

**UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268 0001**

**Regulations Establishing System
Of Ratemaking**

DOCKET No. RM2007-1

**REPLY
OF
PARCEL SHIPPERS ASSOCIATION
TO
COMMENTS FILED IN RESPONSE TO
SECOND NOTICE OF PROPOSED RULEMAKING
(Issued May 17, 2007)**

Pursuant to Order No. 15, Parcel Shippers Association (PSA) herewith files its Reply to Comments filed to response to Second Notice of Proposed Rulemaking.

In these comments, PSA replies to the comments of UPS, as well as comments made by Valpak, the Office of the Consumer Advocate (OCA), and the Postal Service with respect to the six issues discussed below. At the outset, however, we must disagree with the view of the United Parcel Service (UPS) that “the primary purpose of PAEA as to competitive products is to set price floors.” Comments of the United Parcel Service in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, June 18, 2007, at 6 (USPS Comments (ANPRM II)). Rather, PSA believes the primary purpose of the PAEA as to competitive products is to promote fair competition between the Postal Service and its competitors. Many of UPS’ recommendations – such as requiring significant *a priori* financial reporting and Commission review when rates for competitive products are adjusted – would do

just the opposite, i.e., tilt the playing field against the Postal Service. The Commission should reject such recommendations.

1. Contrary to UPS' position, Bulk Parcel Post excludes pieces entered at non-discounted rates even if entered in quantities of more than one at a time.

In its Initial Comments in response to Order No. 15 (at 3), UPS argues that non-discounted inter-BMC and intra-BMC Parcel Post that is entered in quantities of more than one should be classified as Bulk Parcel Post. Such a classification would be contrary to the use of the terms “bulk” and “single-piece” in the Domestic Mail Classification Schedule (DMCS).

First, the DMCS uses the term “bulk” to refer to mailings that qualify for discounted rates, not to mailings entered in quantities more than one. See, e.g., DMCS §§ 541 and 543. In particular, while it requires updating (as we noted in our Initial Comments in response to Order No. 15 (at 2-3)), the DMCS definition of Bulk Parcel Post makes clear that “bulk” means much more than the entry of more than one piece at a time.

Bulk Parcel Post mail is Parcel Post mail consisting of properly prepared and separated single mailings of at least 300 pieces or 2000 pounds.

DMCS § 521.3.

Further, under the PAEA, Parcel Post can fall into one of two categories – (1) bulk parcel post; or (2) single-piece parcel post. Thus, bulk parcel post excludes pieces properly classified as single-piece. Confirming that “bulk” refers to pieces that qualify for discounted rates is the way in which the DMCS uses the term “single-piece.” Section 221.21 of the DMCS, for example, states “[t]he single-piece rate category [within First-Class Mail] applies to regular rate Letters

and Sealed Parcels subclass mail not mailed under § 221.22 [Presort Rate Category] or 221.24 [Qualified Business Reply Mail (QBRM)].” As explained in § 221.22 of the DMCS, to qualify for Presort Rates, pieces must be entered in mailings of at least 500 pieces as well as be prepared as specified by the Postal Service. Thus, other than the special case of QBRM, all First-Class mailings of 499 pieces or less (and some larger ones) are defined by the DMCS as single-piece mailings.

PSA would also like to clarify its position on the proper classification of Bulk Parcel Return Service (BPRS). In its Initial Comments in response to Order No.15, OCA stated (at 24-25) that PSA believes BPRS should be classified as Bulk Parcel Post. This is not the case. In our Initial Comments in response to Order No. 2 (at 8) and again in our Initial Comments in response to Order No. 15 (at 3), we stated that Parcel Return Service (PRS) pieces should be classified as Bulk Parcel Post. By PRS, PSA was referring only to parcels mailed at Parcel Select Return Service – Return Delivery Unit (DMCS § 521.27) and Parcel Select Return Service – Return Bulk Mail Center (DMCS § 521.28) rates. These two rate categories are collectively referred to as PRS. See, *e.g.*, DMCS § 585.

PSA agrees with OCA that BPRS is not Bulk Parcel Post because it is a service for returning Standard Mail, not Parcel Post.

2. UPS’ admitted attempt to redefine the term “subsidy” should be rejected.

In its Initial Comments in response to Order No. 15 (at 9), UPS argues that the PAEA “essentially redefines [the meaning of the term] subsidy.” The PAEA does nothing of the sort. Rather, UPS itself attempts to redefine the term “subsidy” in a way it prefers, but is entirely at odds with the perspective of the economics profession. PSA Initial Comments in response to Order No. 2 at 5. Thus, UPS’ argument should be ignored.

UPS' rationale is as follows. First, UPS appears to concede that the accepted test to prevent subsidization – which is the purpose of § 3633(a)(1) of the PAEA – is the incremental cost test. Specifically, as discussed in our Initial Comments in response to Order No. 2 (at 5-6), if a product's revenue covers its incremental cost, then there is no cross-subsidization. Second, it suggests that this test is similar to that required by § 3633(a)(2), which explicitly requires that each competitive product cover its attributable cost. Third, UPS reasons that such an interpretation of the term "subsidy" would effectively render the § 3633(a)(1) superfluous (i.e., duplicative of § 3633(a)(2)), so Congress must have meant something else when it spoke, in § 3631(a)(1) of "subsidization."

Finally, it redefines, with no citation to the relevant economic literature, the term subsidy to its own benefit. Specifically, UPS, not the PAEA, attempts to "redefine subsidy by requiring that competitive products as a whole bear some additional amount beyond their attributable costs and a fair share of the...unattributable network costs." UPS Comments (ANPRM II) at 9.

In addition to being inconsistent with the accepted definition of a subsidy, there are other problems with UPS' definition. First, there is a more reasonable way "to give effect" to § 3633(a)(1) of the PAEA that is consistent with the accepted definition of a subsidy. Specifically, § 3622(a)(2) applies individually to each competitive product – requiring that "each competitive product covers its costs attributable" – while § 3622(a)(1) applies collectively to all competitive products. As explained by the Postal Service:

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.

USPS Comments (ANPRM II) at 22.

Put differently, § 3633(a)(1) of the PAEA is not superfluous because it applies at a different level – competitive products collectively rather than individually – than § 3633(a)(2); and the test required by § 3633(a)(1) includes costs – group-specific costs causally related to competitive products as a group – that are not included in the § 3633(a)(2) test.

Another problem with UPS' definition is that it presupposes that the competitive playing field is tilted in the Postal Service's favor. This is quite a leap. As we explained in our Initial Comments in response to Order No. 2 (at 17), there are many differences in the legal and regulatory requirements between the Postal Service and its competitors. Some are to the advantage of the Postal Service and, as recognized by the Commission in R2000-1 (fn. 151), others cut against it. Any analysis of the net economic effect of differences in legal and regulatory requirements for the Postal Service and its competitors must account for both.

3. The PAEA does not change the definition of an attributable cost. Suggestions that the Commission should significantly alter its attribution approaches should be rejected.

As we explained in our Initial Comments in response to Order No. 15 (at 10), the PAEA does not change the definition of an attributable cost. Rather, it reaffirms the Commission's current approach to costing by explicitly stating that attributable costs should be determined "through reliably identified causal relationships."

PSA's view was echoed by other parties in their responses to Order No. 15 and previous comments filed in response to Order No. 2. See, e.g., Pitney Bowes Initial Comments in response to Order No. 15 at 11-12; Pitney Bowes Initial Comments in response to Order No. 2 at 26; ADVO Initial Comments in response to Order No. 15 at 11; and Valpak Initial Comments in response to Order No. 2 at 22. Given the PAEA's reaffirmation of the Commission's existing approach for attributing costs, the Commission need not make significant

changes (e.g., the adoption of a long-run incremental costing approach suggested by UPS to its costing methods.) See UPS Comments (ANPRM II) at 12,

UPS asserts that PAEA requires increased attribution. *Id.* at 17. A plain reading of §§ 3622(c)(2) and 3631(b) makes clear that the PAEA requires accurate cost attribution based upon analysis of “reliably identified causal relationships,” not increased attribution. Improvements in attribution methods, i.e., better identification of causal relationships, could increase *or decrease* attribution levels.

Further, we note that reductions in attribution levels over time in particular cost segments and components do not necessarily indicate problems with costing systems as UPS suggests. *Id.* at 17-18. Rather, there are many reasons why attribution levels could and, in fact, should change over time, such as changes in operations and improvements in the Postal Service’s and Commission’s ability to distinguish between fixed and variable costs. PSA urges the Commission not to jump to the conclusion that decreases in attribution over time are necessarily due to attribution problems. Further investigation of areas where attribution levels have changed significantly in either direction may, however, be appropriate.

4. UPS’ and Valpak’s logic for attributing prior period retiree health costs is flawed.

In its Initial Comments in response to Order No. 15 (at 19), UPS provides just one sentence on why retiree health benefits incurred in prior periods should be attributed:

Otherwise, current users of market-dominant products will be subsidizing costs incurred in the past by past users of competitive products.

This argument is simply incorrect because past users of competitive products were not subsidized. As discussed above, products are only subsidized if their revenues do not cover their incremental costs. This is certainly not the case for competitive products today or in the past. See, e.g., R2006-1 Op., Appendix G, Schedule 1; CRA Reports (available at www.usps.com/financials).

Rather, competitive products have covered their costs and made significant contributions to institutional costs. As explained in our Initial Comments in response to Order No. 2 (at 9), without these contributions, rates for market dominant products would be much higher. It is unlikely that an additional charge for retiree health benefit costs would significantly reduce this contribution.¹

Further, whether or not past users of competitive products or, for that matter, market-dominant products were subsidized is irrelevant for the purpose of cost attribution. Attributing prior period costs because of past subsidies would simply be bad economics. As the Postal Service accurately noted in its Initial Comments in response to Order No. 15 (at 30), “[t]he attribution of prior period costs...would be to commit the fallacy of attributing sunk costs.”²

Valpak also argues in support of the attribution of prior period retiree health benefit costs. Valpak Initial Comments in response to Order No. 15 at 16-18. In addition to proposing an incorrect attribution method, this argument is contrary to the costing principle that Valpak praises in previous comments. In its Initial Comments in response to Order No. 2, Valpak extolled the virtues of marginal costing principles. In fact, it titled a long and persuasive section of those comments as follows:

¹ It is also worth noting that past ratepayers did pay for some retiree health benefit costs. These costs were treated attributed in the same manner as all labor costs. Docket No. R2006-1, USPS-LR-L-1 at 18-7 – 18-8.

²We note that the Postal Service fashioned its discussion of the attribution of retiree health benefit costs (at 29-30) as a reply to PSA among others. This must have been based upon a misunderstanding of our position. We agree with the Postal Service that while prior period retiree health benefit costs should not be attributed, retiree health benefits **earned** by workers in the current year should be attributed in the same manner as direct labor costs. PSA Initial Comments in response to Order No. 15 at 10-11.

Marginal Costs Should Continue to Provide the Foundation and Principal Guidance for Determining the Costs of Individual Products and Services.

In that section of its comments (which runs from page 15 through 22), ValPak quotes a number of economic authorities on the virtues of the marginal cost principles. For example, it quotes William Vickery as stating:

In my view, the primary focus should be on the economic consequences of alternative price structures.... Total cost per unit of small price-induced change is the **marginal cost** that is relevant to the present inquiry.

Valpak Initial Comments in response to Order No. 2 at 16 (citing Docket No. R74-1, Direct Testimony of William Vickery, Sept. 25, 1997, Tr. 3-78)

Then, Valpak ultimately concludes:

The Commission has a long and distinguished history of fostering improved costing, and substantial progress has been made. The clock should not be turned back. The progress to date should be built on, and marginal costing principles should be followed. It is well understood that a theory must guide costing activities. Cost measurement without theory is meandering, wayward, and arbitrary, and leads to results that have no meaning and that cannot be interpreted. Marginal cost analysis should not be abandoned or compromised.

Valpak Initial Comments in response to Order No. 2 at 22.

Attributing prior period retiree health costs, which are not only fixed, but also sunk, would compromise these marginal cost principles by attributing costs that would be unaffected by small or, for that matter, large changes in volume or even the elimination of entire product offerings. APWU Initial Comments in response to Order No. 15 at 7; USPS Comments in response to Order No. 15 at 29-30; PSA Reply Comments in response to Order No. 2 at 5-6; and ANM-MPA

Initial Comments in response to Order No. 15 at 4; ANM-MPA Reply Comments in Response to Order No. 2 at 9-10.

5. PSA opposes the use of the “objective standards” for determining the “appropriate share” of institutional costs listed by UPS in its comments.

In its Initial Comments in response to Order No. 15 (at 13), UPS argues that the Commission should develop an objective standard for determining the “appropriate share” of institutional costs to be borne by competitive products. It then lists two examples of objective standards – (1) assign institutional costs in proportion to attributable costs; and (2) assign them in proportion to revenue. The Commission should not adopt either of the example standards listed (although apparently not advocated) by UPS.

Either of these standards would require that the collective percentage markup on competitive products be at least as large as that on market-dominant products.³ This would be a significant increase from the markups on competitive products recommended by the Commission in Docket No. R2006-1 based upon an analysis of the PRA’s pricing factors that the PAEA left essentially unchanged. As we explained in our Initial Comments in response to Order No. 2 (at 12-14), the markups on competitive products recommended in Docket No. R2006-1 are presumptively fair. No increase would be appropriate. In fact, several provisions in the PAEA suggest that the collective markup on competitive products required to meet the “appropriate share” provision should be lower than recommended in Docket No. R2006-1.

³Either of these standards would require competitive products to at least pay the same share of institutional costs as they comprise of attributable costs. Mathematically, either boils down to requiring the collective markup for competitive products to be at least as large as that for market-dominant products. PSA notes that because the unit cost of competitive products is substantially higher than of market dominant products, these standards would require competitive products to make a significantly larger unit contribution to institutional costs than that for market-dominant products. In fact, as PSA previously noted, even the R2006-1 recommended markups require a significantly larger unit contribution from competitive products than from market dominant products. PSA Initial Comments in response to Order No. 2 at 16.

First, the “appropriate share” requirement represents a contribution floor, not (as under the PRA) a reasonable contribution. The Postal Service will almost certainly exceed the floor for two reasons: (1) it will likely maintain a “margin of safety” to ensure that the contribution from competitive products meets or exceeds the floor; and (2) the elimination of the breakeven requirement will provide it with the incentive to charge users of competitive products whatever the market will bear.

Second, the PAEA’s elimination of the breakeven requirement severs the link between rates for competitive and market-dominant products. Under the PRA, once a revenue requirement was established, any reduction in rates for competitive products necessarily results in higher rates for market-dominant products and vice versa. Thus, the negative impact of reductions in rates for competitive products on rates for market-dominant products had to be evaluated. Under the PAEA, rates for market-dominant products are determined largely independently from the rates for competitive products. Thus, the impact of lower rates for competitive products on users of market-dominant products is minimal and need not be a major consideration.

Third, several provisions of the PAEA eliminate advantages that the Postal Service currently derives from its status as a governmental agency. Section 402 requires the Postal Service to pay tax on the income that it makes from competitive products. Section 403 prohibits unfair competition. Section 703 requires the Federal Trade Commission (FTC) to prepare a report on laws that apply differently to the Postal Service and make recommendations for bringing these legal differences to an end. The PRC must take the FTC’s recommendations into account and then must promulgate regulations. Thus, a lower markup is necessary to promote fair competition.

6. The PAEA requires that the Postal Service file only a statement of explanation and justification and the effective date when establishing rates and classes of mail for competitive products. As we explained in

our Initial Comments, CRA data should be filed and reviewed as part of annual reporting requirements.

In its Initial Comments in response to Order No. 15 (at 4-6), UPS recommends that the Commission require the Postal Service to submit a substantial amount of data along with its notices of price adjustments for competitive products so that it can “make a prima facie showing that the rates comply with the statutory requirements.” This recommendation should be rejected as contrary to the intent of the PAEA. It would also tilt the playing field against the Postal Service.

As discussed in our Initial Comments in response to Order No. 2 (at 21-22), the PAEA provides the Board of Governors with substantially increased authority to establish rates for competitive products.⁴ Consistent with this substantial authority, § 3632(b) of the PAEA requires the Postal Service to file only the following when it provides notice of price adjustments for competitive products:

a statement of explanation and justification,
the date as of which each such rate or class takes effect, and
each rate and class decision ...and the record of the Governors’
proceedings in connection with such decision to be published in the
Federal Register.

Nowhere does the PAEA contemplate requiring the Postal Service to file substantial amounts of data to make a prima facie showing of compliance. Rather, as discussed in our Initial Response (at 4, 6-7) to Order No. 15, §§ 3652 and 3653 of the PAEA explicitly call for annual reporting of, among other things, actual cost and revenue data followed by an annual compliance review by the Commission. Had Congress wanted the Postal Service to file such data before

⁴ On this, UPS appears to agree. Specifically, it states (at 9, fn. 5), “In short, the Postal Service has been given vastly greater discretion as to how to price each competitive product so as to meet PAEA’s requirement.”

price adjustments accompanied by an *a priori* review by the Commission, it could and presumably would have included similar requirements in § 3632(b). It certainly knew the words. Rather, it decided annual reporting requirements followed by compliance reviews would provide the transparency necessary to ensure compliance with § 3633.

Further, in its Initial Comments in response to Order No. 15 (at 9, fn. 5), UPS accurately notes that the PAEA includes “the elimination of the Postal Reorganization’s Act pre-implementation hearing process.” PSA is concerned that, if adopted, UPS’ recommendation that the Postal Service file significant volumes of data to make a prima facie showing of compliance would, contrary to the PAEA’s intent, ultimately devolve into the PRA’s pre-implementation hearing process.

Finally, as discussed above, the intent of the PAEA in regard to competitive products is to allow the Postal Service and its competitors to compete on a level playing field. One of the disadvantages that the Postal Service faces relative to its competitors is that it must have its rates reviewed by an external regulator. To allow the Postal Service to compete, the Commission should keep the burden of this review to a minimum. Regulating rates for competitive products through after-the-fact compliance reviews (as explicitly envisioned by the PAEA) will appropriately do that while still ensuring compliance with § 3633.

Respectfully submitted

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