

**BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON DC 20268-0001**

REGULATIONS ESTABLISHING SYSTEM)
OF RATEMAKING)

Docket No. RM2007-1

**REPLY COMMENTS OF
ALLIANCE OF NONPROFIT MAILERS AND
MAGAZINE PUBLISHERS OF AMERICA, INC.
ON FURTHER ADVANCE NOTICE OF PROPOSED RULEMAKING
(ORDER NO. 15)**

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The Alliance of Nonprofit Mailers (“ANM”) and Magazine Publishers of America, Inc. (“MPA”) respectfully submit these joint reply comments in response to Order No. 15, the further Advanced Notice of Proposed Rulemaking (“ANPR”) issued by the Commission on May 17, 2007, and published in the Federal Register at 72 Fed. Reg. 29284 (May 25, 2007). These comments involve Questions 2 and 4 through 9 posed by the Commission.

Question 2

In their June 18 comments, ANM and MPA explained that the same “volume weights” should be used to determine average revenue per piece under existing and new rates for calculating the average rate increase for each mail class. Consistent with this approach, 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 for the new, altered rate structure should be based on a mail characteristics study for the same time period as the billing determinant data used to calculate average revenue per piece under the existing rates. This method ensures that

the average revenue per piece under existing and new rates is based upon an identical mail base, i.e., a constant mail mix. ANM-MPA Comments (June 18, 2007) at 2-3.

Several parties have argued for a different approach, in which “the question of whether and if so, to what extent, altered rate designs affect 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.” PostCom Comments (June 18, 2007) at 5. ANM and MPA do not object to this alternative approach when the change in rate design is relatively straightforward, provided that the method for estimating the rate change assumes a constant mail mix. When the change in rate design is complex and far-reaching, however—as occurred for Periodicals mail in R2006-1—we believe that the approach advocated by ANM and MPA is superior. Where to draw the line on this issue is a question that the Commission may wish to defer for case-by-case resolution.

Questions 4 through 9 (rate regulation for competitive products)

The members of ANM and MPA rely primarily on market dominant products. Except for question 8(c), our comments have not discussed the standards for pricing competitive products. We wish to add our support, however, to the comments that advocate pricing flexibility for competitive products, and our opposition to the imposition of artificial regulatory constraints on the Postal Service’s ability to compete on price with rival carriers.

Competitive products cover their attributable costs and make a significant contribution to institutional costs. For example, as UPS itself calculates, the combined

cost coverages for competitive products were 157 percent in Docket No. R87-1 and 143 percent in Docket No. R2006-1. UPS comments (June 18, 2007) at 10. The Postal Service's provision of competitive products at coverage ratios like these is a clear benefit to users of market dominant products:

Not only is there no cross subsidization of competitive products by market dominant products, but the rates for market dominant products are lower because the Postal Service offers competitive products. In FY 2008, competitive products were estimated to cover their attributable costs and in addition make a contribution of \$2.6 billion towards institutional costs. Without this contribution from competitive products, market dominant products would have to cover this \$2.6 billion in institutional costs. This would require market dominant rates to increase by more than four percent.

PSA Initial Comments in response to Order No. 2 at 9. This conclusion is consistent with the longstanding recognition that allowing a regulated network carrier to charge relatively low markups over variable or attributable cost for relatively competitive services benefits market dominant customers by reducing the markups that they latter group of ratepayers must make to cover the remaining institutional costs of the regulated firm. See 1 Alfred E. Kahn, *Economics of Regulation* 155-156, 199 (1970); *Cost Standards for Railroad Rates*, 362 I.C.C. 800, 806-08 (1980), *aff'd*, *Water Transport Ass'n v. ICC*, 684 F.2d 81 (D.C. Cir. 1982) (upholding ICC rules allowing railroads to set prices for competitive traffic as low as short-run variable cost); *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984); *Coal Rate Guidelines--Nationwide*, 1 I.C.C.2d 520, 526 (1985), *aff'd*, *Consolidated Rail Corp. v. ICC*, 812 F.2d 1444 (3d Cir. 1987).

The risk that the Postal Service will respond to competition by pricing below contribution-maximizing levels is of far less concern than the risk that constraints on

downward pricing flexibility will inadvertently harm competition and ratepayers and reduce the Postal Service's contribution by handcuffing the ability of the Postal Service to compete vigorously on price with private carriers. If that occurs, ratepayers generally—even those that use only the Postal Service's market dominant products—will be worse off. For this reason, light-handed Commission oversight over rates for competitive products is the wiser course.

Question 8(c)

Question 8(c) asks how Retiree Health Benefit costs should be classified in attributing costs to competitive products under 39 U.S.C. §§ 3631(b) and 3633(a)(2). ANM and MPA discussed the attribution of Retiree Health Benefit costs at pages 25-33 of their joint reply brief in Docket No. R2006-1 (filed January 4, 2007), and at pages 9-10 of their May 7, 2007 reply comments in this docket.

The Postal Service, in its June 18 comments (at 30), criticizes ANM and MPA for claiming that “the acceleration of the payment schedule renders any attempt to attribute [retiree health benefit] costs meaningless.” This is an attack on a straw man. The causation-based principles identified by ANM and MPA for attributing (or not attributing) such costs is not only meaningful and economically sound but similar to the middle ground approach proposed by the Postal Service itself. Specifically, in its response to Order No. 15 (at 30), the Postal Service advocates the following approach to attribution:

- Classify prior period retiree health benefit costs as institutional costs because doing otherwise would be to “commit the fallacy of attributing sunk costs.”
- Using actuarial methods, determine the retiree health benefit costs earned by workers through their service in the current year and attribute them in the same manner as direct labor costs.

- Cap attributable retiree health benefits costs at accounting costs.

Compare ANM-MPA Reply Comments (May 5, 2007) at 9-10; R2006-1, ANM-MPA Reply Brief (Jan. 4, 2007) at 25-33.

Although the method proposed by OCA for attributing the costs of retiree health benefits is not perfectly clear, OCA appears to agree with the basic approach of attributing a portion of the retiree health costs earned during the year by current workers, but not attributing prior period costs. OCA relies in this regard on 5 U.S.C. § 8909(a), which states:

Not later than June 30, 2007, and by June 30 of each succeeding year, the Office shall compute the net present value of the future payments required under section 8906(g)(2)(A) and attributable to the service of Postal Service employees during the most recently ended fiscal year.

This section of the law relates only to retiree health benefit costs earned by workers due to their *current* service. Thus, when OCA concludes in the next paragraph of its comments that retiree health benefit costs should be attributed to the same extent as the underlying labor cost, we presume that OCA was referring only to those costs for benefits earned during the year:

The Postal Service must account for the annuitant health benefits on an accrual basis because the annuitant health benefit costs are related to the current labor force. Therefore, the accrued annuitant health benefit costs should be allocated as attributable to the same extent as the underlying labor cost.

OCA response to Order No. 15 (at 54). Further supporting this interpretation is OCA's reference to "annuitant health benefit costs [that] are related to the *current* labor force." (emphasis added).

The two parties with a clearly divergent position are UPS and Valpak: both argue for attributing prior period retiree health costs. UPS (at 18-19) and Valpak (at 16-18). Their arguments should be rejected. As we have previously discussed, prior period retiree health benefit costs are not only fixed, but sunk. Sunk costs should not be attributed to current or future mail because they lack the requisite causal relationship with such mail. Docket No. R2006-1, ANM-MPA Reply Brief at 32.¹

Valpak gains nothing by arguing that “[i]f retiree health benefit costs are treated as institutional, mailers of products which pay little markup will escape virtually all payment of these labor benefit costs.” Valpak response to Order No. 15 at 17. The same is true of any institutional cost. If a product does not cause the cost to occur, the cost cannot be attributed to the product. And, if the ratemaking factors of Section 3622(b) warrant only a low coverage ratio, it is entirely appropriate for the product to make on a small contribution to institutional costs as a matter of pricing.

Moreover, and in any event, under the PAEA, attributable cost levels will have no effect on the aggregate postal revenue for a particular market-dominant class. Rather, the maximum rates for a class will depend on changes in the CPI. Hence, at least for market-dominant products, Valpak’s recommended treatment of prior period retiree

¹ As Alfred Kahn has stated, sunk costs are “bygones, unchangeable past history, and best forgotten.” 1 Alfred E. Kahn, *The Economics of Regulation* 118 (1970); *accord, id.* at 71 and 73; Kahn & Shew, “Current Issues in Telecommunications Regulation: Pricing,” 4 *Yale J. on Regulation* 191, 224 (1987); Kahn, “Deregulation: Looking Backward and Looking Forward,” 7 *Yale J. on Regulation* 325, 333-34 (1990); III P. Areeda & H. Hovenkamp, *Antitrust Law* ¶ 741e (2d ed. 2002); Richard Posner, *Economic Analysis of Law* 7-8, 39, 560 (4th ed. 1992) ; *Coal Rate Guidelines—Nationwide*, 1 I.C.C.2d 520, 540, 544-45 (1985), *aff’d*, *Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3rd Cir. 1987).

health benefit costs would not resolve its concern. See MPA-ANM Comments (April 6, 2007) at 2-12 (explaining why the language, structure and history of PAEA dictate that the CPI cap trump the attributable cost floor).

UPS (at 19) argues that “[r]etiree health benefit costs incurred in the past fiscal year should also be attributed. Otherwise, current users of market-dominant products will be subsidizing costs incurred in the past by past users of competitive products.” This argument is mistaken. To be sure, an intergenerational cross-subsidy can result when a portion of the costs attributable to the provision of goods or services in one period are recovered from customers in a later period. But intergenerational cross-subsidies of this kind are received by *the entire generation of customers as a whole*. It is a non sequitur to suggest that such a cross-subsidy, if it exists, can be causally attributed to any individual product or subset of a product *within* the past period in which mail received the putative subsidy.

Moreover, in any event, to the extent ratepayers in past years effectively received a subsidy of the health care costs attributable to postal service provided in those years, the resulting intergenerational subsidy is beyond the power of anyone to eliminate. Even if the mailers and their volumes in those years could be identified—an obvious impossibility—the Commission has no authority to reach into the past and impose rate surcharges on mail carried in the past. Regardless of who compensates the Postal Service for the unrecovered costs of past mail service—i.e., regardless how those sunk costs are allocated or apportioned among current or future mailers—the intergenerational cross-subsidy of past mailers will remain.

CONCLUSION

ANM and MPA respectfully request that the Commission adopt the standards and procedures proposed herein.

Respectfully submitted,

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