
REGULATIONS ESTABLISHING
SYSTEM OF RATEMAKING

Docket No. RM2007-1

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

ADVO, Inc., a wholly owned subsidiary of Valassis, Inc., hereby submits its reply comments in response to the Commission's Second Advance Notice Of Proposed Rulemaking On Regulations Establishing A System Of Ratemaking (Order No. 15), issued on May 17, 2007. Our reply comments are presented in the order listed in the Commission's notice.¹

I. ISSUES RELATING TO MARKET-DOMINANT PRODUCTS

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

Notwithstanding the Postal Service's reasons for favoring the point-to-point method for measuring CPI-U changes, we continue to believe that the moving-average approach better comports with the statutory objective of rate predictability and stability in section 3622(b)(2), both for mailers and the Postal Service. Although the moving-average will lag the monthly data (either up or down), these differences will even out over time.

¹ Advo is also one of a number of parties to the joint response of Postcom, *et al*, addressing the initial comments of the Office of Consumer Advocate.

Issue 2 – Calculation of Average Rates When New Rate Elements, Rate Designs, or Products Are Introduced

We believe the approach to calculating average rates when there are changes in rate design or products needs to be pragmatic, not dogmatic. The goal should be to provide a reasonable assurance that the overall proposed average rate for the class meets the CPI-U cap, without turning the process into a tedious and contentious free-for-all. One way to accomplish this is to distinguish between major and minor changes.

If a proposed rate design change is optional for mailers or affects only a relatively small portion of the class volumes, there is no need to require volume estimates since the effect on the overall average class rate would likely be minimal. As APWU and the Postal Service note, those rates can simply be ignored in their first year of implementation. We likewise agree with the recommendation of Pitney Bowes that new products, special classifications or pricing arrangements should be excluded – as long as they are simply options and not mandatory.

Conversely, if the change is mandatory and affects a significant portion of the class volume, then the Postal Service will need to provide volume estimates to test compliance with the class's rate cap. We agree with the Postal Service (Comments at 7-8) that these can generally be estimated based on either historic billing determinant data or special studies.

In evaluating the Postal Service's volume estimates, the Commission should apply a test of "reasonableness" rather than striving to obtain "rate case precision" by substituting its own projections for those of the Postal Service. So long as the Postal Service's estimates are within a zone of reasonableness, the Commission should accept them.

Such major changes would be subject to review in the Commission's annual compliance review, to ensure that the new rates conform to the CPI cap. Even there, however, the Commission should apply a test of reasonableness. As with any volume estimate, the actual results will inevitably vary (up or down) from the estimates. The rates that were allowed to go into effect, based on the estimates, should be presumed compliant. A variance in actual volumes should not be evidence of "non-compliance" unless the deviation is significant; and in any event, the remedy for such deviations should be confined to adjustments in the next regular rate cycle.

Issue 3 – Compliance of Worksharing Discounts

Pitney Bowes and others have restated their earlier arguments that worksharing discounts should be quantified on the basis of Efficient Component Pricing. As explained in our earlier reply to those arguments, ECP is the appropriate basis for worksharing discounts only if those discounts apply to a single homogeneous product. Unfortunately, current postal subclasses are comprised of many different products and their price differences should, ideally, reflect both cost and market differences. See ADVO Reply Comments, May 7, 2007, at 6-8.

With respect to the timing of support for established worksharing discounts, we agree with Time Warner and Pitney Bowes that such data should be provided as part of the Postal Service's annual compliance report. By contrast, the OCA's proposal that worksharing costs should be updated monthly as "realtime" data is absurd, imposing an impractical burden that far outweighs any practical benefit. Pitney Bowes proposes that such data be historic and we generally agree. However, we also believe that historic

avoided costs should be updated to reflect the change in CPI-U and any operational changes affecting avoidable costs.

II. ISSUES RELATING TO COMPETITIVE PRODUCTS

As we explained in our initial comments, Advo and all mailers in the market-dominant category have a stake in the success of the Postal Service's competitive products. While the new statute ostensibly isolates the two categories, the competitive products, if successful in the marketplace, will provide a contribution to total institutional costs that will in the long run reduce the rate burden on market-dominant products.

First, to the extent the Postal Service is able to earn a profit on its competitive products, that profit will be subject to an imputed income tax under section 3634 of the PAEA which will be transferred from the Competitive Products Fund to the Postal Service Fund – to the benefit of market-dominant products.

Second, and more importantly, competitive products today make a significant contribution to the Postal Service's institutional costs. Express Mail and Priority Mail alone contribute more than \$2 billion annually to defraying those overhead costs of the postal system.² If the Postal Service is unable to compete and is driven out of the competitive market, it will lose that valuable contribution to overhead costs. Those costs will not go away, but will have to be recovered by the Postal Service either by cutting costs and service or by raising rates for other mailers. Thus, mailers in the market-dominant category will end up paying for those costs one way or another – either through reduced service and/or increased rates.

² See PRC Recommended Decision, Docket R2006-1, Appendix G, Schedule 1.

UPS has nevertheless apparently decided that now is the time to put the Postal Service's competitive services out of their misery. The Commission should be under no illusion. UPS's proposed approaches to cost attribution, cost coverage, and particularly its new third-tier of cost allocation – a surcharge for the Postal Service's supposed "unfair competitive advantages" – would simply drive the Postal Service out of the competitive market, to the great detriment not only of the users of those services but to all mail users and the American public.

Issue 6(d) – Standard For Subsidy From Market Dominant Products

If competitive products cover their combined incremental costs, they are not being subsidized as a group by the market-dominant products. This is a standard upon which virtually all economists would agree. UPS, however, claims that in the PAEA, Congress has redefined the term "subsidy" to include an allocation of additional costs above and beyond both attributable and institutional costs, a category of phantom imputed costs ostensibly designed to counter the Postal Service's "unfair competitive advantages." UPS Comments at 7-9.

UPS cites two sections of the PAEA for the proposition that Congress has "redefined" subsidy and mandated a "three-step" cost allocation method for competitive products. Neither comes close to supporting its novel interpretation.

First, it cites, without discussion, section 2011(h)(1)(A)(i)(II) which concerns development of accounting practices by the Secretary of the Treasury. The cited section in its entirety reads:

"(h)(1)(A) The Secretary of the Treasury, in consultation with the Postal Service and an independent, certified public accounting firm and other advisors as the Secretary considers appropriate, shall develop recommendations regarding—

(i) the accounting practices and principles that should be followed by the Postal Service with the objectives of—

(I) identifying and valuing the assets and liabilities of the Postal Service associated with providing competitive products, including the capital and operating costs incurred by the Postal Service in providing such competitive products; and

(II) subject to subsection (e)(5), *preventing the subsidization of such products by market-dominant products.*” (emphasis added).

On its face, this language clearly does not “redefine” subsidy. Moreover, the “subsidization” referred to here in subparagraph (II) relates to *cross-subsidy* by market-dominant products. It has nothing whatsoever to do with any alleged “unfair advantages” that the Postal Service supposedly enjoys by virtue of other federal and state laws.

The other section UPS cites is §3633(a)(1). Because subsection (a) has three paragraphs, UPS leaps to the conclusion that the three represent a new “three-part” allocation of costs to competitive products: not just attributable costs plus an appropriate share of institutional costs, but a new category of costs on top of all supposedly to offset the Postal Service’s competitive advantages. That contention is pure hokum. Section 3633(a) reads as follows:

“§3633. Provisions applicable to rates for competitive products.

(a) IN GENERAL.—The Postal Regulatory Commission shall, within 18 months after the date of enactment of this section, promulgate (and may from time to time thereafter revise) regulations 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.”

Paragraph (1), which UPS claims represents the new third tier of costs, does not in any way “redefine” subsidization. In particular, that paragraph specifically refers only to *cross-subsidization* of competitive products “*by market dominant products.*” It in no way suggests the claim that UPS makes: that the term subsidization goes beyond cross-subsidy to encompass alleged unfair competitive advantages due to other federal or state laws.

We will leave aside for the moment the underlying contention in UPS’s argument: the premise that the Postal Service does, indeed, have substantial unfair competitive advantages over UPS. That is an issue that will be considered initially by the Federal Trade Commission. However, we would pose a question. If the Postal Service has such great unfair advantages, then why does it lag so far behind UPS and FedEx in the real-world marketplace for products like Express Mail and Bulk Parcel Post? Why is it not *the* dominant competitor? Could it be, perhaps, that although free from paying parking tickets, the Postal Service, as a creature of Congress and a highly regulated governmental entity, is handcuffed with a slew of federal laws and rules and regulations and public service obligations and political oversight that constrain its ability to manage its employees and its operations and its contracts and its services? The reality is that such constraints on the Postal Service’s flexibility undermine its efficiency, and hence its competitiveness, to a greater degree than mere parking tickets and such that UPS decries.

Cost Attribution Under the PAEA

At various places in its comments, UPS repeatedly cites the old 2004 Senate report that accompanied S. 2468 (a bill that died in the Senate) for the proposition that Congress believed cost attribution was too low and should be increased. See, e.g., UPS comments at 10, 11, 17. Its touting of this report offers a cautionary tale about the curious ways legislative history is created and the danger in undue reliance on such history. The Senate Report's ostensible concern about low attribution stemmed from statements in the report of the President's Commission on the United States Postal Service. As the Senate Report states:

“The Committee agrees with the President's Commission when they say this situation should be improved.¹⁶ The Postal Service should be able to attribute a greater percentage of its costs.

¹⁶ Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service, 93.”

S. Rep. No. 318, 108th Cong., 2d. Sess. (August 25, 2004), at 29.

The President's Commission, in turn, (in the passage cited by the Senate Report), rested its conclusion of “low attribution” on the response of a UPS vice-president to questions following testimony, wherein the witness claimed that UPS utilized a procedure for “achieving 100% cost allocation.” The President's Commission, accepting this UPS statement at face value, concluded:

“While the Postal Service claims that significant improvements are not feasible, one leading private-sector carrier noted *it had a procedure for achieving 100% cost allocation*.¹⁴ The Commission feels that the appropriate target for the Postal Service lies somewhere in between. While the Commission hesitates to prescribe a percentage, there is a strong consensus that an attribution level of less than 60% is far too low, and would not be considered acceptable in similar private-sector ventures.

¹⁴ Holsen, James, Vice President, Industrial Engineering, United Parcel Service, Response to Questions Following Testimony Before President’s Commission on the United States Postal Service, May 28, 2003.”

Report of the President’s Commission on the Postal Service (July 31, 2003), at 93 (emphasis added).

This oral exchange with UPS’s witness is a classic example of failure to communicate, as the President’s Commission uncritically equated UPS’s claimed “100% cost allocation” with “cost attribution.” The Postal Rate Commission itself has always “allocated” 100% of postal costs to products, through a combination of causally-based cost attribution plus judgmental institutional cost assignment – consistent with the statutory costing requirement (and the economically-correct approach) of attributing costs on the basis of cost causality, with the remaining common costs allocated on the basis of pricing factors.³

This underscores another danger in reliance on the 2004 Senate Report cited by UPS: the final law Congress passed in 2006 differed in significant respects from the

³ The notion that 100 percent of UPS’s costs can be causally traced to individual products is absurd. Among other things, it would imply that UPS has zero “common costs” in its system, and that even the entire compensation of its top executives could be traced causally as either volume variable or incremental to specific products. We would further note that UPS’s oral statement has never been presented to the PRC for scrutiny in an “on-the-record” adversarial proceeding with opportunity for cross-examination and rebuttal.

2004 version of S. 2468. Of particular note, Congress changed the language of the attributable cost requirement in section 3622(c)(2) by emphasizing that such cost attributions must be established “through reliably identified causal relationships.” The PAEA states:

“(2) the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service *through reliably identified causal relationships* plus that portion of all other costs of the Postal Service reasonably assignable to such class or type.” (changed language emphasized).

Thus, the language of the law (differing from the bill discussed in the old Senate Report) reaffirms the traditional approach to causally-based cost attribution as interpreted by the courts and applied by the Postal Rate Commission.⁴ This belies UPS’s contention that Congress believes cost attribution is too low.

Issue 6(e) – Standard For Appropriate Share Of Institutional Costs

In Advo’s reply comments to the Commission’s original advance notice, responding to the arguments of UPS, we explained in detail the critical reasons why the cost coverage for competitive products must be set *below* their current average aggregate cost coverage.

- First, a high mandated cost coverage will not necessarily maximize institutional cost contribution, particularly for price-elastic products in highly competitive markets.
- Second, unlike the old cost coverages under the Postal Reorganization Act that served to fix the rates and contribution from a class, the competitive cost coverage under the new PAEA will set only the *minimum* contribution; the Postal Service will be free to charge *higher* rates that may generate greater

⁴ Compare section 3622(c)(2) of the PAEA *with* section 3622(c)(3) of S. 2468.

contributions, and it will have the incentive to do so (assuming it is able to raise rates in the face of competitors' prices).

- Third, as a matter of mathematics and prudence, a lower average cost coverage is essential to avoid an inadvertent upward spiral in rates due to any volume losses from high-contribution products such as Express and Priority Mail, a situation that could (1) easily precipitate a downward death spiral for all competitive products; and (2) tempt competitors to "game the system" by targeting the Postal Service's highest-contribution products by cutting their own rates knowing the Postal Service cannot match, and knowing that any diversion they capture will force the Postal Service to *raise* its rates to meet the mandatory average cost coverage requirement.
- And fourth, the Postal Service will need a margin of freedom below the current average coverage if it is to have any flexibility to respond to changing competitive marketplace conditions, particularly in light of its well-known need to invest in enhancement of its service offerings.

See Advo Reply Comments, May 7, 2007, at 15-19.

Although our reply comments to the Commission's first notice were filed more than a month prior to the due date for comments to the second notice, UPS in its June 18th filing chose not to address our above points. Instead, UPS just repeats its worn and irrational mantra that the Commission should ignore price elasticities in setting the cost coverage for price-elastic competitive products. UPS Comments at 14.

Issue 7 – Imputed Federal Income Tax

We agree with APWU, PSA, and the Postal Service that the imputed federal income tax on competitive products is not attributable. Income tax is calculated on the basis of net income, or the excess of revenues over total cost. That *total* cost includes not just attributable costs but also the overhead costs (i.e., the institutional costs) that the Commission requires be recovered by competitive products. In other words, the

Postal Service earns a profit on its competitive services only if its revenues exceed its attributable-plus-institutional costs.

Issue 8(c) – Attribution Of Retiree Health Benefits.

UPS, OCA, and Valpak argue that the annual PAEA retiree health benefit expense should be attributed in the manner that retiree health benefit premiums were attributed under the PRA. We disagree for the reasons presented in the comments of PSA, APWU and the Postal Service. The sunk cost of retiree health benefits is not attributable to any current mail volume, but current incurrence of retiree health benefits should be. Current rate payers should not and cannot be “attributed” costs caused by past rate payers.

Issue 9 – Definition of Separate Products Under Section 3633(a)

We agree with PSA, Pitney Bowes, the Postal Service and others that the individual subclasses should generally be considered “products” for purposes of implementing PAEA requirements. Thus, when NSAs, ICAs, and special classifications are variations of products already in an individual subclass, they should not be considered separate products. Consistent with this approach, when the Postal Service subdivides a subclass into two or more subclasses, each of those individual subclasses should be considered separate “products.” This interpretation is consistent with the Commission’s long-held criterion that a subclass should be based on relatively homogeneous cost and market characteristics. In contrast, the OCA’s expansive interpretation of “product” could lead to ridiculous results whereby every rate cell or rate category could be considered a separate product, contrary to any real-world understanding of the term.

III. POSTAL SERVICE CLASSIFICATION AUTHORITY.

On June 19th, the Postal Service filed supplemental comments on the classification process, explaining the necessary nexus between rate and classification flexibility, and proposing a framework for assessing classification changes under the PAEA. We concur with the Postal Service's position on this matter. We believe that Postal Service flexibility with respect to classification of its market-dominant products is critical to its ability to develop efficient pricing and to respond to the changing marketplace.

Respectfully submitted,

John M. Burzio
Thomas W. McLaughlin
Burzio McLaughlin & Keegan
1054 31st Street, N.W., Suite 540
Washington, D.C. 20007-4403
(202) 965-4555; Fax (202) 965-4432
burziomclaughlin@covad.net

Counsel for ADVO, Inc.

July 3, 2007