

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

REGULATIONS ESTABLISHING SYSTEM
OF RATEMAKING

Docket No. RM2007-1

REPLY COMMENTS OF THE UNITED STATES POSTAL SERVICE ON THE
SECOND ADVANCE NOTICE OF PROPOSED RULEMAKING
(July 3, 2007)

On May 17, 2007, the Commission issued a Second Advance Notice of Proposed Rulemaking in this docket (Order No. 15), soliciting responses to nine sets of questions concerning the implementation of the pricing provisions of the Postal Accountability and Enhancement Act (PAEA, or Act). Over twenty parties, including the Postal Service, filed initial comments in response on June 18, 2007. The Postal Service hereby submits its Reply Comments. The Postal Service first replies to specific comments made by other parties in their initial comments on the Second Advance Notice.¹ The Postal Service then concludes by briefly summarizing some of the primary themes it has set forth in this docket, since the Commission has indicated that it expects to issue proposed rules following this round of comments.²

¹ The Postal Service's failure to reply to a specific statement made by another party does not necessarily represent endorsement of that statement. In addition, the Postal Service has not responded to several parties who have addressed matters not at issue in this proceeding. This includes the comments of the NAHB, which allege that the Postal Service's policies concerning centralized delivery violate various provisions of title 39, and the comments of *The Nation*, which disapprove of the Periodicals rates recommended by the Commission and approved by the Governors in Docket No. R2006-1. Finally, as discussed in more detail later in these comments, the Postal Service has not responded to specific proposals to improve the attribution of costs in specific cost components, or to change the methodology used to calculate workshare discounts. Such technical issues should be dealt with in separate proceedings (such as the proceeding to implement the Annual Compliance Review process), rather than in this proceeding.

² Order No. 15 at 2.

I. Market-Dominant Products

A. The Price Cap Calculation

No party has opposed the Postal Service's proposal to use historic volumes for calculating compliance with the price cap by suggesting that forecasted volumes be used instead. Some parties have, however, made suggestions concerning the cap compliance calculation that the Postal Service respectfully submits are inadvisable.

1. The Commission should use a constant mail mix assumption when calculating the cap

The use of a "constant mail mix" facilitates the cap compliance calculation and mitigates potential difficulties in projecting changes in mail mix based on elasticities, forecasts, or other projections about the reaction of the marketplace to a change in price structures. ANM/MPA suggest an "exception...to the general rule" when changes to mail preparation requirements have "significant rate implications."³ In the Postal Service's view, however, there is a compelling need to maintain a constant mail mix, and the ANM/MPA example of changes in mail preparation requirements causing mail to shift between presort categories should not precipitate a deviation from that principle.

The ANM/MPA recommendation fails to place the Commission's choice in context. Clearly, a constant mail mix rule might have potential advantages or disadvantages when viewed through the lens of an individual party. It is not difficult to conceive of circumstances in which assuming a constant mail mix would be in one party's interest (perhaps a user of a mail product) if it kept prices lower, while being against the interests of another party (perhaps a competitor of that user). A constant mail mix assumption allows the Commission to adopt a pricing mechanism that

³ See ANM/MPA Comments on Second Advance Notice at 1-3.

simplifies the determination of cap compliance and reduces the reliance on forecasts. Basing cap compliance on anything other than a “constant mail mix” would invite contentious litigation and would be inconsistent with the need for a transparent, predictable price cap mechanism.

There is instead a simple way to deal with the situation discussed by ANM/MPA that does not violate the constant mix approach. Specifically, when some existing mail shifts from one category to a second category due to changes in mail preparation requirements, the solution is to create three volume groupings: (1) volume that starts in the first category and stays there, (2) volume that starts in the first category and shifts to the second category, and (3) volume that starts in the second category and stays there. When applying prices to these three groupings, volume in the first grouping is always charged the price applicable to the first category, volume in the third grouping is always charged the price applicable to the second category, and volume in the second grouping is charged the price applicable to the first category under existing rates, but the price applicable to the second category under the proposed rates. Such a process achieves the exact same objective sought by ANM/MPA – a fair process for the evaluation of compliance with the cap – but avoids the troubling prospect of allowing the volume weights to vary. The volume of each grouping remains the same at either set of prices. The identification of the contents of the three groupings in this example would constitute an illustration of an “adjustment” to historical billing determinants of the type discussed in the Postal Service’s Initial Comments on Question 2 of the Second Advance Notice.⁴ In practical terms, it requires the availability of no further inputs

⁴ See Postal Service Initial Comments on Second Advance Notice at 9-10.

beyond those that would be required by the alternative approach advocated by ANM/MPA, and the computations are essentially equivalent.

2. Some clarification of the Postal Service's proposal is needed with respect to calculating the cap for restructured rate designs and new products or services

Based on the comments of other parties, some specific elements of the Postal Service's cap compliance proposal with respect to new price structures and new products and services may require clarification. First, if new price structures are created for existing mail characteristics, volumes would be allocated to these new structures based on mail characteristics studies, other data, or the best available information or judgment.⁵ This would occur when the mail characteristic existed within the historical mail stream but that characteristic was not previously used in rate calculation (*e.g.*, when basic automation rates were deaveraged into mixed-AADC and AADC rates). Advo and APWU both support this approach.⁶ Thus, PostCom's argument that determining cap compliance for an altered rate design should be done retrospectively is unfounded, since there is a sensible way to calculate compliance for new rate structures by the use of historical volumes, without the need for forecasts and rollforwards.⁷

Second, if a completely new product or service is created, the volume weight for the purposes of the cap compliance calculation would be zero, because no historical volume with those mail characteristics would exist. Advo and Pitney Bowes both

⁵ See *id.* at 7-10.

⁶ See Advo Comments on Second Advance Notice at 3-4; APWU Comments on Second Advance Notice at 4.

⁷ See PostCom Comments on Second Advance Notice at 5. PostCom's fears are not only unfounded, but would exclude any altered rate design from the cap compliance calculation pursuant to § 3622(d)(1)(C). Thus, under certain circumstances, large portions of a class could be excluded from the cap compliance calculation. Consider, for example, the Docket No. R2006-1 proposal to establish shape-based rates in First-Class Mail. This affected virtually all mail within the First-Class Mail Letters and Sealed Parcels subclass because rates averaged across shape were deaveraged into a new rate design.

support this approach.⁸ Conversely, the OCA proposes that new products or services be priced “similar to the pricing of existing products”; that is, by determining its attributable costs and then assigning institutional costs based on past Commission practice.⁹ This approach, however, seeks to inappropriately maintain portions of the former, cost-focused, regime of the Postal Reorganization Act (PRA) in the new price cap structure established by the PAEA. Consistent with the principle of “pricing flexibility,” the Postal Service should be allowed to innovate and maintain the vitality of the mailstream through the introduction of new postal products and services. Adopting OCA’s proposal would seem inconsistent with the purposes and objectives underlying the Act, and with the division of responsibilities that the Act sets forth with respect to the Postal Service and the Commission.¹⁰

Finally, some of the comments of other parties may not fully reflect the data constraints faced by the Postal Service.¹¹ For example, ANM/MPA suggest that in calculating volume weights, any adjustments reflecting an altered rate structure should be based on a mail characteristics study for the same time period as the billing determinant data.¹² In an attempt to ensure that the most recent billing determinant data is used, the Postal Service commits to developing quarterly billing determinants approximately two months following the end of a quarter.¹³ The breadth of information

⁸ See Advo Comments on Second Advance Notice at 4; Pitney Bowes Comments on Second Advance Notice at 3-4.

⁹ See OCA Comments on Second Advance Notice at 18.

¹⁰ See Postal Service Supplemental Comments on the Classification Process at 3-4. (*hereinafter* “Supplemental Comments”)

¹¹ The Postal Service hopes to improve its data systems over time; however, data availability today is constrained given the current data systems and the statistical validity of the system outputs.

¹² See ANM/MPA Comments on Second Advance Notice at 2.

¹³ See Postal Service Reply Comments on First Advance Notice at App. C. Advo and APWU appear to misunderstand the Postal Service’s description of the most recent billing determinants available for use in the cap compliance calculation. See APWU Comments on Second Advance Notice at 3; Advo

collected in a mail characteristic study is unlikely to be amenable to compilation, analysis, and interpretation within this very short period of time. For the purposes of calculating cap compliance the Postal Service intends to rely on the most recent data available, but recognizes that, in some circumstances, less robust data or informed judgment will be used in constructing the volume weights. APWU recognizes this and its suggestion that the old total volume be used as a “control total” is consistent with the Postal Service’s proposals that a constant historical mail volume be used and allocated to rate design using the best data available.¹⁴

3. Customized agreements are relevant to the price cap, and should be considered in an administratively efficient manner

Contrary to the arguments of some parties, the Postal Service does not believe that customer-specific pricing can be set aside and not considered within the cap compliance calculation. To date, customized agreements have involved the provision of alternative price structures to mailers using existing mail classes. Consequently, the statute (at § 3622(d)(2)(A)) seems to require that, for example, First-Class Mail service purchased at a customer-specific rate must be included within the cap compliance calculation for First-Class Mail, particularly for those agreements in effect prior to the date of a given price change notice.

Section 3622(d)(1)(C) supports this position, since it expressly extends to contract prices. However, from a practical perspective, and reflecting historical

Comments on Second Advance Notice at 5-6. The Postal Service proposes to use billing determinants for the most recently available quarter, assuming that at least two months (needed for the compilation of the billing determinants) have passed since the end of that quarter. Therefore, the billing determinant data used may be for a period that ended from two to approximately five months previous to the date of the notice of price change. For the four quarters ending June, billing determinant data would likely be available no earlier than September (two months). These billing determinants would be used in any notice of price adjustment until the billing determinants for the four quarters ending September became available sometime in December.

¹⁴ See APWU Comments on Second Advance Notice at 4.

experience with customized agreements that have reduced prices, the Postal Service also believes that a new customized agreement noticed pursuant to § 3622(d)(1)(C) may not always create a need for a calculation of revenue per piece in order to demonstrate that the affected class remains in compliance with the cap. The Commission should adopt an administratively efficient rule which states that, for customer-specific pricing that clearly would not run afoul of the cap (*e.g.*, price reductions or *de minimis* changes), it is permissible for the Postal Service to submit an explanation of why cap compliance is not an issue at the time the contract prices are noticed, as opposed to imposing a potentially burdensome requirement that mandates an arithmetic showing equivalent to that used for the annual notice of price changes.

In addition, the assumption that all customer-specific pricing be excluded (*ex ante*) from the cap compliance calculation is premised on an implicit assumption that *no* customer-specific agreement would *ever* result in a price increase.¹⁵ However, it is not difficult to imagine a customer entering into an agreement that would, for example, reduce the prices it paid if certain requirements are met but would increase those prices above the “list prices” if those requirements are not met. A simple rule, as discussed above, with respect to contract prices and the price cap will provide the Commission with the most flexibility to apply common sense approaches to customized agreements.

B. Section 3622(e)

1. The definition of “workshare discount” should be narrowly applied

By its terms, § 3622(e) applies only to “workshare discounts.” Thus, a threshold issue in applying that section is characterizing exactly what are “workshare discounts”

¹⁵ See Advo Comments on Second Advance Notice at 5; NAA Comments on Second Advance Notice at 10.

within the meaning of the Act. As the Postal Service discussed in its Supplemental Comments on the Classification Process:

Within any market-dominant product there may be a number of prices, including “workshare discounts” within the meaning of § 3622(e) and other services that are predicated on market considerations or on costs that are not associated with worksharing.¹⁶

Section 3622(e)(1) defines “workshare discount” as “rate discounts provided to mailers for the presorting, prebarcoding, handling, or transportation of mail, as further defined by the [Commission].” Congress thus limited the application of § 3622(e) to those activities that have traditionally been associated with worksharing activity. Presortation and barcode discounts were developed based on the Postal Service’s costs avoided for mail processing and delivery, and destination entry discounts were developed based on the avoided origin handling and transportation costs. While § 3622(e) grants the Commission the authority to further define “presorting, prebarcoding, handling, or transportation of mail,” it does not appear to grant the Commission the authority to create new workshare categories (to which § 3622(e) would be applied) that are unrelated to those four activities.

The Commission should thus adopt a narrow reading of this definition. At this time, a common sense application of this provision to prices that constitute a discount due to a mailer undertaking one of the statutorily-enumerated activities is appropriate. Further refinement of the statutory definition of “workshare discount” can mature over time.

¹⁶ See Supplemental Comments at 12-13 (footnote omitted)

2. The plain language of § 3622(e) demonstrates that it sets forth a general principle, not a hard and fast pricing rule

In applying § 3622(e) to those prices that are “workshare discounts” within the meaning of the PAEA, the Commission should recognize that the language of that section plainly accords substantial pricing flexibility to the Postal Service. To read that section as imposing rigid constraints on the Postal Service’s prices would be inconsistent with its plain language, read in the context of the statute as a whole. OCA attempts to advance such a rigid reading in its comments to the Second Advance Notice, arguing that § 3622(e) is an “unambiguous command” that the new regulatory system “achieve[] an explicit outcome: no discounts in excess of avoided costs,” and criticizing as inconsistent with the statutory text the Postal Service’s previous characterization of that section as establishing a “general principle” that workshare discounts not exceed avoided costs.¹⁷

It is OCA’s position, however, that is inconsistent with the plain language of § 3622(e). Arguing, as it does, that the section constitutes an “unambiguous command” that there must be “no discounts in excess of avoided costs” completely ignores the presence of §§ 3622(e)(2) and (3), which set forth five broad circumstances in which workshare discounts in excess of avoided costs are permissible.¹⁸ Read in its entirety, § 3622(e) clearly does not establish an “unambiguous command” that passthroughs not exceed 100 percent, but rather a general pricing principle that should not be applied in the abstract but rather in a thoughtful manner permitting reasoned exceptions consistent with sound business decisions.

¹⁷ See OCA Comments on Second Advance Notice at 20-21 (discussing Postal Service Initial Comments on First Advance Notice at 19-20).

¹⁸ 39 U.S.C. § 3622(e)(2)-(3). See also NPPC Comments on Second Advance Notice at 2-3.

NAA, meanwhile, characterizes § 3622(e) as establishing a rule that workshare discounts must not exceed costs avoided except in “exceptional” circumstances.¹⁹ While NAA seems to imply that the Commission must prevent workshare discounts in excess of avoided costs except in rare or extraordinary situations, the Postal Service submits that the Commission should simply implement the plain language of § 3622(e). Sections 3622(e)(2) and (3) are broadly worded and betray no indication that they should be applied in a manner more constrained than their language suggests.

A constrained application of those provisions would not only ignore the statute’s plain language, but would also be inconsistent with the broader objectives of the Act. As the Postal Service noted in its Initial Comments on the First Advance Notice, the Commission must interpret § 3622 as a unified whole, in order to give effect to the general purposes and objectives of the Act.²⁰ The PAEA clearly mandates a more market-responsive and flexible regulatory structure, in which the Postal Service has the ability to respond to changing market and operational conditions.²¹ The language of § 3622(e), which states that “workshare discounts” within the meaning of the PAEA should “not exceed the cost that the Postal Service avoids as a result of workshare activity, *unless*” one of five broad circumstances apply,²² fits comfortably within a regulatory framework that accords substantial pricing flexibility to the Postal Service. In this regard, the Commission should generally defer to the Postal Service’s business judgment as to when discounts in excess of avoided costs are appropriate for one of the

¹⁹ See NAA Comments on Second Advance Notice at 6, 9.

²⁰ See Initial Comments on First Advance Notice at 8-9.

²¹ See, e.g., H.R. REP. NO. 109-66, pt. 1, at 44 (2005) (“The bill gives postal management and employees the tools to adapt and survive in the face of enormous challenges caused by changing technology and a dynamic communications marketplace.”).

²² Emphasis added.

reasons set forth in § 3622(e).²³ The language of § 3622(e) simply does not lend itself to a rigid view of pricing, as OCA and NAA (as well as those parties discussed in the next section below) allege, but is instead fully consistent with the flexibility contemplated by the Act.

3. The Act does not support the ECP arguments of NPPC and Pitney Bowes

One thing § 3622(e) (or, indeed, the PAEA as a whole) does not do is support the imposition of the Efficient Component Pricing Rule (ECP) in the manner suggested by NPPC and Pitney Bowes. In their initial comments on the Second Advance Notice, both parties take the opportunity to extol once again the perceived virtues of ECP, and to urge the Commission to require adherence to ECP to the maximum extent possible.²⁴ However, both parties do nothing more than rehash the claims made in their initial comments to the First Advance Notice. The Postal Service has already provided extensive discussion of those views in an earlier filing.²⁵ As indicated there, § 3622(e) provides no support for ECP, since it speaks only to a maximum passthrough of avoided costs, and even then gives the Postal Service broad authority, as discussed above, to implement workshare discounts in excess of costs avoided.²⁶ In addition, the imposition of ECP in the manner suggested by these parties would also be thoroughly inconsistent with the pricing flexibility codified in both § 3622(b)(4) and (e) of the Act.

²³ To be sure, as Congress recognized, the Postal Service generally believes that workshare discounts should not exceed costs avoided. See S. REP. NO. 108-318 at 12 (2004). However, it is important that the Postal Service have the flexibility to offer discounts that exceed costs avoided in a manner contemplated by the Act. See Postal Service Initial Comments on First Advance Notice at 20-21. Thus, the Postal Service respectfully submits that the Commission give strong deference to Postal Service business justifications concerning why a discount should exceed costs avoided.

²⁴ See NPPC Initial Comments on Second Advance Notice at 4-10; Pitney Bowes Comments on Second Advance Notice at 5-6.

²⁵ See Postal Service Reply Comments on the First Advance Notice at 10-15.

²⁶ Section 3622(e) also demonstrates that when Congress wanted to establish a general pricing principle, it knew how to do so. Congress has, of course, nowhere mandated or endorsed the use of ECP.

This is even more true if, as advocated by these parties, ECP were to be extended beyond worksharing cost differences to cost differences based on intrinsic or inherent factors such as shape and weight. In the end, the arguments advanced for establishing ECP as a broad based pricing policy prescription simply lack any statutory basis, and should not be adopted by the Commission.

4. The Commission should review workshare discounts for compliance with § 3622(e) in the annual compliance review

Parties have expressed different views concerning when the Commission should review Postal Service prices for compliance with § 3622(e). NAA believes that such review should occur prior to implementation.²⁷ Time Warner, on the other hand, believes that § 3622(e) should be enforced through post-implementation review, as part of the Annual Compliance Review or through complaints.²⁸ Advo, PostCom, and Pitney Bowes agree with Time Warner.²⁹ The Postal Service also agrees that the Commission should not review the Postal Service's prices for compliance with § 3622(e) as part of its prior review.³⁰

This view seems most consistent with the plain language of the Act. As Time Warner indicates, and as the Postal Service discussed in a previous filing, there are three statutory avenues through which the Commission can review market-dominant prices: the prior review of § 3622(d)(1)(C), and the post-implementation reviews of §§ 3653 and 3662.³¹ Each of those sections specifies different scopes of review, with

²⁷ See NAA Comments on Second Advance Notice at 5-9.

²⁸ See Time Warner Comments on Second Advance Notice at 4-15.

²⁹ See Advo Comments on Second Advance Notice at 7; PostCom Comments on Second Advance Notice at 6; Pitney Bowes Comments on Second Advance Notice at 8.

³⁰ See Postal Service Reply Comments on First Advance Notice at 6.

³¹ See Time Warner Comments on Second Advance Notice at 10-11; Postal Service Reply Comments on First Advance Notice at 2. This statement disregards the Postal Service's use of the exigency provision, § 3622(d)(1)(E), which provides for a 90-day prior review of any proposed exigent price increase.

corresponding remedial authorities tailored to that review. While § 3653 and § 3662 both contemplate Commission review of the Postal Service's prices for compliance with chapter 36 (and thus § 3622(e)),³² § 3622(d)(1)(C) by its terms contemplates only that the Commission review the Postal Service's compliance with the price cap.³³

NAA asserts that relying on post-implementation review will not "ensure" that workshare discounts satisfy the ceiling set by § 3622(e), in contravention of the duty of the Commission under that section.³⁴ This argument seems inconsistent, however, with the plain language of § 3622(d)(1)(C). The Act clearly allows the Commission to fulfill its responsibilities under § 3622(e) through the Annual Compliance Review. This is also the most sensible approach, since it would allow the § 3622(e) inquiry to be based on actual, historical cost data, rather than projected costs.³⁵

The fact that compliance with § 3622(e) is contemplated by the Act to be a subject of the Annual Compliance Review means that the Commission should not require new data at the time of the price change notice. Section 3622(e)(4) does not lead to a contrary conclusion. As the Postal Service discussed in its Reply Comments to the First Advance Notice, that provision applies only to newly established workshare discounts, rather than to pre-existing discounts that are either changed or unchanged by

³² Section 3653 also involves a review of the Postal Service's service performance, in addition to a review of the Postal Service's prices for compliance with chapter 36. See 39 U.S.C. § 3653(b). Section 3662, meanwhile, authorizes the Commission to review compliance with chapter 36 and other specified provisions of title 39. See 39 U.S.C. § 3662(a).

³³ See Postal Service Reply Comments on First Advance Notice at 6.

³⁴ See NAA Comments on Second Advance Notice at 8.

³⁵ Advo suggests that whenever the Postal Service sets a discount greater than the costs avoided, it should "provide an estimate of how much additional operational efficiency, cost savings, and/or contribution/profit it generates as compared to discounts based on avoided costs alone." See Advo Comments on Second Advance Notice at 8-9. While the Postal Service will provide a complete business rationale for any workshare discount that exceeds avoided cost, it should be recognized that providing empirical data of the kind suggested by Advo is likely to prove impractical.

a price adjustment notice.³⁶ Its purpose is one of transparency, and, as Time Warner notes, does not authorize the Commission to conduct a review during the prior review process, make findings, or impose remedies like §§ 3653 or 3662 do.³⁷

In the end, the Postal Service has proposed a sensible approach to this issue in its response to Question 3 of the Second Advance Notice. When the Postal Service files its Notice of Price Adjustment, it will also file, for pre-existing workshare discounts, a comparison of the new (or unchanged) discount price with the historical, Commission-reviewed cost avoidances of the last Annual Compliance Review, and will provide appropriate justification for any discount that exceeds those cost avoidances. For newly established workshare discounts, meanwhile, the Postal Service will provide avoided cost data through the report mandated by § 3622(e)(4), which will be reviewed in the next Annual Compliance Review once actual cost data is available. This approach is sufficient to gauge prospective compliance with § 3622(e) in the period between the price change and the next Annual Compliance Review, while providing appropriate transparency to mailers and the Commission. This approach also reduces the administrative burden to the Postal Service, and keeps the 45-day review process focused on cap compliance, as required under § 3622(d)(1)(C).

5. Technical workshare matters should not be addressed in this proceeding

Several parties present specific analyses of the substantive question of how avoided costs should be calculated, or argue that the data provided by the Postal

³⁶ See Postal Service Reply Comments on First Advance Notice at 7-8. This interpretation is supported by several parties. See Advo Comments on Second Advance Notice at 7; NAPM Comments on Second Advance Notice at 3-4; Pitney Bowes Comments on Second Advance Notice at 6-7.

³⁷ See Time Warner Comments on Second Advance Notice at 13-14.

Service with respect to workshare discounts should be “improved” in certain ways.³⁸ The Postal Service does not address these issues in these comments, as they are technical matters properly considered outside the scope of this rulemaking. At this stage, current workshare methodologies and data should be considered sufficient for determining compliance with § 3622(e).

6. Monthly data of the type required in the Annual Compliance Report should not be required

OCA once again argues for the provision of data consisting of the same type of data as the annual report every month, in order to ensure compliance with §§ 3622(e) and 3633.³⁹ The Postal Service presented its views on the inappropriateness of requiring such monthly data in its Reply Comments on the First Advance Notice, noting that developing such data at a frequency greater than annually would impose large costs for little or no benefit.⁴⁰ In summary, the Postal Service noted that:

- Most reported costs and revenues are statistical estimates derived from sampling systems designed to produce reliable annual cost data. Monthly or quarterly product costs would not be statistically valid. In addition, cost avoidance data would vary dramatically from month to month because of seasonality in mail mix, labor costs, transportation costs, and other factors.
- Developing reliable monthly or quarterly product cost estimates would add significantly to the costs incurred by the Postal Service in collecting and

³⁸ See, e.g., NPPC Comments on Second Advance Notice at 8-9; NAA Comments on Second Advance Notice at 7-8.

³⁹ See OCA Comments on Second Advance Notice at 21, 28.

⁴⁰ See Postal Service Reply Comments on First Advance Notice at 21-23.

reporting the data. Moreover, the expanded data collection efforts could impede the delivery of the mail.

- Because developing any cost report requires time to compile, verify, and analyze the underlying data, a monthly cost avoidance report would lag the product cost report by at least two months.

The OCA's assertion that the Commission must have monthly data "so that it can verify compliance with § 3622(e)(2) at any time necessary" is particularly unworkable. Monthly cost avoidance data would neither be reliable nor timely. Due to the presence of extensive statistical noise in monthly data, the results from any given month would not be reliable or a useful predictor of annual results without extraordinary increases in data development expenses. Nor would such data be timely, since monthly special studies would require at least three months to produce (one month for the CRA, and another two months to demonstrate the relationships between cost avoidances and discounts through a special study). In addition, given the seasonal nature of the mail mix and costs such as labor and purchased transportation, the comparison of one month to another would not be meaningful or appropriate.

This, in turn, leads to perhaps the most fundamental question: even if the data were somehow made reliable, what exactly would the point of producing it be? Does OCA suggest that the Postal Service is required to constantly fine-tune its workshare discounts throughout the year so that they are consistent with the latest monthly cost avoidance number? This would be impractical and inconsistent with the principle of "predictable and stable" prices.⁴¹ Increased transparency is, of course, a primary goal

⁴¹ Suppose, for example, that the monthly report indicates that the discounts are higher than the measured cost avoidances. In such a situation, it is unclear whether interested parties should be

of the statute, but increased data production requirements must be considered carefully, with a view towards the benefits of that data as compared to the costs of producing it and the associated administrative burden (the reduction of which is also a goal of the Act). Here, the sensible approach is to simply adhere to the statutory structure laid out by Congress, which wisely contemplates that the reporting and review of workshare data would occur annually (as part of the Annual Compliance Review). Requiring monthly data would, on the other hand, result in unreliable, untimely data, which are costly to produce and have no clear utility.

C. The Legislative History of the “45-Days” Provision

As it has throughout this proceeding, Valpak continues to assert that the 45-day review period specified in § 3622(d)(1)(C) represents a minimum rather than a maximum period of review, and in the process attacks the Postal Service’s discussion of the pertinent legislative history in its Reply Comments to the First Advance Notice.⁴² In particular, Valpak clearly does not believe that Senate Report No. 108-318 represents legitimate legislative history concerning the PAEA. The Postal Service does not agree, considering that many of the provisions of the PAEA—including, in particular, the provisions of chapter 36 that are the subject of this rulemaking—can be directly traced to S. 2468 in the 108th Congress; in fact, the language of § 3622(d)(1)(C) in S. 2468 was identical to the language in the PAEA. The fact that the provisions of S. 2468 are substantively identical or very similar to the provisions that ended up in the PAEA is not

concerned. By the time they read the monthly report, a COLA wage increase could have been implemented and/or use of overtime could have increased, or the mail mix could have changed in a way requiring more manual handling so that now, in the current month, the discounts are actually lower than the avoided costs. Any action taken in response to the first monthly report could be exactly the wrong action to take in response to the current – but as yet unreported – circumstances.

⁴² See Valpak Comments on Second Advance Notice at 15 n.6.

surprising, since it was sponsored by the same Senators who led postal reform efforts in the 109th Congress, and was motivated by the same concerns as was the PAEA. In the Postal Service's view, the Senate Report provides an important source of legislative history that can help illuminate both the reasons why Congress chose to pass the PAEA, and how to interpret statutory text whose meaning is ambiguous.⁴³

Even accepting Valpak's belief about the irrelevance of the Senate Report from the 108th Congress, its argument is still unavailing because there *is* legislative history from the 109th Congress specifically about the PAEA, which discusses § 3622(d)(1)(C). As the Postal Service noted in its Initial Comments on the First Advance Notice, at the time the PAEA was placed before the Senate prior to its passage, Senator Collins (the Chair of the Senate Committee on Homeland Security and Governmental Affairs, and also the primary sponsor of the bill who led the effort for its passage) described the legislation as follows:

The compromise legislation before the Senate replaces the current lengthy and litigious rate-setting process with a rate cap-based structure for products such as first class mail, periodicals, and library mail. *For 10 years, the price changes for market-dominant products like these will be subject to a 45-day prior review period by the Postal Regulatory Commission.* The Postal Service will have much more flexibility, but the rates will be capped at the CPI. That is an important element of providing 10 years of predictable, affordable rates, which will help every customer of the Postal Service plan.⁴⁴

⁴³ Courts, in interpreting the meaning of a statute, have found that committee reports or other forms of legislative history with respect to a predecessor bill that was unenacted are relevant to an understanding of the subsequent statute when the operative language in both is substantially the same. See, e.g., *United States v. Enmons*, 410 U.S. 396, 404-05 n.14 (1973); *Huffman v. OPM*, 263 F.3d 1341, 1347-48 n.1 (citing *Amin v. Merit Sys. Prot. Bd.*, 951 F.2d 1247, 1250 n.1 (1991); *Bolden v. Blue Cross & Blue Shield Assoc.*, 848 F.2d 201 (D.C. Cir. 1988).

⁴⁴ 152 CONG. REC. S11,675 (daily ed. December 8, 2006) (emphasis added).

Case law establishes that floor statements by the primary sponsor and chair of the committee handling a bill are relevant legislative history.⁴⁵

D. OCA's "Subclass Banding" Proposal

The OCA argues that the Commission should establish a rule precluding the Postal Service from increasing the prices for a subclass by more than 50 percent above the price increase for the class as a whole.⁴⁶ This proposal is a variant on the banding proposal put forth by NAA in the round of comments on the First Advance Notice, except that it would apply at the subclass level rather than the rate cell level, and would be an absolute prohibition rather than a requirement that such increases be "specially justified." The Postal Service views this proposal as inconsistent with the PAEA for the same reasons as it did the NAA proposal.

As the Postal Service noted in its discussion of the NAA proposal,⁴⁷ the ability of the Postal Service to manage its prices within the cap by changing some prices by more or less than the rate of growth in CPI-U is implicit in the statutory scheme set forth by Congress. Congress specifically chose to apply the price cap at the class level rather than the subclass level, and thus specifically chose to give the Postal Service the ability to change prices for one subclass within a class by a different amount than the change for another subclass within the class.⁴⁸ Congress clearly believed that this provision would satisfy the statutory objectives of "predictability and stability" (or what the OCA

⁴⁵ See, e.g., *N. Haven Bd. of Educ. v. Bell*, 456 U.S. 512, 526-527 (1982).

⁴⁶ See OCA Comments on Second Advance Notice at 15. The OCA appears to have appropriately abandoned its earlier position that the price cap applies at the subclass level rather than the class level. See OCA Reply Comments on First Advance Notice at 5.

⁴⁷ See Postal Service Reply Comments on First Advance Notice at 17-19.

⁴⁸ The House version of postal reform legislation in the 109th Congress applied the cap at the subclass level, while the Senate version applied it at the class level. Compare H.R. 22, 109th Cong., § 201 (2004) (proposed § 3622(e)) (as passed by House) with H.R. 22, 109th Cong., § 201 (2005) (proposed § 3622(d)(2)(A)) (as passed by Senate). In the PAEA, Congress chose the Senate approach. See 39 U.S.C. § 3622(d)(2)(A).

terms “continuity of expectations”), and would also lead to “just and reasonable” prices.⁴⁹ The Commission should therefore decline the OCA’s invitation to craft a restriction on the flexibility that Congress clearly afforded to the Postal Service.

II. Competitive Products

A. Discussion of UPS Initial Comments

1. UPS’ apparent call for projected costs as part of the Postal Service’s notice of competitive price changes should be rejected

Section 3632 requires the Governors to set prices and classifications for competitive products in a manner consistent with the regulations of § 3633. For rates of general applicability, the Governors’ decision and supporting record will be published in the Federal Register; for other rates (e.g., customized agreements), the decision is filed with the Commission.⁵⁰ Question 5 of the Second Advance Notice asked, in essence, for input on what data the Governors should publish or file at the time it changes competitive prices.

As stated in its Initial Comments to that Notice, the Postal Service believes that the Annual Compliance Review process of §§ 3652-53 is the forum in which the Act contemplated that the Commission would examine the revenues and costs of competitive products in order to determine compliance with the requirements of § 3633.⁵¹ As such, at the time that the Governors change competitive prices, their decision under § 3632 would refer back to the most recently filed Annual Compliance Report.⁵² More specifically, the Governors’ decision would provide the relevant historical attributable cost by product, the relevant historical volumes, the new prices,

⁴⁹ 39 U.S.C. § 3622(b)(8).

⁵⁰ See 39 U.S.C. § 3632(b)(2)-(3).

⁵¹ See Postal Service Comments on Second Advance Notice at 17-18.

⁵² *Id.*

and the resulting revenue by product.⁵³ On the type of historical data to be provided, it appears that the Postal Service and UPS generally agree.⁵⁴

However, the Postal Service and UPS diverge in that UPS apparently would also require that *prospective* data be provided, including the Postal Service's volume forecasts for the competitive products at the billing determinant level and its projections for costs (including any substantial cost changes that are expected).⁵⁵ Such a requirement would "rollback" the pricing reform envisioned by the Congress in the PAEA should be rejected.

UPS is unclear as to the role that the forecasted data would play in the regulatory scheme. It merely states that both historical and forecasted data are needed to make a *prima facie* showing that the rates comply with the statutory requirements in §3633, particularly the requirement that the rates cover attributable costs.⁵⁶ The term "prima facie" implies that the forecasts must meet an evidentiary standard, which would presumably include the business and factual assumptions underlying the forecasts. But what would happen if a party disagreed with the projections? Would it be able to file a complaint to challenge the forecasts? What would the complaint seek, a forced change in prices? And what role would the Annual Compliance Report have in that scenario should a complainant's alternate forecasts be proven incorrect? Mandating that the Postal Service provide public projections of volumes and costs when it seeks to change its competitive prices invites unnecessary litigation and inappropriate second-guessing

⁵³ The relevant data would be for those volume and costs elements that are affected by the price change.

⁵⁴ UPS does not specifically state that the data in the Annual Compliance Report would be the source of the historical information it advocates. However, this report should meet UPS' desire for historical data from the most recently completed fiscal year. See UPS Initial Comments on the Second Advance Notice at 5.

⁵⁵ *Id.*

⁵⁶ *Id.*

of the Postal Service's business decisions, in contravention of the policies underlying the Act. It would also place the Postal Service at a severe competitive disadvantage, as no competitor of the Postal Service is required to publish the financial analyses or other detailed data underlying their pricing strategy.

It is consistent with the statutory scheme to use historical information, rather than commercially sensitive forecasted data, to support (for regulatory purposes) the Postal Service's competitive price increases. The PAEA ensures that every year the Postal Service will provide actual, rather than forecasted, data to show compliance with the pricing provisions of both the market-dominant and competitive products in the Annual Compliance Review process. This will enable the Commission and other interested parties to use actual data to track key trends over time. For competitive products, the Commission's review will determine whether in a given fiscal year, the products met the cost floor established pursuant to § 3633.

A related but distinct issue is what any data filed at the time of the price change notice should demonstrate. The PAEA does not require the Postal Service to demonstrate at the time it changes its prices that it can meet all the elements of the cost floor. Instead, it is sufficient for the Postal Service to show that the price changes will result in revenues that cover the attributable costs of its products plus the group-specific costs, by reference to the costs reviewed by the Commission in the previous Annual Compliance Review.⁵⁷

This is sufficient because the PAEA provides strong incentives for the Postal Service to price its competitive products to comply with the cost floor. The Act allows

⁵⁷ The Postal Service discussed the concept of "group specific" costs in its response to Question 6 of the Second Advance Notice. See Postal Service Comments on Second Advance Notice at 21-24.

the Postal Service to retain earnings and earn a profit, thus creating a strong incentive to not only meet the cost floor but also to exceed it by a healthy margin to meet the Postal Service's need to invest in capital and improve its competitive offerings. In addition, as stewards of the Postal Service with a fiduciary responsibility to maintain its vitality, the Governors have a statutory obligation to ensure that the Postal Service's competitive product prices are consistent with the Act.

UPS would also restrain the Postal Service's flexibility in two other ways. First, UPS advocates that the Postal Service should explain any significant price change even if that price change meets the cost floor of § 3633.⁵⁸ There is no basis in the statute for such a requirement, since the regulatory restraint on the Governors' authority to price competitive products is a *floor*, not a ceiling (instead, the market establishes the ceiling). Second, UPS argues that when the price change significantly affects products, for example, when the change affects products with greater than 50% of the total revenue for competitive products, the data for all competitive products must be provided.⁵⁹ In practice, this is overbroad and could require the filing of extraneous data (for example, if the Postal Service makes a price change to only Priority Mail, filing data for International Mail would be irrelevant).

In sum, UPS appears to suggest that the Commission issue hard and fast rules that would impose onerous procedures and data requirements before the Postal Service, the Commission, and other interested parties gain any experience under the PAEA. As the new approach to competitive products begins, the Commission need not require any more data than those required to find compliance with the Act, as proposed

⁵⁸ See UPS Comments on Second Advance Notice at 5.

⁵⁹ See *id.* at 5-6.

by Postal Service. This will help ensure the viability of the competitive products, while meeting the requirements of § 3633.

2. UPS confuses the intent of each of the three subparts of section 3633

a. Section 3633(a)(1)

Section 3633(a)(1) requires the Commission “to prohibit the subsidization of competitive products by market-dominant products.” UPS argues that inclusion of this provision “essentially redefines 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 from which competitive products benefit.”⁶⁰ Subpart (a)(1) does not, however, operate as a redefinition of “subsidy.” A subsidy is properly defined as what results if revenues for a product (or group of products) fail to cover all of the costs caused by that product (or group of products).⁶¹ What *has* changed with the introduction of § 3633(a)(1) by the PAEA is that the scope of the subsidy prohibition is now expanded to a specific group of products – those classified as competitive. This is in contrast to the PRA, which was exclusively directed at prohibiting subsidy of individual products (an issue dealt with by § 3633(a)(2) of the PAEA). The definition of “subsidy,” however, remains unchanged.

The Initial Comments of the Postal Service to the Second Advance Notice explain in practical terms what the change in scope mandated by § 3633(a)(1) requires beyond what was required before:

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

⁶⁰ *Id.* at 9 (footnote omitted).

⁶¹ See, e.g., Docket No. R87-1. Direct Testimony of William J. Baumol, USPS-T-3, at 11.

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.⁶²

In terms of the standard to evaluate compliance with § 3633(a)(1), the Postal Service’s Initial Comments stated:

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.⁶³

The approach proposed by the Postal Service gives full effect to the language of § 3633(a)(1). That provision simply requires that competitive products as a whole bear their attributable costs as a whole, keeping in mind that the attributable costs taken as a whole will include the competitive products’ group-specific costs (which are not included within the attributable costs of an individual competitive product).⁶⁴ This approach in no way reads § 3633(a)(1) “out of the statute,” and remains consistent with the economically appropriate definition of “subsidy.”

UPS identifies exactly what type of “additional amount” is required to be included by § 3633(a)(1):

It is clear, for example, that the Commission must take into account in evaluating the legality of competitive rates any net economic benefit the Postal Service derives from the differential application of Federal and state laws between it and private sector companies. Thus, the Commission should require that competitive products as a whole generate revenue covering the net economic benefit realized by the Postal Service due to

⁶² Postal Service Comments on Second Advance Notice at 21.

⁶³ *Id.* at 24.

⁶⁴ Section 3633(a)(2), in turn, requires that each individual product cover its specific attributable costs.

preferential legal treatment, on top of their attributable costs and their appropriate share of institutional costs.⁶⁵

Here, UPS assumes that the Postal Service's status as a governmental entity accords it "advantages" that result in a "net economic benefit." At a minimum, this assertion jumps the gun and prejudices the outcome of both the FTC's analysis and the Commission's review of the matter.⁶⁶ Until the Commission receives that analysis, it cannot anticipate in this rulemaking what, if any, implications that analysis may have for the Commission's regulations.

More fundamentally, UPS assumes but offers no support for the position that the Postal Service in fact derives some unquantified "net economic benefit" from the differential application of Federal and state laws. The Postal Service believes that any balanced analysis may well reach the opposite conclusion. Numerous laws specially burden the Postal Service with limitations and requirements regarding labor and employment, social policies, finance, and market access and flexibility, in ways not applied to private companies. The PAEA itself requires the Postal Service to make annual pre-funding payments between \$5.4 billion and \$5.8 billion annually to be directed after FY 2016 for the payment of health benefits for postal annuitants.⁶⁷

These payments have no direct parallel under the Employee Retirement Income Security Act of 1974 or other legal requirements imposed on private companies. The

⁶⁵ UPS Comments on Second Advance Notice at 9 (citation omitted).

⁶⁶ In a footnote UPS also contends that the work of the Treasury under 39 U.S.C. 2011(h) "is central to this docket" and should inform the Commission's regulations implementing 39 U.S.C. 3633. See UPS Comments on Second Advance Notice at 1 n.1. Advo also stated that the final rules on competitive products should await Treasury's report. See Advo Comments on Second Advance Notice at 9-10. The Postal Service sees this an attempt to wag the dog from the tail. Section 2011(h) calls for developing procedures to administer two separate postal funds in the Treasury in place of the present single fund. It also directs Treasury to recommend rules for implementing the Federal Income Tax provision, § 3634. The pricing regime for competitive products is a matter for the Commission under § 3633 and does not depend on § 2011.

⁶⁷ See PAEA § 803.

impact of this and other such requirements likely outweigh any comparative economic benefits the Postal Service might possibly enjoy through its status as a federal entity.

UPS concedes that the Commission currently has no basis to quantify the net economic consequences of this myriad of factors, but nonetheless suggests that the Commission inject an unspecified “additional amount” into the mix to address the situation.⁶⁸ When the actual direction of the effect is contrary to what UPS supposes, the lack of merit to this suggestion is clear. Even clearer, however, is the point that such factors provide no basis for either raising or lowering the cost floor established by § 3633 beyond the level at which long-established economic principles would dictate.

Finally, as a concluding note in its discussion of § 3633(a)(1), UPS claims that the relatively slight decline in the system-wide level of attribution over the last two decades demonstrates a cause for heightened concern regarding cross-subsidization.⁶⁹ In fact, however, this overlooks the most obvious driver of the fall in attribution levels. Over the time period in question, mailer worksharing has increased substantially. By definition, however, the postal costs removed from the system when the postal workload is reduced via worksharing are volume-variable (*i.e.*, attributable) costs. Institutional costs, in contrast, are unaffected.⁷⁰ The percentage of total costs attributed is the ratio of attributable costs to the sum of attributable and institutional costs, and, as worksharing reduces attributable but not institutional costs, the numerator of the ratio declines more rapidly than the denominator, with the inevitable result being the observed decline cited by UPS. This phenomenon does not imply cross-subsidization

⁶⁸ See UPS Comments at 9.

⁶⁹ *Id.* at 10.

⁷⁰ See Docket No. R2006-1, Direct Testimony of Donald J. O'Hara, USPS-T-31, at 13-14.

of competitive products by market-dominant products, but is rather an arithmetic byproduct of the cumulative success of postal worksharing.

b. Section 3633(a)(2)

Section 3633(a)(2) requires that “each competitive product covers its costs attributable” and, as a practical matter, reestablishes the same obligations for competitive products as those found previously (with respect to competitive subclasses) in the requirements of former § 3622(b)(3) of the PRA. In response, UPS notes that “Congress intended that cost attribution increase under [the] PAEA.”⁷¹ In advocating this opinion, however, UPS fails to acknowledge that Congress, in new § 3631(b), also codified the Commission’s and Postal Service’s long-standing approach to attribution; namely, that it be based on “reliably identified causal relationships.” Thus, the Congress has at most endorsed the principle of attempting to attribute more costs based on reliable indicators of causality.⁷²

The UPS proposal is as follows:

To best ensure that each competitive product is covering its attributable costs, the Commission should adopt long-run incremental costs as the proper measure of attributable costs. Long-run incremental costing is widely used for competitive elements in the telecommunications industry. Long-run incremental costs are those costs that the Postal Service would avoid if it did not provide a specific competitive product. It captures a more accurate and greater share of attributable costs than the more restricted “volume variable plus specific-fixed costs” method primarily relied upon to date because it includes those fixed costs that are increased over the long run by adding a competitive product but that, unlike specific fixed costs, are incurred by more than one product (“shared fixed costs”).⁷³

⁷¹ UPS Comments on Second Advance Notice at 11.

⁷² See SEN. REP. NO. 108-318 at 9-10.

⁷³ UPS Comments on Second Advance Notice at 12 (citations omitted).

This proposal fundamentally agrees with the Postal Service’s discussion in its Initial Comments on the Second Advance Notice on the appropriate incremental cost approach (the costs avoided if a product is not offered). More specifically striking is the agreement between the UPS proposal and the Postal Service’s earlier comments on the importance of the identification of costs common to competitive products as a whole, referred to by UPS as “shared fixed costs” and referred to by the Postal Service as the “competitive products’ group-specific costs.”⁷⁴ On the other hand, it is perplexing why UPS would believe that these costs (“shared fixed costs,” using its nomenclature) are relevant with respect to subpart (a)(2), which relates to the attributable costs of individual competitive products, as opposed to subpart (a)(1), which relates to competitive products as a whole; it is with respect to subpart (a)(1) that the Postal Service believes this concept appropriately applies. The confusion can perhaps be traced to UPS’ last sentence quoted above, in which there seems to be a disconnect between the notion of “fixed costs that increase ... by adding a competitive product” and the allegedly same fixed costs that “are incurred by more than one product.” It would seem that, if fixed costs are already incurred to provide at least one competitive product, then adding additional competitive products would not cause any change in those fixed costs.

In any event, what is most important is that, as noted above, both UPS and the Postal Service seem to agree that, for purposes of § 3633(a)(2), the cost floor for each competitive product should be the costs that the Postal Service would avoid if it did not offer that competitive product. UPS notes that, in measuring such costs, it is necessary to evaluate “a period that is sufficient for the Postal Service to fully adjust to the impact

⁷⁴ See Postal Service Initial Comments on Second Advance Notice at 21.

the provision of the product creates.”⁷⁵ Exactly how one defines the period that is sufficient to allow the Postal Service to adjust “fully” is not clear, but the Postal Service agrees that ample opportunity for adjustment is a reasonable component of the exercise.

c. Section 3633(a)(3)

Section 3633(a)(3) requires that “all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.” Unlike subparts (a)(1) and (a)(2), this provision moves beyond the realm of costing, which is based on causal relationships under the PAEA, into the realm of the non-causal allocation of institutional costs. Unfortunately, UPS appears reluctant to make the break:

Here, PAEA requires that all competitive products bear some share of the unattributed costs of the national network from which they benefit, in addition to the requirement that each competitive product cover its attributable costs. Some of those costs are undoubtedly caused by (attributable to) the competitive products, but cannot reliably be identified as such.⁷⁶

UPS then misconstrues the intent of the last clause of section 3633(b):

PAEA explicitly provides that the institutional cost requirement for competitive products should reflect costs that are “disproportionately associated with any competitive products.” 39 U.S.C. § 3633(b).⁷⁷

⁷⁵ UPS Comments on Second Advance Notice at 12.

⁷⁶ *Id.* at 13.

⁷⁷ *Id.* The clause to which UPS refers indicates that in conducting its five-year review of the appropriate competitive products’ contribution to institutional costs, the Commission “shall consider all relevant circumstances, including the prevailing competitive conditions in the market, *and the degree to which any costs are uniquely or disproportionately associated with any competitive products.*” 39 U.S.C. 3633(b) (emphasis added). As the Postal Service has discussed previously, this standard should also be used in determining the initial “appropriate share.” See Postal Service Comments on Second Advance Notice at 25 n.27.

This assertion is incorrect. Instead, to the extent that there are costs that are “disproportionately associated” with competitive products, § 3633(b) states that they should *not* be “marked up” or otherwise used to generate contribution to the institutional costs of the Postal Service.

Ironically, the rationale for the “disproportionally associated costs” clause of § 3633(b) shares the same roots as the rationale behind UPS’ expectation that “competitive products bear some share of the unattributed costs of the national network from which they benefit,” and the subsequent statement that competitive products “should not get a ‘free ride’ on the Postal Service’s network, with market dominant products paying all such costs.”⁷⁸ Essentially, UPS is suggesting that the share of institutional costs paid by competitive products, usually expressed as a mark-up on attributable costs, should serve as recognition that competitive products benefit from existing broader postal networks, be they retail networks, transportation networks, processing networks, or delivery networks. But what if materially large portions of attributable costs for competitive products are unrelated to the networks used by market-dominant products, or, in the language of § 3633(b), are “uniquely or disproportionately associated with ... competitive products”? Section 3633(b) indicates that such costs should not be treated in the same way as shared network costs for purposes of determining the “appropriate share.”

For example, imagine that the Postal Service implemented a Priority Mail processing network devoted exclusively to Priority Mail, similar to the PMPC network in years past. Under this hypothetical, without question, competitive products in general, and Priority Mail in particular, should cover the entire costs of such a network. But

⁷⁸ See UPS Comments on Second Advance Notice at 13.

market-dominant products, and the networks which serve them, would be largely unaffected by the presence (or the absence) of this hypothetical network. Therefore, under the reasoning presented by UPS itself, no justification exists to mark-up the attributable costs of a PMPC network to the same extent that one might, for example, mark-up the costs attributable to Priority Mail from the postal retail network, which is shared with other competitive and market-dominant products. The purpose of the last clause of § 3633(b), therefore, is to allow the implicit subtraction (from both the numerator and the denominator) of any portion of competitive products' attributable costs relating to activities or operations "uniquely or disproportionately associated" with competitive products, and thus not "common" to market-dominant and competitive products, *prior to* the calculation of the competitive products' mark-up. Thus, contrary to what UPS argues, this language is not intended to extend attribution on some pseudo-causal basis, but is intended merely to aid in the judgmental determination of appropriate markups, if circumstances warrant.

UPS then proceeds to argue that the Commission should adopt "some objective method of assigning institutional costs to competitive products."⁷⁹ In substance, UPS appears to be arguing for the long-discredited theory of Fully Distributed Costing. For example, UPS proposes using the competitive products' share of total postal revenue as the basis for determining their "appropriate share" of institutional costs. Revenue is an entirely arbitrary basis for distribution, but it is no mystery why UPS does not propose the equally arbitrary basis of volume share. Competitive products are relatively high revenue per piece products, so their collective revenue share exceeds their

⁷⁹ *Id.*

collective volume share. In any event, the Commission has rejected Fully Distributed Costing in the past, and should continue to do so now.

UPS also questions reliance on demand elasticities to evaluate relative institutional cost shares, calling it “contrary to the structure of the statute.”⁸⁰ In making this claim, however, UPS ignores the plain language of § 3633(b), which calls for the consideration of “all relevant circumstances,” including “the prevailing competitive conditions in the market,” when determining the “appropriate share.”⁸¹ Clearly it is not contrary to the structure of the statute to consider a factor which is one of the most relevant quantifications of a type of circumstance (“prevailing competitive conditions in the market”) which the Commission is explicitly required to review.

3. Determinations of undue discrimination under § 403(c) must be made in context of the specific circumstances

In response to Question 9 of the Second Advance Notice, concerning the definition of competitive “products,” UPS asserts that there must be “a distinct and significant cost or market characteristics for a given type of mail” for there to be “a different set of rates.”⁸² UPS concludes, “[o]therwise a number of PAEA’s requirements, such as the undue preference/discrimination prohibition in section 403(c), would be violated.”⁸³ In singling out § 403(c) as an impediment to the Postal Service’s pricing flexibility, however, UPS incorporates into that provision restrictions on pricing under the modified statutory scheme that are simply not there. The standard for compliance under unchanged § 403(c) remains, as it always has, whether discrimination or preference is undue or unreasonable. When evaluating any pricing result, that

⁸⁰ *Id.* at 14.

⁸¹ See Postal Service Initial Comments on Second Advance Notice at 24-25.

⁸² See UPS Comments on Second Advance Notice at 19.

⁸³ *Id.*

determination can only be made in the context of all relevant considerations, including the particular circumstances, the Postal Service's changed role under the PAEA, and the specific requirements and policies now embodied in title 39.

4. The assumed Federal income tax is not an attributable cost

Except for UPS, the parties agree with the Postal Service's position that the Federal Income Tax should not be attributed.⁸⁴ UPS wrongly states that the responsibility for the tax can be traced to individual competitive products, based upon the extent to which each contributes to the total income on which the tax is calculated.⁸⁵ This is incorrect. The Federal Income Tax is assessed on *net* income, which can only be derived by analyzing both income and expenses in total. One of the expenses will be the competitive products' group-specific costs, which are applied collectively to all competitive products. There is no way to trace each product's share of the group-specific costs and thus no way to trace its share of the tax. To put it another way, there is no means to attribute the tax to a specific product through reliably identified causal relationships.

B. Initial Level of Appropriate Share

No party has attempted to define with numerical precision what should be the initial "appropriate share of the institutional costs of the Postal Service" that competitive products should collectively cover. This reflects, perhaps, the inherent difficulty in a precise definition of the imprecise and inherently judgmental term "appropriate." This may also reflect the difficulties inherent in defining an "appropriate share of the institutional costs" without reference to the price structures for the competitive products.

⁸⁴ See, e.g., APMU Comments on Second Advance Notice.

⁸⁵ See UPS Comments on Second Advance Notice at 17.

As the Postal Service has often observed, customers pay prices, not mark-ups or contribution; therefore, the requirements of § 3633(a) must be viewed within the context of the potential effect on the prices that customers pay.

No party alleges that the Postal Service's current prices for competitive products, either individually or collectively, fail to cover their attributable costs. The current price structure also includes a substantial contribution to the institutional costs of the Postal Service that the Commission found to be appropriate under the pricing criteria of the PRA, including the effect of that structure on competitors and customers. However, hardwiring the Commission's estimate of that contribution (either in percentage markup or dollar terms) would neglect the fact that Commission-recommended mark-ups were never intended to be an absolute benchmark that would drive prices. Rather, Commission-recommended markups were the result of a pricing process, and actual markup experience over time reflected changing cost and mail mix factors.

In establishing the initial "appropriate share," MOAA notes that the "institutional cost contribution must be set low enough to enable the Postal Service to actually compete."⁸⁶ PSA, in turn, indicates that, to enhance social welfare, the threshold should be "significantly less" than that recommended by the Commission in Docket No. R2006-1.⁸⁷ Advo suggests "a small percentage over the incremental costs of all Competitive Products."⁸⁸ The collective guidance from these comments can fairly be summarized as seeking a truly minimal "appropriate share."

Once again, the Postal Service reiterates that the "appropriate share of institutional costs" determination does not act as a ceiling on rates, but merely

⁸⁶ MOAA Comments on Second Advance Notice at 2.

⁸⁷ PSA Comments on Second Advance Notice at 7.

⁸⁸ Advo Comments on Second Advance Notice at 13.

establishes a minimum threshold. The Postal Service desires to make a profit on competitive products, and it can only do so if it maintains a margin between the cost floor and the prices it sets. In any event, section 3633(a) expressly gives the Commission authority to revise its regulations in this regard “from time to time.”⁸⁹

C. OCA’s Discussion of “Bulk Parcel Post”

The OCA misinterprets the Postal Service’s previous discussion of the definition of “bulk parcel post” in its belief that the Postal Service has proposed to include Bulk Parcel Return Service (BPRS) within that definition.⁹⁰ The Postal Service is not proposing that BPRS (Fee Schedule 935) be included within the competitive product “bulk parcel post”; instead, the passage from the PSA’s Comments cited by OCA was referring to Parcel Select Return Service (Parcel Post paying the rates in Schedules 521.2F and 521.2G). The Postal Service’s proposed definition of “bulk parcel post” is presented on pages 12-13 of its Initial Comments to the Second Advance Notice. The fees for BPRS, meanwhile, should be included in the Special Services class, while the Standard Mail postage for pieces with a BPRS endorsement should be included with the Standard Mail class.

D. Definition of “Product”

In its Supplemental Comments on the Classification Process, the Postal Service discussed the statutory meaning of “product”:

The PAEA defines “product” as “a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied.” Read solely in isolation, this definition could be interpreted as stating that individual rate categories are individual “products.” Determining what constitutes an individual “product” under the PAEA requires, however, a practical consideration of the statutory definition read

⁸⁹ See Postal Service Comments on Second Advance Notice at 26.

⁹⁰ See OCA Comments on Second Advance Notice at 24-25.

in conjunction with the statute as a whole. There are a number of aspects of the PAEA that, when read as a whole, support an understanding that “product” should be interpreted at a high level of aggregation. At this time, it is most practical and legally supportable to interpret “product” as being generally equivalent to the current “subclasses” under the PRA. Going forward, meanwhile, the use of the disjunctive “cost or market” in the definition of “product” allows the Postal Service and Commission greater ability to group postal services into distinct “products” based on customer and business needs, regardless of how those postal services were grouped under the old PRA law. In other words, when read in conjunction with the statute as a whole, the definition of “product” does not demonstrate that the term equals “rate category,” but that under the new system the standard for treating mail matter as distinct “subclasses” (i.e., “products”) has been made more flexible. The exercise of this flexibility, in turn, must be practiced with care, based on changing business and market needs, and should be considered gradually over time.⁹¹

Thus, “product” is a more fluid term than the old paradigm of “subclasses” and “rate categories” under the PRA, consistent with the fact that the PAEA replaces the rigid framework of the PRA with a more dynamic and market-responsive regulatory structure.⁹² At the same time, a consideration of the Act as a whole clearly demonstrates that “product” signifies a grouping of mail matter at a high level of aggregation, such that it is most appropriate to initially equate the term with the current subclasses of mail.

The comments of NAA with respect to this topic largely accord with the views of the Postal Service, as expressed in its Supplemental Comments. The Postal Service agrees with NAA that customized agreements are unlikely to be “products” within the meaning of the PAEA,⁹³ since they will typically involve the provision of existing products at customer-specific terms and prices. At the same time, it is theoretically

⁹¹ Supplemental Comments at 6-7.

⁹² *Id.* at 5.

⁹³ See NAA Comments on the Second Advance Notice at 16.

possible to have a customized agreement that is so different from existing products that it constitutes a separate “product” within the meaning of the PAEA.

E. OCA Comments on International Mail

The OCA presents inconsistent comments on what mail matter constitutes “bulk international mail” under the PAEA. On the one hand, it indicates that since section 3631(a) does not restrict or qualify the terms “priority mail” and “expedited mail,” all priority and expedited mail, “whether domestic or international, bulk-entered or single-piece, must be treated as competitive products.”⁹⁴ Several pages later, however, the OCA argues that only services in which the International Mail Manual (“IMM”) references the terms bulk mailers, bulk mailings or similar terms should be included in the competitive category.⁹⁵

While the Postal Service agrees in principle with the notion that certain single-piece international services should ultimately be categorized in combination with bulk international services in the competitive category, as indicated in our Initial Comments, the rule of construction applied by the PAEA appears to contemplate a classification schedule analogous to the DMCS, which currently does not include international categories of mail.⁹⁶

The OCA also comments on the Postal Service’s assertion that the most logical interpretation of “bulk international mail” refers to multi-item mailings tendered by a single mailer, implying that as few as two international pieces tendered by a single mailer would qualify, “irrespective of the degree of competition.”⁹⁷ As the Postal Service

⁹⁴ See OCA Comments on Second Advance Notice at 23.

⁹⁵ *Id.* at 26.

⁹⁶ See Postal Service Comments on Second Advance Notice at 15-16.

⁹⁷ See OCA Comments on Second Advance Notice at 26 n.16.

explained in its Initial Comments, the multiple quantities in a “bulk “ international mailing might be entered either at the time of each mailing or over the course of a specific term, pursuant to an annual guarantee, whether based on pieces, weight, or postage. Thus, the Postal Service does not share the OCA’s views on how the Postal Service currently provides its international offerings or on how it plans to in the future. The international categories listed by the Postal Service in its Initial Comments on the Second Advance Notice thus fit within a logical definition of “bulk international mail.”

F. Cost Attribution Proposals

In response to Question 8 of the Second Advance Notice, both UPS and NAA complain about certain results of the current costing methodologies which, in their opinion, could be improved.⁹⁸ In large part, however, the Postal Service believes that these comments are not relevant to the Commission’s inquiry, which sought to explore whether there are appropriate changes in attribution directly resulting from enactment of the PAEA. Almost all of the comments made by UPS and NAA in response to that Question, however, appear to relate to alleged improvements in costing (*a priori* equated by both parties with higher levels of attribution) which they give no reason to believe should not have been pursued even under the previous law. Rather than discussing changes that should emanate from the new law, they are simply taking the opportunity to complain about costing results that are essentially independent of any

⁹⁸ See UPS Comments on Second Advance Notice at 17-19, NAA Comments on Second Advance Notice at 10-14.

portion of the PAEA. Their comments thus appear to be well outside the intended scope of this rulemaking.⁹⁹

There are a few exceptions. NAA, in its response to Question 8, once again raises the notion of “combinatorial cost tests,” as it did in its initial comments to the First Advanced Notice.¹⁰⁰ As noted in the Postal Service’s Reply Comments on the First Advance Notice, the concept as addressed by NAA is unnecessary and too broad-ranging to be practical.¹⁰¹ But to the extent that what NAA is really suggesting (as did UPS in response to Question 6) is that there is a need under the PAEA to test for cross-subsidization of the competitive products as a whole, which in turn creates the need to estimate what amounts to the joint incremental costs of the competitive products, the Postal Service does not disagree, and in fact made essentially the same point in its initial comments in response to Question 6.¹⁰² Also, UPS once again addresses Retiree Health Benefits, which was a specific topic of Question 8, and which is directly affected by enactment of the PAEA.¹⁰³ In its comments, however, UPS offers nothing new on this topic relative to its previous statements, which the Postal Service has addressed previously.¹⁰⁴

G. OCA Capital Structure Argument

In its initial comments, the OCA surmises that capital structure and return on investment information would be used to analyze potential cross-subsidization and to

⁹⁹ In suggesting (at page 11-12 of its Comments) that the Commission should commence another proceeding on cost attribution issues, NAA at least implicitly recognizes that the issues are not appropriate for resolution in this rulemaking.

¹⁰⁰ NAA Comments on Second Advance Notice at 13-14.

¹⁰¹ See Postal Service Reply Comments on First Advance Notice at 24-26.

¹⁰² See Postal Service Comments on Second Advance Notice at 20-24.

¹⁰³ See UPS Comments on Second Advance Notice at 18-19.

¹⁰⁴ See Postal Service Comments on Second Advance Notice at 29-30; Postal Service Reply Comments on First Advance Notice at 28-29.

calculate the assumed Federal Income Tax.¹⁰⁵ OCA's lengthy discussion appears to advocate that the Commission should embark on a mission to assign capital, or assets, to the competitive products through comparison to similarly situated companies. However, its discussion of imputing capital structure appears to be flawed,¹⁰⁶ and the entire discussion is misplaced.

Under § 2011 the Department of the Treasury has the role of advising the Commission on the accounting rules and procedures for the proper assignment of assets and liabilities to the Competitive Products Fund, including capital and operating costs incurred with respect to those assets and liabilities. The Treasury's recommendations should be provided between June 20 and December 20, 2007.¹⁰⁷ The Commission will then provide the Postal Service and interested parties an opportunity to present their views on the recommendations. There is no need for this rulemaking to decide the appropriate identification and valuation of assets.

Furthermore, it is also premature to discuss whether information on the value of assets, liabilities, and return on investment is needed for the calculation of the Federal income tax. In addition to recommending the accounting practices and principles for splitting the assets and liabilities, the Treasury's other task is to develop the substantive

¹⁰⁵ See OCA Comments on Second Advance Notice at 39.

¹⁰⁶ The OCA's methodology is based on the faulty premise that "[o]ne would expect the operating results of the stand-alone competitive operations to be similar to the operating results of other competitive companies with economically similar business operations in terms of functions performed, types of markets, and risks assumed." OCA Comments on Second Advance Notice at 39. No two companies, even ones with "similar business operations in terms of functions performed, types of markets, and risks assumed" — such as General Motors and Ford, perhaps — necessarily achieve similar operating results. The list of reasons why such results could differ is endless: assets could be utilized more or less efficiently, management could be more or less creative and innovative, etc. Moreover, companies that perform similar business functions may have a very different capital structure. The Postal Service and its competitors UPS and FedEx deliver packages nationwide, but these competitors are substantially more capital-intensive than the Postal Service (e.g., they own and operate their own air fleets). Imputing UPS's and FedEx's capital structure to the Postal Service would only serve to layer capital costs that are the industry average on top of labor costs that are above the industry standard.

¹⁰⁷ See 39 U.S.C. § 2011(h)(1)(B).

and procedural rules that should be followed for determining the assumed Federal income tax on competitive products income. Once again the Treasury has the lead on this task and must make its recommendations to the Commission by December 20, 2007.

III. Conclusion

The PAEA was designed to fundamentally remake the regulatory structure so that the Postal Service could better respond to the challenges it faces in the current marketplace and thereby maintain universal service at affordable prices. When Congress looked at the pricing regime of the PRA, it saw a system that was overly rigid, cumbersome, and litigious.¹⁰⁸ The PAEA creates a modern regulatory structure whose objectives are to (among other things) increase the transparency of the Postal Service, the incentives for the Postal Service to operate efficiently, the predictability and stability of prices, and the Postal Service's flexibility to respond to market considerations.¹⁰⁹ It is also intended to reduce the administrative burden of the regulatory process.¹¹⁰ All of these objectives mesh into a coherent structure that mandates profound changes to the procedural and substantive elements of the pricing regime.

The PAEA sets forth a set of procedural provisions, which replace the extensive, pre-implementation adjudicatory processes of the PRA with a system characterized by, on the market-dominant side, a short, 45-day prior review to ensure compliance with the cap, and, on the competitive side, no prior review at all. Post-implementation review, through the Annual Compliance Review (or complaints), is designed to handle issues concerning market-dominant products outside of cap compliance (such as the

¹⁰⁸ See, e.g., SEN. REP. NO. 108-318 at 7-8.

¹⁰⁹ See 39 U.S.C. § 3622(b)(1), (2), (4), (6).

¹¹⁰ See 39 U.S.C. § 3622(b)(6).

“workshare discount” provision of § 3622(e)), and whether competitive products have covered the § 3633 cost floor set by the Commission in a given year.

A sensible approach under the Act is that the Commission should rely on historical cost and volume data in fulfilling its regulatory responsibilities. Litigation over projected costs and volumes derived through a roll-forward and forecasting models open the door to untimely litigation and delay, and should be a thing of the past. Therefore, for market-dominant products, compliance with the cap should be calculated by reference to historical, rather than forecasted, volumes, and determination of the Postal Service’s compliance with the “workshare discount” provision of § 3622(e) should be made by reference to actual, rather than projected, costs. Similarly, for competitive products, determination of compliance with the provisions of § 3633 should be made by reference to the Annual Compliance Review, rather than through forecasted cost and volume data.

From a substantive perspective, the Act accords the Postal Service substantial flexibility to price in order to meet customer needs. The Act has fundamentally altered the respective roles for the Commission and the Postal Service. As the Postal Service noted in its Reply Comments on the First Advance Notice:

Perhaps most fundamentally, the PAEA changes the Commission’s role in the pricing process. Under the Postal Reorganization Act (PRA), the Commission’s primary task was to recommend specific rates, fees, and classifications for postal services by exercising its best judgment as to which among a spectrum of potential, lawful rates, fees, or classifications was most consistent with the statutory criteria. Under the PAEA, however, the Commission’s role has changed from ratemaking to oversight, ensuring that the prices and classifications that are established by the Postal Service in the exercise of its business judgment are “compliant” with the Act (*i.e.*, stay within the statutory limits on the Postal Service’s

discretion). The Commission is aided in this oversight role by the Act's provisions for increased transparency.¹¹¹

On the market-dominant side, Congress has, in § 3622, set forth a regulatory structure that focuses on compliance with a price cap applied at the class level and the establishment of rates that are just and reasonable (i.e., fall within a “zone of reasonableness”), rather than the cost-focused, “fair and equitable” regime of the PRA. There are, of course, elements of the new regime that have relevance to costs, but these fit comfortably within the price cap framework set forth by Congress. While “workshare discounts” within the meaning of the Act are subject to an additional standard based on costs avoided, the Act expresses that standard as a general principle rather than a rigid pricing rule. In addition, while the “requirement” of former § 3622(b)(3) is carried forward by the PAEA, its significance in the new regime is significantly lessened by its placement as a “factor.”

On the competitive side, Congress has accorded the Governors the authority to set the prices and classifications as they deem necessary to meet business needs, subject only to principles of fair competition and to a cost floor established by the Commission pursuant to § 3633. In particular, the Act accords to the Governors the authority to determine what prices the market will bear, and what profit margin to seek on competitive products above the cost floor set by the Commission.

Consistent with the statutory scheme set forth by Congress in the PAEA, the appropriate approach for the Commission to take in this rulemaking is to exercise a light-touch by not seeking to impose potentially onerous burdens on the Postal Service

¹¹¹ Postal Service Reply Comments on First Advance Notice at 3.

on the basis of hypothetical or theoretical concerns. As the Postal Service stated in its Initial Comments on the First Advance Notice with respect to market-dominant products:

The Postal Service respectfully suggests that the optimal approach for the Commission to take in this rulemaking is to recognize that, to paraphrase John Dewey, an ounce of experience is likely to prove better than a ton of theory. On the market-dominant side, the Commission should adopt those rules that are necessary to operate the CPI-U price cap structure laid out by Congress in § 3622(d), and to refrain from imposing additional requirements until it perceives a compelling need to do so based on how the market and public needs develop. Given the complexities involved, and the existence of the CPI-U constraint, it would be better to proceed slowly with the benefit of actual experience rather than theoretically, which presents the danger of producing unintended consequences as hypothetical issues are addressed without a specific factual basis. Indeed, we suggest that a bias towards the issuance of regulations only on an “as-needed” basis comports well with the overall intent of the PAEA and the implications of rapidly changing markets.¹¹²

Such an approach on the market-dominant side is also fully consistent with the provisions of § 3622, read as a unified whole and in the context of the statute as a whole, as the Postal Service discussed extensively in its Initial Comments on the First Advance Notice at pages 7-23. It also applies with perhaps more force to the competitive side.

Respectfully submitted,

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¹¹² See Postal Service Initial Comments to First Advance Notice, at 4.

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