Postal Regulatory Commission
Submitted 7/3/2007 3:42:00 pm
Filing ID: 56971
Accepted 7/3/2007

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

REGULATIONS ESTABLISHING SYSTEM OF RATEMAKING) Docket No. RM2007-1

VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. REPLY COMMENTS ON REGULATIONS ESTABLISHING A SYSTEM OF RATEMAKING IN RESPONSE TO COMMISSION ORDER NO. 15
(July 3, 2007)

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (hereinafter "Valpak"), pursuant to Commission Order No. 15 (Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking), issued May 17, 2007, submit this reply to comments filed on June 18, 2007 by various parties.[1]

I. CONFLICTS EXIST UNDER PAEA BETWEEN PRICING FLEXIBILITY, ON THE ONE HAND, AND PREDICTABILITY AND STABILITY, ON THE OTHER

The Commission requested all parties to discuss how the "point-to-point" method and 12-month-moving-average method for computing changes in the CPI "conform[] 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)." Order No. 15, p. 4. In response, several parties evaluated the two methods in terms of the statutory objective of creating "**predictability** and **stability** in rates."[2] 39 U.S.C. § 3622(b)(2) (emphasis added). Several

---

[1] The Supplemental Comments of the United States Postal Service on the Classification Process, filed on June 19, 2007, will be responded to by Valpak at a later date.

[2] *See* Initial Comments of the American Postal Workers Union, AFL-CIO, in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a

parties also discussed the factor that requires that the system observe "the importance of pricing **flexibility** to encourage increased mail volume and operational efficiency" (39 U.S.C. § 3622(c)(7)) as well as the objective that the system "allow the Postal Service pricing **flexibility**."[3] 39 U.S.C. § 3622(b)(4) (emphasis added).

The PAEA statute does not define "flexibility." When there is no statutory definition for a word or phrase, the words in a statute are presumed to have their usual and ordinary meaning, or their ordinary meaning within the statutory context.[4] One dictionary definition of "flexible" is "susceptible of modification or adaptation; adaptable; *a flexible schedule*."[5] Of the various dictionary definitions provided, this would appear to be the one most applicable to the modern postal ratemaking system envisioned by PAEA. With respect to such a modern ratemaking system, "flexibility" can be seen to involve at least two dimensions: (1) the timing of rate changes, and (2) the amount by which rates are changed. Valpak addressed the first

---

System of Ratemaking, p. 2; Comments of Advo, Inc. in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, p. 2; Comments of the Greeting Card Association in Response to Second Advance Notice of Proposed Rulemaking, p. 2; Comments of the Newspaper Association of America on Second Advance Notice of Proposed Rulemaking, p. 2; Initial Comments of Pitney Bowes Inc. in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, p. 2; Comments of PostCom in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, p. 3.

[3] *See* APWU Initial Comments, p. 2; Response of the Mail Order Association of America to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking (Issued May 17, 2007), pp. 2-3; Pitney Bowes Initial Comments p. 3; and PostCom Initial Comments, pp. 5-6.

[4] *See* Perrin v. United States, 444 U.S. 37, 42 (1979); Burns v. Acala, 420 U.S. 575, 580-81 (1975).

[5] Random House College Dictionary. Other definitions pertain to (i) capability of being bent, and (ii) willingness to yield, as *a flexible personality*.

dimension in its initial comments, pointing out that a rigid requirement to implement rate changes at the same time each year is the antithesis of flexible scheduling, and that any system which reduced the time necessary for the Postal Service to change rates from the current 12 months would, by definition, meet the standard of increased flexibility. *See* Valpak Initial Comments, p. 2. In these comments, Valpak addresses the second aspect, flexibility with respect to the amount by which individual rates are changed within the rate cap.

Regardless of whether the rate cap is based on the point-to-point method proposed by the Postal Service, or the 12-month-moving-average method as suggested by the Commission in Order No. 15, once increases in CPI have occurred, then under either method the Postal Service will be allowed to increase rates.[6] Within the confines of the rate cap, however arrived at, pricing flexibility within each class of mail means that the Postal Service has considerable discretion as regards individual rates — so long as the weighted average increase does not exceed the rate cap.

Although an across-the-board rate increase for all mail rates in a class exactly equal to the rate cap is conceivable, such an increase would not seem to constitute an exercise in pricing flexibility as envisioned either by section 3622(c)(7) or by section 3622(b)(4). Nor would a **series** of annual across-the-board increases be anticipated. Pricing flexibility means, for example, that, if the cap were determined to be 2 percent, then within a class of mail the Postal Service could:

---

[6] As several parties have noted, over time, the cumulative increase will be the same under either method — the principal difference being the amount of increase in any given year.

(i) increase rates by 40 percent for 5 percent of the mail within the class, and not change any other rates within the class; or

(ii) increase rates by 8 percent for 25 percent of the mail within the class, and not change any other rates within the class; or

(iii) increase rates by 4 percent for 50 percent of the mail within the class, and not change any other rates within the class.

Of course, an infinite number of other possibilities also exist. However, these examples serve to illustrate how pricing flexibility could be exercised, and what might be expected from the two pricing flexibility provisions. Moreover, since the Postal Service now is expected to live within the cap (except in exigent circumstances) **and make a profit**, for selected products and categories the Postal Service could be motivated to use pricing flexibility to effect rate changes of disparate magnitude. This is especially so for any product or category within a class that makes little or no contribution to overhead, or that does not even cover its attributable costs.[7] Indeed, this disparate result is sanctioned and even anticipated by 3622(b)(8) ("changes of unequal magnitude").

Interestingly, no party has recognized that pricing flexibility can be at direct odds with both "predictability" and "stability." However, allowing the Postal Service to alter the time of the year when rate changes are put into effect would make timing of rate changes less predictable, while not permitting any leeway in timing would eliminate one aspect of

---

[7] The profit motivation embodied in PAEA creates a situation where, from the viewpoint of increasing profitability, the Postal Service clearly would be better off without all volume whose revenues fail to cover attributable costs, and likely would scarcely miss any volume that makes only a *de minimis* contribution in excess of attributable costs.

flexibility. Similarly, whenever some rates within a class are increased by a large magnitude in comparison to the rate cap, those mailers subject to the higher rates are unlikely to consider themselves to have received either "rate stability" or a "predictable" rate increase, regardless of whether the cap was determined by a 12-month moving average method or the point-to-point method. Thus, when deciding on a method for determining the rate cap under the new, modern ratemaking system, the Commission should be cognizant that exercise of pricing flexibility may create differential rate changes that far exceed any differences between the point-to-point and 12-month-moving-average methods of determining the rate cap. The Commission also should be cognizant that under PAEA the exercise of pricing flexibility can reduce predictability and stability for mailers. If a mailer asserts that the primary goal of PAEA is pricing flexibility and that all other factors are secondary, that mailer necessarily is saying that PAEA had little or no concern for the predictability and stability of rates — which is not the case. *See* 39 U.S.C. § 3622(b)(2). Clearly, pricing flexibility cannot have the paramount role some seek to give it.

II. THE NATIONAL POSTAL POLICY COUNCIL PROVIDES IMPORTANT OBSERVATIONS ON COMPETITION, WORKSHARING, AND EFFICIENCY.

The Comments of National Postal Policy Council ("NPPC") in Response to Further Advance Notice of Proposed Rulemaking (Order No. 15) describe question 3, "how should the Commission best promote competition for the products that the Postal Service offers?" as "one of the most important issues … under the" new law. NPPC Initial Comments, p. 1. NPPC states that "'worksharing' is a form of competition," that "promoting effective competition … requires full pass-through of worksharing-related cost avoidances," and that "the Commission should establish safeguards to ensure that the Postal Service does not leverage its remaining market power to impair competition…." *Id.*, pp. 2-3. NPPC believes it is far from certain that the cap alone will restrain the Postal Service from using any new pricing powers to jeopardize competition to the Postal Service. NPPC raises important concerns relating to what a "modern ratemaking system" would do to ensure the nation enjoys efficient postal services. A monopoly with a profit maximization motive, even constrained by a cap, could price its goods in a way that abuses that monopoly power so as to frustrate real competition and jeopardize the gains achieved by worksharing.

Rate differences can be established to achieve a number of objectives, including, fairness, efficient resource allocation, proper signals to mailers, and maintaining the competitive posture of the Postal Service, as well as market and demand factors. Although some rate differences are matters of worksharing, many are not. NPPC points out that rate differences associated with acceptance methods, postage purchase options, and mailpiece shape are not matters of worksharing under 39 U.S.C. section 3622(e)(1). Similarly, Valpak's

Initial Comments (pp. 9-10), *inter alia*, observed that destination-entry rates apply without regard to worksharing.

The destination entry of mail illustrates that some things which might appear to some to be worksharing are not. For discussion proposes, assume that "nationwide" mail has an average haul of 1,200 miles (on long-haul, cost segment 14 transportation) and that mail entered in a destination SCF has an average haul of zero. This means that if 100 percent of the cost difference is recognized in rates, mailers entering mail at a destination SCF receive what is in effect a 1,200-mile discount, regardless of how far they have transported their mail. Putting aside the real possibility that some mailers might choose to print and enter mail near a destination facility, this rate arrangement means that mailers 300 miles away from a destination facility would get a 1,200-mile discount for driving 300 miles. Clearly, when offered the same discount, those mailers 300 miles away from a destination facility would be much more likely to dropship than mailers 2,500 miles away. Given this imbalance, one would expect the average haul of the mailers who dropship (even excluding mailers who reside near the destination facility) to be far below 1,200 miles. Thus, the avoided unit cost due to dropshipping would be far below the 1,200-mile discount.

Under the conditions just described, which relate directly to the situation that now exists, identifying the destination-entry rates as matters of worksharing would be illogical and counterproductive for several reasons.

> (1) Some mail is entered in a destination facility because the mailer and the associated printing operation are located near the destination facility. No worksharing is involved with this mail, and it deserves a rate based on its costs without any artificial limitation.

(2) Some mail is entered in a destination facility because the mailer chooses to print the mail near that facility. This decision by the mailer is an appropriate, efficient response to cost-based rates — not a matter of dropshipping or worksharing. The notion of an avoidance does not apply.

(3) If the Postal Service under PAEA is to be competitive with private delivery operations, all of which would willingly accept mail near the delivery points, it **must** price destination-entered mail based on its costs, which does not occur if a discount is based on a low estimate of cost avoidance.

(4) If the rates for mail entered at a destination facility are to be based fairly on costs, it is essential to maintain the perspective that has led to the 1,200-mile rate difference discussed above, regardless of whether it is called a discount. To do otherwise would be to discriminate against local mailers who are doing nothing more than seeking reasonable rates to reach their neighbors.

The Commission needs to exercise the authority it is given in the statute (39 U.S.C. § 3622(e)(1)) to determine that destination-entry rates are not a simple matter of worksharing. They are, instead, a component of the broader assignment of developing rates that are fairly aligned with accepted ratesetting principles.

In the context of the concepts involved and their interrelationships, the provisions relating to worksharing need to be addressed carefully. In doing this, the Commission must exercise extreme care, lest the clock be turned back on the efficiency of the rates that are now in place.

III. IN THE CALCULATION OF A PRICE INDEX FOR A CLASS OF MAIL, CHANGES IN THE STRUCTURE OF RATES CAN BE ACCOMMODATED, BUT THE PROCEDURE FOR DOING SO SUGGESTED BY POSTCOM'S INITIAL COMMENTS IS UNSUPPORTABLE.

In question 2 of Order No. 15, the Commission asked for comments on a method of developing a price index for a class of mail, involving the development of a Laspeyres index, as suggested by the Postal Service in Appendix C of its Reply Comments to Order No. 2. The Commission concluded: "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." (Order No. 15, p. 5.)

The Initial Comments of Alliance of Nonprofit Mailers and Magazine Publishers of America, Inc. on Further Advance Notice of Proposed Rulemaking (Order No. 15) ("ANM/MPA") state that:

> when the Postal Service makes structural changes to a rate design and thus has no billing determinant data that matches the altered rate design, the volume weights used … [in the price index] should be based on a mail characteristics study … [just as was done] by the Commission to determine Test Year After Rates revenue for the Periodicals Outside County subclass in Docket No. R2006-1. [ANM/MPA Initial Comments, p. 2.]

Commission workpapers in Docket No. R2006-1 show (i) calculation of its Laspeyres price index for the new Periodicals rate structure in PRC-LR-2, file FWI1_R06PRCLR2.xls, sheet 'REG_PRC', (ii) the associated before-rates revenue in PRC-LR-14, file PRC-Outside County.xls, sheet 'tybr-4', and (iii) after-rates revenue on sheet 'tyar-1' of the latter file. In fact, the Commission has relied many times on mail characteristics studies and no difficulties have been encountered. The resulting price index is the one that theory suggests should be developed, as appropriate to the situation at hand.

PostCom asserts, however, that:

> the Commission has … unnecessarily complicated the proposed methodology by suggesting that the historic, fixed weight methods will not work in cases where the annual rate adjustment is accompanied by "altered rate design." PostCom strenuously maintains that the impact of a change in rate design is to be considered only in the context of an annual compliance audit or a complaint in the year following the change, at which time billing determinants for the new or altered rate design will be available. [PostCom Initial Comments, p. 2.]

PostCom adds that the Commission has "gone astray" by even asking such a question, and states that the question of "compliance with the CPI cap must be addressed retrospectively, once billing determinant information becomes available, in the annual compliance audit or in response to complaints that may be filed." *Id.*, p. 5. We do not read the Commission's question to have "suggest[ed] that the historic, fixed weight methods will not work in cases … [of] 'altered rate designs.'" Moreover, as explained below, PostCom's argument is flawed and should be rejected.

1. The approach PostCom suggests easily could have consequences that are anathema to a price cap regime. For example, the Postal Service could restructure rates for a subclass and impose on mailers, say, a rate increase (under the Laspeyres formula) of 50 percent, when the CPI cap is just 3 percent. Then, when PostCom's "retrospective[]" review showed a rate increase of 48 percent, an immediate rate reduction in the neighborhood of 45 percentage

points would be needed.[8] An approach that would allow an outcome such as this to occur should be rejected on its face. It might be argued that the Postal Service would hesitate to implement rate increases as large as 50 percent, but, without information from a mail characteristics study, as suggested by ANM/MPA, there would be no way to know *a priori* how large the rate increase would be.

2. Timing difficulties are associated with PostCom's approach. Suppose that on October 1, 2007, the Postal Service sought a rate increase that would be implemented on April 1, 2008. Suppose also that the Postal Service succeeded in developing quarterly billing determinants. On October 1, 2008, the Postal Service would notify the Commission that it is seeking another rate increase to be implemented on April 1, 2009. On January 1, 2009, the Postal Service would file information to allow an annual compliance audit for FY 2008, a period containing two sets of rates,[9] and the file would include billing determinants for quarters 3 and 4 under the new rates. At this point, an argument of some merit could be made that concerns over seasonality effects render these billing determinants unsuitable for

---

[8] Presumably, in its retrospective review, PostCom would use a Paasche index, which would require sufficient retrospective information to apply the old rate structure (and rates) as well as the new. PostCom refers on page 5, for example, to the "average revenue per piece at the class level" under the new rate design. In any case, the rate increase under a Paasche index would be expected to be lower than the rate increase under a Laspeyres index. Accordingly, the example in the text refers to increases of 48 percent and 50 percent. A second-order effect of a Paasche scheme, then, would be increased revenue for the Postal Service.

[9] The annual review will have to focus on a period during which at least two sets of rates were in effect, which would be troublesome enough by itself. And, as quantified by lags in demand models traditionally used by the Commission, any adjustment by mailers to the new rates will not be complete. This will be true *a fortiori* under a change in rate structure.

construction of a price index, particularly if mailers are still adjusting to a change in rate structure. But if the billing determinants were used anyhow, and agreement on implications of the findings were reached on, say, February 1, 2009, the rates previously filed for implementation on April 1, 2009 would need to be adjusted. Then, on July 1, 2009, a full year of billing determinants for the rates implemented on April 1, 2008 would become available, allowing additional checks for compliance with the cap. If a simpler alternative were available, and one is, one could not be faulted for wanting to avoid such a chain of developments.

3. Assuming that the Postal Service could provide billing determinant data under the old rates, but not provide mail characteristics data, PostCom comments:

> At the time a new rate design is proposed, there is obviously no volume data to determine the effects of the new rate design on historic volumes or average revenue per piece at the class level. [PostCom Initial Comments, p. 5.]

But no theoretical or practical reason exists for even **wanting** to determine *a priori* "the effects of the new rate design on historic volumes…." PostCom perceives a non-existent problem. The notion of a price cap coupled with a Laspeyres index is that the price index is calculated using historic volumes as weights, and mailers have total freedom to adjust to the new rates according to their preferences. As mailers adjust, the expectation is for increases in efficiency of the postal sector, but no information about the nature of this adjustment would be helpful in ratesetting. This would be the case even if estimating mailer responses were easy, which it is not.

4. In addition, PostCom explains:

> Thus, any attempt by the Commission to assess the effects of a change in rate design at the time that the change is proposed will entail a re-introduction of the old cost of service methods that the Commission has used under the Postal Reorganization Act, including the attempt to establish a test year, the reintroduction of roll-forwards and volume and revenue forecasts, and all of the uncertainty, controversy and confusion that these methods entail. [PostCom Initial Comments, p. 5.]

This argument misstates what is involved. Using a mail characteristics study to estimate volumes appropriate to a new rate structure, before any adjustment by mailers to the new rates, does not involve any costs of any kind, and certainly no costs of service. Nor is a "cost of service method[]" or a "test year" or a "roll-forward[]" involved. The specter of terror that PostCom sees does not exist.

5. One fundamental benefit from the use of price caps is that calculation of the price index is based on what mailers are doing before the price change. Under this approach, the Postal Service has a financial incentive to seek economically efficient rates. Then mailers adjust to these new rates. Each such adjustment is a gain in efficiency. For example, a mailer might shift to a lower rate and come out ahead financially, even if making the change requires the mailer to incur some cost. If volumes resulting from the new rates were used to calculate the price index, in some retrospective scheme as PostCom apparently contemplates, some of these efficiency benefits would be lost. This should not be allowed to happen. In effect, even if one waited until the new billing determinants were available, it is the old billing determinants, aligned with the new rate structure, that should be used in the price index.

For all of the above reasons, PostCom's suggestion should be rejected. It not only is unworkable, but also is incorrect theoretically. The Postal Service should supply billing determinants aligned with the new rate structure, through a mail characteristics study if needed, and the price index should be calculated *ex ante*. This approach has been used effectively in the past and it can be used effectively in the future.

Respectfully submitted,

William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.