Since the existing volume of the new service is zero, the volume weight applied to the rate is zero, and therefore the magnitude of the proposed rate for the new service should not and does not affect the calculation of the average price change for the class. In this situation, the absence of billing determinant information does not create the need to attempt to augment billing determinant information, as conceptually there is no need to attempt to incorporate this rate proposal into the rate change calculation.

In the event that alterations in proposed rate design create the need for supplemental billing determinants, the Postal Service anticipates that all “adjustments” to billing determinants would be explained. That explanation would be provided with the materials submitted with the Notice of Price Adjustment at the commencement of the 45-day review period. Alternative sources of information, beyond those normally reflected in the billing determinants, would be identified and documented. Thus, in constructing the fixed volume weights for any noticed price change, the Postal Service would “map” the historical volumes to the noticed price structure using the best data available. These data could include historical volume data (*e.g.*, for shape distribution) that were not previously needed for postage calculation; the results of mail characteristics or market research studies; or, observed volume patterns for a recent period (shorter than a full year) for which the price structures were in effect. The choice as to which data are “best” for a particular circumstance would need to be evaluated on

a case-by-case basis; and, in some circumstances, informed judgment may form the basis for the volume mapping. In presenting its cap compliance calculation, the Postal Service will present the bases for any required mapping from previous to new price structures. With this type of information provided at the outset, the Commission's burden in evaluating compliance with the price cap would be only marginally exacerbated even by fairly substantial changes in rate design.

### **QUESTION 3**

3. Section 3622(e) directs the Commission to "ensure that workshare discounts do not exceed the cost that the Postal Service avoids as a result of the workshare activity," except in certain specified situations. In the context of a Notice of Rate Adjustment for a class of mail —

- a. What information and/or data are needed to allow the Commission to evaluate whether new workshare discounts are consistent with this standard?
- b. What information and/or data are needed to allow the Commission to evaluate whether unchanged workshare discounts remain consistent with this standard?
- c. What information and/or data are needed to allow the Commission to evaluate whether changed workshare discounts remain consistent with this standard?

### **RESPONSE:**

(a) As stated in its Reply Comments,<sup>6</sup> when the Postal Service establishes a new workshare discount, it will provide the report required by § 3622(e)(4).<sup>7</sup> This will include data similar to that included in the special studies and cost avoidance calculations currently filed with an omnibus rate case.

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<sup>6</sup> Postal Service Reply Comments at 7-8.

<sup>7</sup> That section requires a report which explains the Postal Service's reasons for establishing the discount; sets forth the data, economic analysis, and other information relied upon by the Postal Service to justify the discount; and certifies that the discount will not adversely affect the prices or services provided to users who do not use the discount.

(b)-(c) Although the Commission has not yet issued its rules regarding the content of the Annual Compliance Report, the Postal Service anticipates that it will include avoided cost data similar to those provided to the Commission in Docket No. R2006-1 for existing workshared rates. When it provides its Notice of Price Adjustment pursuant to § 3622(d)(1)(C), the Postal Service will also compare the resulting workshare discounts to the most recent Annual Compliance Report. If a discount equals or is less than the avoided cost, no further information is needed to comply with § 3622(e). On the other hand, if a resulting workshare discount exceeds the cost avoided, the Postal Service will provide the appropriate justification based on the provisions of §3622(e).

#### **QUESTION 4**

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). 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”?
- 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:**

(a)-(b) The current Domestic Mail Classification Schedule (DMCS) clearly answers the question of what is “priority mail” and “expedited mail.” “Priority mail” refers to all mail pieces within the “Priority Mail Subclass” (DMCS § 223), which pay the rates in Rate Schedule 223. “Expedited mail” (commonly known as “Express Mail”) refers to all mail pieces within the “Expedited Mail Classification Schedule” (DMCS § 110 *et seq.*), which

pay the rates in Rate Schedules 121, 122, and 123. These are both products that compete in highly competitive markets.

(c) Unlike “priority mail” or “expedited mail,” “bulk parcel post” cannot be defined by reference to a preexisting grouping of mail within the DMCS. That term should be defined as the mail matter within the Parcel Post Subclass (DMCS § 521) that is used solely by commercial bulk mailers, who have numerous competitive options from which to choose. As the Postal Service noted in its Reply Comments to the first Advance Notice, it agrees with PSA that “bulk parcel post” should consist of Parcel Select, Parcel Return Service, and workshared non-destination entry Parcel Post;<sup>8</sup> in other words, all Parcel Post that does not pay the retail (non-discounted) Intra-BMC and Inter-BMC rates. Thus, “bulk parcel post” refers to:

- 1) Parcel Select and Parcel Select Return Service pieces paying the rates in Rate Schedules 521.2C, 521.2D, 521.2E, 521.2F, and 521.2G.
- 2) Inter-BMC Parcel Post pieces paying the rates in Rate Schedule 521.2A, if
  - A) the OBMC presort discount (footnote 1 to Rate Schedule 521.2A) applies;
  - B) the BMC presort discount (footnote 2 to Rate Schedule 521.2A) applies;
  - C) the barcode discount (footnote 3 to Rate Schedule 521.2A) applies; or

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<sup>8</sup> Postal Service Reply Comments at 31-32.

D) the postage for the piece is paid using a Merchandise Return Service permit.

3) Intra-BMC Parcel Post pieces paying the rates in Rate Schedule 521.2B, if

A) the barcode discount (footnote 1 to Rate Schedule 521.2B) applies; or

B) the postage for the piece is paid using a Merchandise Return Service permit.

(d) With respect to “bulk international mail,” the Postal Service noted in its Reply Comments that the term “seems most logically interpreted to refer to multi-item mailings tendered by a single mailer.”<sup>9</sup> The multiple quantities could be entered at the time of each mailing or throughout the course of a given term, pursuant to volume commitments or other types of annual guarantees. An annual guarantee based on weight or postage, rather than pieces, is still roughly equivalent to a predetermined volume commitment. A number of existing international categories fall within such a definition of “bulk” international mail:

- International Priority Airlift (IPA), which, according to the International Mail Manual (IMM),<sup>10</sup> is “available to bulk mailers of all First-Class Mail International items . . . .”<sup>11</sup>

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<sup>9</sup> *Id.* at 32.

<sup>10</sup> The IMM contains the mailing standards of the Postal Service for international mail services, and is incorporated by reference in the Code of Federal Regulations at 39 CFR § 20.1. The IMM was updated on May 14, 2007. Certain international categories listed in the Postal Service’s Reply Comments have changed. See 72 Fed. Reg. 16604, April 4, 2007. For example, Publisher’s Periodicals no longer exists as a separate category; items previously entered as Publisher’s Periodicals are now sent as First-Class

- International Surface Airlift (ISAL), which is defined by the IMM as “a bulk mailing system” for economical delivery of First-Class Mail.<sup>12</sup>
- Global Bulk Economy, which provides for surface transportation of volume mailings of First-Class Mail International items, and available through an International Customized Mail Agreement (ICM).
- Global Direct, a direct entry service for multiple-item mailings in which customers send items through the Postal Service bearing the indicia, postal markings and return address of the destination country, also available through an ICM.
- M-bags, defined as “direct sacks of printed matter to a single foreign addressee,”<sup>13</sup> consist of multi-item shipments of printed matter and merchandise, although there are no specific minimum requirements.

ICMs, while not a separate category of international mail,<sup>14</sup> also generally consist of multi-item mailings tendered by a single mailer, whereby the mailer receives discounted rates in exchange for agreeing to an annual minimum volume or revenue requirement.<sup>15</sup> ICMs normally provide for discounted rates from existing international mail categories and services based on an annualized volume guarantee. ICMs with

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International. See IMM § 141.5. Customized agreements may also be arranged for mailers of former surface services. See 72 Fed. Reg. 16605.

<sup>11</sup> IMM § 292.11. The eligibility criteria for IPA mailings consist of either presorted or nonpresorted mailings of at least 11 pounds in weight.

<sup>12</sup> IMM § 293.1. The eligibility criteria for ISAL mailings provide for a minimum volume requirement of 50 pounds per mailing except for the Direct Shipment option, which requires a minimum 750 pounds to a single country destination. ISAL is prepared as (1) direct country sacks when there are 11 pounds or more to a single country or required country separation; (2) mixed country package sacks when there are 10 or more pieces or at least 1 pound of mail to a single country, but less than 11 pounds; and (3) residual mail when there are fewer than 10 pieces or less than 1 pound of mail to a single country. Residual mail may not exceed 10 percent, by weight, of the mail presented in direct country sacks, M-bags, and mixed country package sacks. IMM § 293.2.

<sup>13</sup> IMM § 261.1.

<sup>14</sup> See the response to Question 9(a), below.

<sup>15</sup> See IMM § 297.

per-mailing volume minimums clearly fit within the definition of “bulk international mail.” This includes ICMs for Global Shipping Solutions (GSS), a value-added service which provides labeling and harmonization of customs forms for Express Mail International and Priority Mail International shipments. A minimum of 50 pounds or 200 pieces per manifest mailing is required for GSS shipments.

ICMs without per-mailing minimums also logically fit within the definition of “bulk international mail.” For instance, Global Package Discount offers customers access to discounts for Express Mail International; while no per-mailing minimum is required, the ICM does provide for an annualized volume commitment.<sup>16</sup> In light of the annualized volume guarantee, items tendered under ICMs could be logically grouped with other “bulk” international mail, even if no per mailing minimum is required.<sup>17</sup>

(e) Section 3631(a)(5) does not refer to any current mail matter, since Mailgram service has been discontinued.<sup>18</sup>

(f) The PAEA applies a rule of construction stating that the mail matter assigned to the market dominant or competitive categories is “to have the meaning given to such mail matter under the *mail classification schedule*.”<sup>19</sup> As the Postal Service discusses in its Supplemental Comments on the Classification Process, to be filed tomorrow, the Act thus appears to contemplate a classification schedule that is analogous to the DMCS

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<sup>16</sup> Eligibility requirements are either 600 pieces or \$12,000 in postage per year.

<sup>17</sup> While Global Package Discount clearly could be considered a bulk international category, there currently is no system in place to separately track its costs and revenues. Hence, in order for this product to be grouped with other bulk international mail, single-piece Express Mail International would also need to be transferred to the competitive product grouping.

<sup>18</sup> See Letter from Daniel J. Foucheaux, Jr., to Steven W. Williams, Secretary, Postal Rate Commission, dated November 1, 2006, available at [www.prc.gov](http://www.prc.gov).

<sup>19</sup> See 39 USC §§ 3621(b), 3631(c) (emphasis added).

promulgated by the Commission pursuant to former § 3623 (which also required the Commission to establish a “mail classification schedule”). However, in recognition of the distinct regulatory regimes applicable to market-dominant and competitive products, there should be separate “mail classification schedules” for the competitive and market-dominant products, respectively.

The Commission should therefore interpret "mail classification schedule" as used in § 3631(c) as referring to a classification schedule that describes and differentiates, at a level of detail equivalent to the current DMCS, the competitive products.<sup>20</sup> At the outset, this classification schedule should contain the provisions of the current DMCS that are applicable to competitive products; a schedule would also be created for market dominant products. International mail classification language would also be added to correspond to the division of the international class into "single-piece" and "bulk" groupings, as provided in the PAEA, and as may be further re-categorized by the Commission under the criteria of § 3642.

## **QUESTION 5**

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

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<sup>20</sup> Similarly, the term "mail classification schedule" in § 3621(b) describes and differentiates market-dominant products at a level equivalent to the current DMCS.

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) The PAEA, in § 3632, gives the Governors the authority to set the prices and classifications for competitive products, subject to the procedural requirements of § 3632(b), and to the substantive requirements of § 3633(a). As discussed extensively in the response to Question 6 below, the Commission will, under § 3633(a), establish regulations that require each competitive product to cover its attributable costs, and for competitive products collectively to cover their group-specific costs and make what is determined to be an “appropriate” contribution to institutional costs. The Governors are free to price competitive products as they deem necessary to meet business needs, so long as the revenues produced by those prices cover the cost mandates of § 3633(a). In particular, it is fundamentally the prerogative of the Governors to determine the profit margin to seek on competitive products above the cost floor set by the Commission.

From a chapter 36 perspective, therefore, the only relevant question is whether the prices set by the Governors produce enough revenue to satisfy the cost floor requirements of § 3633(a). The data necessary to make such a showing is discussed in the response to Question 6. The nature of this data, consisting of measures of the revenue earned by competitive products, the attributable costs of competitive products

individually, and the group-specific costs for competitive products, is most appropriately examined in the Annual Compliance Review process of §§ 3652-53. At the time the Postal Service changes the prices for its competitive products, it would therefore reference back to the volume and cost data filed in the most recent § 3652 annual report.

Consistent with its expectations concerning market-dominant products,<sup>21</sup> the Postal Service currently plans to file one general price change for competitive products each year, with smaller, focused changes (such as new service offerings or customized agreements) being implemented throughout the year. Small changes such as customized agreements are unlikely to be significant enough to materially affect the Postal Service's compliance with the cost floor in any given year. For the annual general price change, meanwhile, the volume and cost data provided in the previous Annual Compliance Review should be sufficient to assure compliance for the next year.<sup>22</sup>

A related question is whether there should be formal prior review by the Commission of competitive price or classification changes. The structure of the statute, including, as discussed above, the nature of the data required to show compliance with § 3633, suggests that there is no prior review by the Commission. For prices or classes of general applicability, the Postal Service is not required to file anything with the Commission; instead, it must file the Governors' price or classification decision in the

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<sup>21</sup> See Postal Service Initial Comments at 24 n.40.

<sup>22</sup> The Postal Service has an incentive to make a profit on the competitive side, in order to both support the network (through the assumed Federal income tax) and to re-invest in the competitive business. A profit will only come from marking up the competitive products beyond any regulatory mark-up established under § 3633(a)(3). Thus, the Postal Service will have a strong incentive to maintain a healthy cushion between the prices it sets and the cost floor established by the Commission.

*Federal Register*.<sup>23</sup> This suggests that the substantive review of competitive products' compliance with § 3633 should occur in the Annual Compliance Review.

For prices or classes not of general applicability (e.g., customized agreements), the Governor's price or class decision must be filed with the Commission.<sup>24</sup> However, this does not indicate that prices or classes not of general applicability should receive a prior Commission review. Rather, the purpose of filing such decisions with the Commission seems to be to protect the confidentiality of customized agreements involving competitive products, which will be highly commercially sensitive,<sup>25</sup> while still ensuring that the Commission is aware of such agreements for oversight purposes.

(f)-(g) The phrasing of the statutory language suggests that the proper criteria is the availability of the price and classification at issue. If a price is publicly available throughout the nation, it is "of general applicability," and is thus subject to the procedural requirements of § 3632(b)(2). If, however, a price is set through a customized agreement with a specific mailer, then it is "not of general applicability," and is thus subject to the requirements of § 3632(b)(3).

Between these two extremes, however, it is more difficult to determine when a price or classification that is only available in a certain geographic region is or is not "generally applicable." The phrase "substantial region" is not defined. The Postal Service suggests that the most appropriate way of applying that phrase is by

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<sup>23</sup> See 39 U.S.C. § 3632(b)(2).

<sup>24</sup> See 39 U.S.C. § 3632(b)(3).

<sup>25</sup> It is essential that customized agreements involving competitive products are treated as commercially sensitive, and thus not subject to public disclosure. No competitor of the Postal Service publicizes the customized agreements it enters into with its customers. The Commission should therefore protect the confidentiality of such agreements pursuant to § 504(g)(1).

considering the size of the population of the region in which the price or classification is available.

## **QUESTION 6**

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:**

(a)(i) The PAEA has altered the taxonomy of postal costs. Under the PRA, the Commission based the rate for a product on its attributable cost. A product’s

attributable cost was defined as the cost causally related to it and consisted of its volume-variable cost plus any fixed costs that were found to be specifically caused by that product. The residual of costs, after summing the attributable costs of all the products, was referred to as “institutional cost.” By showing that a product’s revenue covered its attributable cost, the Commission established that the product was not receiving a subsidy.

Section 3633(a)(1) requires that the customers of market-dominant products as a group do not subsidize customers of competitive products. The old taxonomy is not adequate to address this question. An analysis will be required to quantify the costs of activities that are causally related to one or the other of the two groups of products, yet are not attributable to any specific product within the group. A hypothetical example of such “group-specific costs” would be if the Postal Service undertook an advertising campaign that involved the “suite” of competitive products (rather than one specific competitive product); this would be a cost causally related to the competitive products as a group, but not to any individual competitive product. Compliance with § 3633(a)(1) therefore requires the annual filing of the attributable cost of each competitive product plus the competitive products’ group-specific costs.

Not all postal costs are caused by one group of products or the other. Rather, some costs serve to sustain the overall enterprise and are common to both groups of products. An example would be salaries of top management. Hence, the new taxonomy resulting from the PAEA effectively redefines the term “institutional cost,” which now becomes total cost less the sum of attributable cost for each product and

less the group-specific costs causally related to either the group of market-dominant products or to the group of competitive products. In symbols,

$$IC = TC - \sum_n AC - GC_{md} - GC_{comp}$$

where IC refers to the (redefined) institutional cost, TC to total expenditure, AC to the attributable cost of  $n$  postal products (both competitive and market-dominant), and GC to the group-specific costs of market-dominant and competitive products, respectively.

(a)(ii) For each of the four competitive products (Priority Mail, Expedited (Express) Mail, Bulk Parcel Post, and Bulk International), the Postal Service should file data that shows the revenue and attributable costs for each product.

(a)(iii) As described in the response to part (a)(i), “institutional costs” are now the residual of total costs that is left after deduction of the attributable costs and the group-specific costs caused by either of the two groups of products. For purposes of compliance with § 3633(a)(1), the revenue of competitive products must at least cover the sum of their attributable costs plus the group-specific costs causally related to competitive products as a group.<sup>26</sup>

Section 3633(a)(3) also requires that competitive products collectively cover what is determined to be an “appropriate share” of the institutional costs of the Postal Service, as redefined under the new taxonomy. In other words, the PAEA requires that the revenue from competitive products be sufficient to cover, in addition to the

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<sup>26</sup> Note that the group-specific costs causally related to competitive products as a group constituted a part of ‘institutional costs’ as defined under the pre-PAEA taxonomy.

attributable cost of each competitive product plus the group-specific costs of competitive products, what the Commission determines to be an “appropriate” portion of the residual after attributable costs (for all products) plus group-specific costs (for both sides of the business) have been subtracted from total cost.

The Postal Service views the “appropriate share” standard of § 3633(a)(3) as a charge to the competitive product group. In that sense, this “cost” must be added to the other components of cost that competitive product revenues must cover. Because this “cost” is incurred at the level of the competitive products as a group, it is best calculated as a mark-up on the sum of the competitive products’ attributable cost. Thus, to ensure that competitive products collectively cover what the Commission determines to be an “appropriate share” of the institutional costs of the Postal Service, the Postal Service would provide the revenue for competitive products, the attributable cost for each competitive product, and the institutional costs of the Postal Service.

Overall, § 3633 requires that the revenue of competitive products be sufficient to cover the sum of attributable costs and group-specific costs, plus any mark-up on attributable costs that the Commission determines is “appropriate.” This is expressed in the following requirements:

$$R_{comp} \geq (1 + \rho) \sum_m AC_{comp} + GC_{comp},$$

$$\text{and } \rho \sum_m AC_{comp} \leq IC,$$

where  $R_{comp}$  refers to the revenue of competitive products,  $AC_{comp}$  refers to the attributable costs of the  $m$  competitive postal products (which are a subset of the entire set of  $n$  postal products ( $m < n$ )),  $GC_{comp}$  refers to the group-specific costs of

competitive products as a group, and  $\rho$  is the Commission-determined mark-up on the attributable cost of competitive products ( $AC_{\text{comp}}$ ).

(b) The data should be filed annually, as part of the annual compliance report of § 3652.

(c) Under the assumption that the Commission will continue to use the costing methodologies established prior to the PAEA, the Postal Service believes the existing data systems to be broadly adequate to enable the Commission to annually assess the Postal Service's compliance with § 3633(a). However, additional analysis not currently performed for the CRA will be needed to quantify the group-specific costs causally related to each group of products. In addition, modifications and/or improvements may be necessary to quantify the costs of categories not currently reported upon, such as bulk parcel post and bulk international.

(d) The standard should be that the total revenue for competitive products must be greater than or equal to the sum of the attributable cost of each competitive product plus the group-specific costs caused by the competitive products as a group.

(e) Section 3633(b) sets forth the standard for determining the "appropriate share" as being a consideration of "all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or

disproportionately associated with competitive products.”<sup>27</sup> Based on this standard, there are compelling reasons for establishing a relatively low institutional cost contribution for competitive products.

First, it must be acknowledged that the establishment of the Competitive Products Fund and separate regulations for competitive products is a new and untested model. As with any new approach, there is risk and opportunity. The Postal Service’s goal is for competitive products to be successful in the marketplace and that income from competitive products will help support the provision of universal service. In order to be successful, the Postal Service needs the freedom to take risks in the highly competitive market and exercise the pricing flexibility contemplated by the Act. The market will drive the prices for the competitive products. A high initial threshold on competitive product prices would be an unreasonable constraint at this early stage in the life of the Postal Service under PAEA. It would seriously restrain the Postal Service from competing, to the detriment of both customers in competitive markets and to users of the Postal Service’s market-dominant products.

Second, the reality in the marketplace is that the Postal Service’s competitive products have a relatively small share of the market. A Colography Group analysis indicates that for calendar year 2006 the market share, as measured by revenue, for domestic competitive products was 11% for the Postal Service. Other analyses indicate that the Postal Service’s share in the market has declined over time. It is clear that limiting the Postal Service’s pricing flexibility by requiring a high contribution to institutional cost is not needed to protect the competition.

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<sup>27</sup> While § 3633(b) relates to the mandatory five-year review of the “appropriate share” requirement, it is logical to set the initial “appropriate share” mark-up based on the standard by which it will later be reviewed.

Third, the minimum contribution is a threshold, and does not imply that the Postal Service would set prices merely to cover this requirement. The Postal Service also has the incentive to make profits which will contribute to the financial viability of the organization and the preservation of universal service. A profit will only come from marking up the competitive products beyond the regulatory mark-up established under § 3633(a)(3). Thus, the Postal Service will have a strong incentive to maintain a cushion between the prices it sets and the cost floor established by the Commission.

Finally, setting a relatively low minimum contribution does not preclude adjustment in the future. The Commission has the discretion to revisit its § 3633 regulations at any time.<sup>28</sup> In addition, the PAEA mandates that the Commission revisit the “appropriate share” standard every five years.<sup>29</sup>

(f) The standard for determining the “appropriate share” is set by the statute at § 3633(b). Every five years, the Commission must review its determination of what constitutes the “appropriate share” by reference to that standard. The Commission’s initial determination of what constitutes the “appropriate share” is therefore valid for at least five years, though the Commission should not preclude the possibility of revisiting its initial determination before those five years are up if circumstances require a re-assessment.

(g) Surely, if the Annual Compliance Report shows that the Postal Service has covered what the Commission has determined to be the “appropriate share” of institutional costs,

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<sup>28</sup> See § 3633(a) (stating that the Commission “may from time to time thereafter revise” the regulations that it initially promulgates).

<sup>29</sup> See § 3633(b).

then the Commission should make a determination pursuant to § 3653 that the Postal Service is in compliance with chapter 36 in that regard.

(h) The Postal Service interprets this question to ask if the Commission's § 3633 regulations should prescribe a minimum rate of return or level of profit from the competitive products, *in addition* to requiring that the competitive products be allocated an appropriate share of institutional cost. The Commission should not require the competitive products to generate any specific financial return or profit. Instead, it is within the prerogative of the Governors to make the determination as to how much profit to seek from competitive products. Any such regulation is also unnecessary, as the Postal Service has clear incentives to set profitability targets and make financially sound investment decisions.

### **QUESTION 7**

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.

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:**

(a) No, the assumed Federal income tax is not a cost. It is a transfer payment from the Competitive Products Fund to the Postal Service Fund, and is thus another source of funding for the institutional costs of the Postal Service. Treating it as an attributable

cost would require the application of a mark-up, leading to a greater tax liability than competitors.

(b) The tax should not be “assigned” among the competitive products, for the reason discussed in the response to part (a).

### **QUESTION 8**

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) No such costs have been identified by the Postal Service.

(b) No such costs have been identified by the Postal Service.<sup>30</sup>

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<sup>30</sup> Analysis will be performed, however, to determine which costs currently considered “institutional” should be characterized as “group-specific,” as discussed in the response to Question 6. These costs cannot be attributed to individual products; rather, they are costs causally related to the respective group.

(c) The enactment of the PAEA enables a full reexamination of postal retirement related costs because Civil Service Retirement System (CSRS) – related and FEHB retiree health benefit costs are addressed in the Act, which puts a new payment system in place. Also, in addition to realigning the payment schedule, the Act reaffirms that “causality” be the means to attribute these and other costs.<sup>31</sup>

To determine how to attribute these costs in the future, it is appropriate to provide some context by examining the previous treatment. Before, attribution was based upon the payment schedules for these costs.<sup>32</sup> While it was recognized that actual payments were not the same as the costs incurred, payments were used as the best available measure of the costs incurred.<sup>33</sup> However, the PAEA breaks any perceived link between the payment schedule and how the costs are incurred. Instead, the retirement-related payments under the Act are as mandated until 2016, recognizing past underfunding of retiree health benefits and overfunding of CSRS obligations.

As such, attributing those pension and health costs based upon the payment schedule, as done in the past, is clearly inconsistent with reflecting the “economic costs” associated with the handling of the mail, due to the accelerated payments and the new information on actual costs incurred. Instead, it may tend to “over-attribute” the costs by

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<sup>31</sup> See 39 U.S.C. § 3622(c)(2), § 3631(b).

<sup>32</sup> In the past, the CSRS payments for pay increases and COLAs were treated as part of labor costs and attributed in the same way. CSRS pay increase payments were the sum of the amortization and interest costs associated with deferred liabilities due to general pay raises. Each year from 1974 to 2002, the Postal Service incurred this liability, which was amortized over 30 years. CSRS Annuitant Cost-of-Living-Adjustments (COLA) payments were the sum of the amortization and interest costs associated with deferred liabilities due to the rise in COLA. Each year from 1990 to 2002, the Postal Service incurred this liability, which was amortized over 15 years. The payments for Annuitant Health Benefits have been and continue to be treated this way. The escrow payment under Public Law No. 108-18 was an exception to this since it was considered institutional. See PRC Op., R2005-1, at 49-53.

<sup>33</sup> See PRC Op., R76-1, App. J, pages 203-210; PRC Op., R77-1, App. J, page 219.

focusing on the accelerated payment schedule.<sup>34</sup> Conversely, taking the view that the acceleration of the payment schedule renders any attempt to attribute costs meaningless, as some have,<sup>35</sup> is equally flawed.

The more practical, moderate approach focuses on how those costs are earned as opposed to the payment schedule. For instance, in any given year, postal employees covered by the CSRS are earning retirement payments. Also, employees accrue eligibility for health care coverage after retirement. These earned benefits form the foundation of economic costs. In other words, the salary and the earned benefits are the true costs incurred by the Postal Service when postal employees are working. Those earned benefits can be measured using recognized actuarial cost methods and assumptions. The same rules of attribution used for the salary can also be used for benefits. Therefore, recognized actuarial cost methods can be put in place to measure and then attribute these retirement-related costs.

On a final note, it will be necessary to reconcile the economic and accounting costs reported in the Postal Service statements, with the primary concern being that the attributed “economic” costs not exceed the accounting costs. This can be addressed by setting the accounting costs as a ceiling that the attributed costs may not exceed. The difference between the accounting costs and attributable costs are institutional costs.

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<sup>34</sup> Basing attribution on the payment schedule would result in attributing prior period retirement cost, as advocated by UPS at page 5 of its Initial Comments to the first Advance Notice. The attribution of prior period costs, however, would be to commit the fallacy of attributing sunk costs.

<sup>35</sup> See Reply Comments of ANPM/MPA at 9-10; Reply Comments of PSA at 4-6.

## **QUESTION 9**

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:**

As the Postal Service has indicated previously, and also discusses in its Supplemental Comments on the Classification Process, which will be filed tomorrow, the Postal Service believes that “product” is appropriately defined at a level equivalent to the current subclasses of mail. The competitive “products” are thus Priority Mail, Express Mail, Bulk Parcel Post,<sup>36</sup> and Bulk International Mail. As such, the proper answer to each of these questions is “no,” as further discussed below.

(a)-(b) Customized agreements, whether covering international or domestic mail, are not individual “products” within the meaning of the PAEA. Instead, customized agreements involve the provision of existing “products” at prices or terms that are specific to a mailer. For instance, assume for hypothetical purposes that the Postal Service enters into a customized agreement with a mailer that gave a discount for Express Mail in exchange for a volume commitment. Such an agreement would not be

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<sup>36</sup> Bulk parcel post consists of mail matter that was previously part of the Parcel Post Subclass in the DMCS. See *supra*, response to Question 4(c).

an individual “product,” but would be included within the rest of “Express Mail” when considering compliance with § 3633(a)(2).

ICMs are mailer-specific agreements covering one or more underlying international mail categories and services (e.g., Express Mail International),<sup>37</sup> in which a customer receives discounted rates from the base rates for existing categories and services of international mail in exchange for minimum volume or revenue commitments. The mailer generally also agrees to meet additional requirements, such as advance deposit account payments, mail entry at designated locations, and various specific preparation requirements, in order to qualify for the discounts. Domestic customized agreements entered into by the Postal Service pursuant to § 3632, meanwhile, would similarly consist of mailer-specific price and service conditions in the provision of an existing competitive “product.”

(c) The Postal Service has not identified the use of the term “special classification” in the PAEA with respect to competitive products. Most likely, a “special classification” would involve the provision of an existing “product,” and would thus not be itself a “product” within the meaning of the PAEA.

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<sup>37</sup> IMM § 297.1. ICMs as a whole have been considered an international service available within the overall international mail class; each ICM has not been considered a separate international category of mail. See 58 Fed. Reg. 29778 (May 24, 1993), which stated that ICMs were “designed to provide the Postal Service with the ability to provide customer-specific service offerings at rates that comply with all of the statutory requirements that apply to international rates.” The Federal Register notice also compared ICMs to service agreements for Express Mail Custom Designed service. *Id.* Each Express Mail Custom Designed service agreement historically has not been considered a separate category of Express Mail.

In fact, traditionally, ICM volume and revenue has not been reported as a separate category or line item. ICM volumes and revenues, for the most part, are contained within the applicable international mail category. For example, ICM Express Mail International revenue is contained within the Express Mail International category. A very small portion of ICM volume and revenue is reported within the Global Direct Outbound and Inbound categories, since those categories do not use the standard services.

(d) As the Postal Service discusses in its response to Question 5, “classes not of general applicability” consist of customized agreements with specific mailers, or to services that are limited to a small region of the country. Since these would typically involve the provision of an existing “product” with mailer-specific or region-specific terms, they would not be individual “products.”

Respectfully submitted,

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