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Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Regulations Establishing System of Ratemaking	))	Docket No. RM2007-1

OFFICE OF THE CONSUMER ADVOCATE REPLY COMMENTS IN RESPONSE TO SECOND ADVANCE NOTICE OF PROPOSED RULEMAKING ON REGULATIONS ESTABLISHING A SYSTEM OF RATEMAKING
(July 3, 2007)

The Office of the Consumer Advocate ("OCA") hereby replies to comments filed on June 18, 2007, in response to the Commission's "Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking" pursuant to provisions of the Postal Accountability and Enforcement Act ("PAEA").[1] Reply comments are due July 3, 2007. The Postal Service filed Supplemental Comments on the Classification Process on June 19, 2007.[2] OCA is today filing a separate response to that supplemental filing.[3]

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[1] "Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," Order No. 15, May 17, 2007.

[2] "Supplemental Comments of the United States Postal Service on the Classification Process," June 19, 2007.

[3] "Office of the Consumer Advocate Comments in Response to Supplemental Comments of the United States Postal Service on the Classification Process."

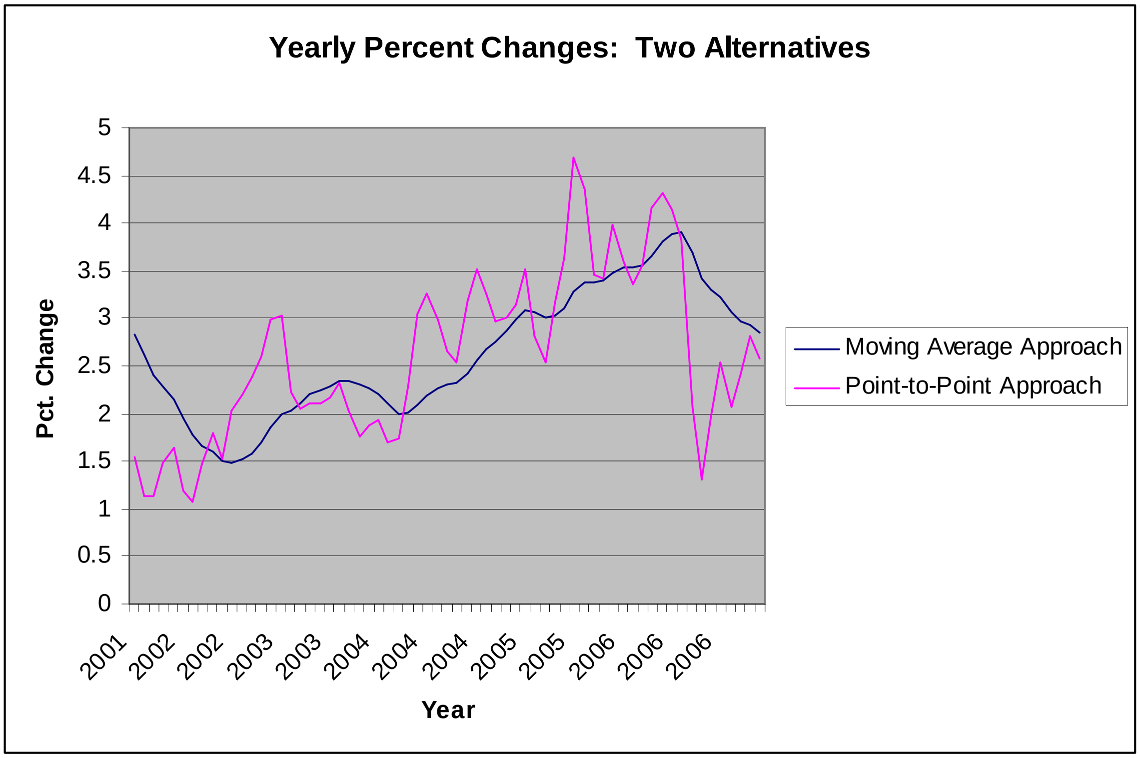
Question 1—Reply Comment.

Comments on the choice between a moving average method versus a point-to-point method in applying the CPI for price escalation contend that the moving average approach provided enhanced rate predictability and stability. In contrast, it is recognized that the point-to-point approach results in rates that are more current than is the case for the moving average approach.

> Respondents in favor of the moving average approach included ADVO, the Greeting Card Association, the Newspaper Association of America, Pitney Bowes, and Postcom.
>
> Respondents in favor of the point-to-point approach included the American Postal Workers Union, the OCA, the Postal Service, and Valpak.

The following graph shows the differences between the two alternative price escalation options over the time period between 2001 and 2007:

> the point-to-point approach computes percent change in the CPI over a 12 month time period;
>
> the moving average approach compares the percent change in the average CPI over a 12 month time period, with the average CPI over the previous 12 months.



As ADVO indicated:[4]

> Either method would be compatible with the language of the statute.
>
> …Over the long run, if the Postal Service implements annual increases the same month each year, either approach will "even out" over time, producing much the same overall results, although the point-to-point approach would have greater year-to-year variabilities, up and down.

The month-to-month approach is, however, more current than the moving-average approach. It provides for rates based on more recent cost data than is the case for the moving-average approach. Accordingly, there is a closer match of costs and rates than with the moving-average approach. The moving-average approach

[4] Comments of ADVO, Inc. in "Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," Docket No. RM2007-1, at 2.

results in rates which are only slightly more predictable and stable. This is due to the inherently greater stability of a 12 month average of data. Fluctuations in escalation factors will clearly be less, as is easily recognized from the above graph.

Differences in rates resulting from the implementation of the two approaches can be analyzed. The tables below assume that new rates are effective in January of a given year, based on the value of the CPI in the previous September and available in mid October of the year. The values of the two alternative escalators as of September of the relevant year are shown for the years 2002-2006. To simulate how the escalators would impact a company using the two escalation approaches, a number of hypothetical cases were developed. Common to all cases is the assumption that higher rates become effective in January based on the previous September's CPI and that the business under consideration has sales of $73 billion, all of which are subject to escalation. The cases illustrate what total revenue would have been in successive years if the inflationary patterns present during 1999-2007 were used to simulate price escalation.

Table 1 presents the CPI as of September of the given year as well as the percent change from the previous time period and the escalation factor (1 plus the percent change converted to a decimal) computed in the two alternative ways.

Column1: The year under consideration.

Column 2: The CPI value reported as of September of the year under consideration.

Column 3: Percent increase in the CPI between September of the given year and September of the previous year. For the year 2003, this is computed as (185.2-181)/181.[5]

Column 4: Computed as 1 plus .01*value in Column 3.

Column 5: CPI Moving Average: Value of the CPI in September of a given year, based on the average of the current and previous 11 months.

Column 6: Percent increase in the 12 month average CPI between September of the given year and September of the previous year. For the year 2003, this is computed as (183.1-178.9)/178.9.

Column 7: Computed as 1 plus .01*value in Column 6.

Table 1

Col 1 Year	Col 2 September CPI	Col 3 Pct Increase 12-Mo P toP	Col 4 Escalation Multiplier Pt. to Pt	Col 5 September CPI Moving Avg	Col 6 Pct Increase Moving Avg	Col 7 Escalation Multiplier Moving Avg
2000	173.7			170.8		
2001	178.3	2.648	1.026	176.3	3.221	1.032
2002	181	1.514	1.015	178.9	1.499	1.015
2003	185.2	2.320	1.023	183.1	2.348	1.023
2004	189.9	2.538	1.025	187.4	2.321	1.023
2005	198.8	4.687	1.047	193.5	3.287	1.033
2006	202.9	2.062	1.021	200.6	3.682	1.037

Table 2 shows the revenue resulting from the escalation process for the hypothetical $73 billion business on the assumption that escalation starts in various years under the two alternative escalation proposals: the point-to-point and the moving average:

5 The numbers in Table 1 are reported on a rounded basis, obtained from a spreadsheet; accordingly, using the rounded data in Table 1 will not exactly replicate the results reported in Table 1 due to rounding errors.

- Case A: $73 billion business in year 2000, with subsequent escalation.
- Case B: $73 billion business in year 2001, with subsequent escalation.
- Case C: $73 billion business in year 2002, with subsequent escalation
- Case D: $73 billion business in year 2003, with subsequent escalation

Table 2

Year	Case A Pt to Pt	Case A Moving Avg	Case B Pt to Pt	Case B Moving Avg	Case C Pt to Pt	Case C Moving Avg	Case D Pt to Pt	Case D Moving Avg
	73.000	73.000						
2001	74.933	75.351	73.000	73.000				
2002	76.068	76.481	74.105	74.094	73.000	73.000		
2003	77.833	78.276	75.825	75.834	74.694	74.714	73.000	73.000
2004	79.808	80.093	77.749	77.594	76.590	76.448	74.853	74.694
2005	83.549	82.726	81.393	80.144	80.179	78.961	78.361	77.150
2006	85.272	85.772	83.072	83.095	81.833	81.868	79.977	79.990

In general, it appears that the 12 month moving average approach is slightly more favorable to the Postal Service in Case A, providing a slightly higher level of revenue in comparison to the point-to-point approach. However, in Cases B through D the differences in revenue resulting from the case alternatives are less pronounced. In some years the point-to-point revenue is higher than the other approach, but in other years the revenue is lower using the point-to-point method. Yet, in all four cases, the revenue is lower at the end of the period in 2006 using the point-to-point method. In general, with some exceptions, differences are well under one percent.

Accordingly, OCA concludes that implementation of the point-to-point approach does not result in significantly less rate stability and predictability. The concerns expressed by a number of parties in opposition to the point-to-point approach are of minimal importance. However, the point-to-point approach has a significant advantage, given that rates set using the approach will be more current in reflecting underlying cost trends than would be the case using the moving average approach.

Question 6(h)—Reply Comment.

In commenting on 6(h), the Postal Service addresses the minimum rate of return or level of profit from competitive products, indicating that:[6]

> 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 financial sound investment decisions.

In its initial filing, the OCA concluded on the basis of established economic theory that the selection of a set of companies comparable to the Postal Service in terms of functions, markets, and risks (denoted as "comps") could be used in determining the appropriate capital structure and rate of return that should be ascribed to the Postal Service's competitive products.

Market competition and market forces, not boards of directors or governors, determines the level of profit from products. The selection of a set of comps and subsequent data analysis provides conclusive evidence of market based rates of return, capital structure, and other economic results. Given that the Postal Service's facilities, activities, and network are not clearly delineated between competitive and market dominant products, it is necessary to look to the results of the comps in order to determine a competitive level of profit and capital structure. Any level of profit in competitive products below the market-based level could potentially indicate cross-subsidization between market-dominant and competitive products.

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[6] "Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking," Docket No. RM2007-1, at 27.

Additionally, it is not clear that the Postal Service does, in fact, have "clear incentives to set profitability targets and make financial sound investment decisions," given the potential for market cross-subsidization. To the degree that market-dominant power can be used to subsidize competitive services, however, there is the possibility of cross-subsidization and the generation of an inadequate return for competitive products. Accordingly, the expectation that the Postal Service's competitive products should yield a market-based rate of return is consistent with the economic concept that businesses earn a return on capital equal to the cost of capital adjusted for risk.

Given that rate increases will be held to changes in the CPI, the Postal Service will have increased incentive for cost control. However, over the past 30 years, rate increases have approximated the CPI, so the degree of increased financial incentive is not clear. Accordingly, OCA believes that the Commission will need to specify a minimum, market-based rate of return on competitive products.

Question 8(c)—Reply Comment. Retiree Health Benefit Costs Should be Classified According to the Weighted Average Attributable Costs of All Labor.

The Postal Service argues that attributing Retiree Health Benefit costs based upon the payment schedule, as done in the past, may over-attribute costs.[7] Therefore, the USPS recommends that actuarial cost methods should be put in place to attribute the retirement-related costs, and ensure that there is causality between the attribution of these costs.[8] The Postal Service's argument is unconvincing.

OCA agrees with VALPAK's argument confirming the need to continue to allocate retiree health benefits to the same extent as the underlying labor costs. Retiree Health benefits are linked to direct labor costs and thus meet the requirements of the Act.[9]

> It is the direct labor costs associated with the processing and delivering of various categories of mail and special services that caused retiree health benefits to be incurred. The fact that the accounting systems recognized these costs some years later as actual payment is required does not break the link of causation.[10]

VALPAK's correctly points out that the Postal Service's proposal will not fairly and equitably attribute Retiree Health Benefit costs:

> If retiree health benefit costs are treated as institutional, mailers of products which pay little markup will escape virtually all payment of these labor benefit costs even though it was their mail which caused the costs to be incurred, not just the mail on which higher markups are imposed.[11]

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[7] "Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking," June 18, 2007, at 29.

[8] *Id*., at 30.

[9] *See* 39 U.S.C. § 3622(c)(2), and § 3631(b).

[10] "VALPAK Direct Marketing Systems, Inc. and VALPAK Dealers' Association, Inc. Comments on Regulations Establishing a System of Ratemaking in Response to Commission Order No. 15," June 18, 2007, at 16.

[11] *Id*., at 17.

As VALPAK explained, the Commission fortuitously addressed how it would handle changes to Retirement Health Benefits in its Docket No. R2005-1 Opinion and Recommended Decision:

> At some future time, Congress could specify that the escrow funds be used to fund Retiree Health Premium costs. In that case, the costs would be attributable to all mail according to the weighted average attributable costs of all labor. [12]

[12] Docket No. R2005-1, PRC Op., at 52, para. 4027.

Question 9—Reply Comment.

The Postal Service "believes that 'product' is appropriately defined at the level equivalent to the current subclasses of mail."[13] This equivalence is logically impossible. The current subclasses of mail exhibit significant cost *and* demand differences from other subclasses. Products are defined in the PAEA as groupings of mail that exhibit cost *or* demand differences sufficient to warrant separate rates. Thus, any subdivision of a subclass based on cost differences—such as a presort discount category—meets the definition of a product. Only if a subclass had no subdivisions would it meet the definition of a product.

The documentation previously filed by the Postal Service to support NSA rate classification filings provides ample evidence that each NSA exhibits distinct cost characteristics. As required by the Commission's Rules,[14] the Postal Service's documentation to support each NSA relies on cost characteristics distinct to the mailer co-proponent. To the extent that an NSA relies solely on cost differences, it falls within the definition of product.

With respect to demand characteristics, it should be noted that in Docket No. MC95-1, the Commission rejected the Postal Service's proposed establishment of separate Automation and Retail subclasses because of a

> lack [of] the kinds of evidentiary support that the Commission has traditionally required for the establishment of new subclasses. This is particularly true in the area of demand differences, where there is no

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[13] "Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking," June 18, 2007, at 31.

[14] *See* 39 CFR §3001.193(e)(1)(i), (ii), and (iv).

> empirical evidence to indicate distinct differences in demand for the Automation subclass versus the Retail subclass. [Footnote omitted][15]

Thus, based upon the Commission's policy that requires a showing of significant cost *and* market demand characteristics, NSAs, being a subset of a subclass such as First-Class Mail, cannot demonstrate cost *and* market demand characteristics so as to warrant subclass treatment.

With respect to ICMAs, to the extent such agreements are based solely on prices or terms that recognize distinct demand characteristics, they would constitute a "product" pursuant to §102(6).[16]

Wherefore, OCA respectfully submits these reply comments to Order No. 15 and asks that they be considered by the Commission.

Respectfully submitted,

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15 PRC Op. MC95-1, Para. 5030.

16 In Docket No. MC2006-3, additional institutional contribution from the proposed NSA with Washington Mutual was to be derived from increased volume owing to Washington Mutual's distinct market demand characteristics.