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Regulations Establishing System Of Ratemaking | **DOCKET No. RM2007-1**

REPLY COMMENTS OF PARCEL SHIPPERS ASSOCIATION ON PROPOSED RULE

Introduction

In their comments United Parcel Service (UPS), Greeting Card Association (GCA), Office of Consumer Advocate (OCA), Newspaper Association of America (NAA) and Valpak advance positions that would seriously disrupt the PAEA's deliberate severance of market dominant mail and competitive products mail, and disable USPS attempts to compete.

UPS has argued for a higher "appropriate share" percentage, once implemented, and argues for a fixed institutional cost share for competitive products, rather than a minimum share.

The GCA argues that, in an exigent rate case, the Commission should determine whether the competitive products should also contribute more in order to make up the expected deficit from market dominant products.

The OCA and the NAA argue that NSAs, or contract rates, are authorized under the PAEA only if they increase overall contribution to institutional costs. This is flatly contradicted by the statute itself. Moreover, the section that they rely on, Section 3622, and 3622(c)(10), relate only to market dominant, not competitive products. The calls of NAA and Valpak for external parties to be involved in the pre-reimplementation review of NSAs and the implications of that for the review process for contract rates is misguided, contrary to the time lines established by the PAEA, and will obstruct the completion of such deals.

While PSA does not take issue with the Postal Service's proposal to separate mail into shape based products, we urge the Commission to be watchful to insure that this does not result in the abandonment of the Commission-established "neutral starting point", setting rates in a manner that equalizes that contribution and promotes productive efficiency.

1. The "Appropriate Share" of Institutional Costs

PSA urges the Commission to reject UPS' suggestion that competitive products' institutional cost share should ultimately be higher than 5.5 percent and its recommendation that the Commission should set a *fixed* institutional cost share for competitive products, rather than a *minimum* share. UPS Comments (September 24, 2007) at 1, 2.

The basis of UPS' argument for a higher appropriate share is that competitive products' institutional cost share, as a percentage of all institutional costs in FY 2005 and FY 2006, is lower than in the past. On page 5 of its September 24 comments, UPS presents a chart[1] purporting to show the percentage of institutional costs contributed by competitive products. The chart shows that the percentage share of institutional costs paid by competitive products has recently decreased, but neither the chart nor the accompanying discussion provide any insight or explanation as to why.

Without such an explanation, the Commission could be left with the false impression that competitive products' share has dropped because the Postal Service is pricing them inappropriately low.[2] Analysis of Priority Mail and Express Mail[3] rates and volumes for what UPS refers to as the

[1] For purpose of these comments, PSA assumes that these UPS calculations are correct. We, however, have no reason to believe that this is the case because UPS has not provided its underlying calculations.

[2] UPS also appears to suggest (at 5) that the decrease in competitive products' institutional share may be related to the settlements in Docket No. R2001-1 and R2005-1. PSA disagrees and notes that the R2001-1 settlement did not result in low rate increases for competitive products. The R2001-1 rate increase was 13.5 percent for Priority Mail and 9.4 percent for Express Mail, as compared to an average increase of 7.5 percent for all mail.

[3] As PSA explained in its September 24 comments (at 3), Priority Mail and Express Mail account for a very large portion of the total institutional cost contribution of competitive products.

"more recent years from FY 1997 on" shows that this is far from the truth. The reality is that the Postal Service has raised Priority Mail and Express Mail prices dramatically since FY 1997 and that the drop in competitive products' institutional cost share during this period is, to a large extent, the result of significant decreases in Priority Mail and Express Mail volumes.

Since 1997, the Postal Service has raised Priority Mail and Express Mail rates five times.[4] As Table 1 below shows, the cumulative rate increases for Priority Mail and Express Mail have far outpaced inflation for this period.[5] In fact, the cumulative rate increase for Priority Mail during this period is nearly 2.4 times as large as the corresponding growth in the consumer price index (CPI) while the cumulative rate increase for Express Mail was more than 1.7 times the growth in CPI. Given the magnitude of these increases, the reduction in competitive products' share of institutional costs obviously was not the result of any attempt to unfairly price these products.

Table 1. Priority Mail and Express Mail Rate Increases (1997-2007)[6]

Rate Case	Year Implemented	Priority Mail	Express Mail	All Mail
R97-1[7]	1999	5.6%	9.0%	2.6%
R2000-1[8]	2001	17.2%	5.2%	6.3%
R2001-1[9]	2002	13.5%	9.4%	7.5%
R2005-1[10]	2006	5.4%	5.5%	5.0%
R2006-1[11]	2007	13.5%	12.5%	7.6%
Cumulative Rate Increase	1997-2007	68.2%	48.9%	32.5%
Cumulative Increase in CPI[12]	1997-2007	28.7%	28.7%	28.7%

[4] To be precise, there were six rate increases because Docket No. R2001-1 was implemented in two phases.

[5] This is despite the more than three-year respite between rate increases resulting from the Postal Civil Service Retirement System Funding Reform Act of 2003.

[6] Percentage increases for Priority Mail and Express Mail in all rate cases were obtained from Governors' Decisions as noted below. Percentage increases for All Mail were obtained from the corresponding Opinion and Recommended Decisions except for R2000-1, which was provided in the Governors' Decision.

[7] *Notice of the United States Postal Service of Decision of the Governors*. 30 June 1999. Pp. 5-6.

[8] *Decision of the Governors of the United States Postal Service on the Recommended Decision on Further Reconsideration of the Postal Rate Commission on Postal Rates and Fees: Docket No. R2000-1*. 7 May 2001. Attachment 4.

[9] *Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Postal Rate and Fee Changes: Docket NO. R2001-1*. 8 April 2002. Pg. 8.

On the other hand, Priority Mail and Express Mail volumes have dropped dramatically during the period. UPS calculated that competitive products paid for an average of 8.2 percent of institutional costs from 1997 to 2002. As Table 2 shows, between then and the FY 2005-2006 period (the two years that the Commission used to calculate the appropriate share), Priority Mail volumes dropped 20 percent and Express Mail dropped by nearly as much (16 percent). Further, R2006-1 Test Year After Rates Priority Mail and Express mail volumes are, respectively, 27 percent and 36 percent, lower than the average volume in the 1997-2002 period.

Table 2. Average Annual Mail Volume (Millions of Pieces)[13]

Time Period	Priority Mail	Express Mail
1997-2002	1,130	67
2005-2006	906	56
Test Year (2008) After Rates	829	43

Given these volume trends, it would be unreasonable to expect, and inappropriate to require, competitive products to cover the same percentage share of institutional costs in the future that they covered during the 1997 to 2002 period. Further, the recent downward trajectory in competitive products' share of institutional costs (a result of volume decreases, not the product of inappropriately low pricing) is further corroboration of the need for an adequate margin of safety in the appropriate share requirement.[14]

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[10] *Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission on Changes in Postal Rates and Fees Pursuant to Public Law 108-18, Docket No. R2005-1 (November 14, 2005).* 15 November 2005. Pg. 16.

[11] *Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Regulatory Commission on Changes in Postal Rates and Fees, Docket No. R2006-1 (March 19, 2007).* 19 March 2007. Pg. 13.

[12] Change in consumer price index for All Urban Consumers from 1997-first half to 2007-first half. Data are provided at http://data.bls.gov/cgi-bin/surveymost.

[13] United States Postal Service Revenue, Pieces, and Weight (RPW) Reports, USPS-LR-L-63, "Volumes," sheet '1993- 2003detail,' and R2006-1 Op., Appendix G at 1.

[14] The institutional share of competitive products may also be worsened by competitor pricing responses to USPS departures from cost-based rates. For example, witness Scherer in R2006-1 explained that the Postal Service's pricing of lightweight, bulky parcels has "caused Priority Mail to become a *magnet* for the very kinds of parcels on which it loses money." R2006-1, USPS-T-33 at 17.

The Commission also should reject UPS's argument that the Commission recommend a fixed share of institutional costs to be paid by competitive products, rather than a minimum share. First, having the Commission dictate the exact share of institutional costs that must be paid by competitive products is inconsistent with the significant pricing authority that the Postal Accountability and Enhancement Act (PAEA) endows in the Postal Service Board of Governors regarding the pricing of competitive products.

Second, such an approach would be entirely impractical. As PSA explained in its September 24 comments (at 3), competitive product volumes (and thus contribution) depend on a number of external factors, including competitor prices. Without knowing the values for all of these factors, it is impossible to estimate accurately competitive product mail volume or contribution at a specific set of prices. PSA suspects that at least one input would be missing from these calculations – that is, unless UPS and other Postal Service competitors would be willing to divulge their pricing strategies and term and conditions of all of their contract rates (under, of course, the same protective conditions as used for confidential USPS information) for the upcoming year.

Further, PSA cannot help but wonder how the Postal Service would be required to act under UPS' approach, if, three quarters into a fiscal year, the institutional cost contribution of competitive products was well in excess of what was needed to meet the fixed share requirement. Would the Postal Service be required to discount all of its competitive products for the remainder of the year to ensure that it hits the fixed share target? Conversely, if the institutional cost contribution was lagging behind after three quarters, would the Postal Service be required to implement competitive product surcharges for the remainder of the year? Neither of these options seems particularly practical.

Given the language and spirit of the PAEA, the inherent uncertainty in forecasts of competitive products' institutional cost share, and the practical problems with requiring the Postal Service to hit a fixed share target, requiring competitive products to exceed a minimum share of institutional costs that includes a reasonable margin of safety is a much more pragmatic solution.

2. Filing Requirement in Support of Exigent Rate Increases

The Commission should reject the Greeting Card Association's (GCA) recommendation that the Postal Service address whether the rates proposed in an exigency filing are reasonable and equitable between market-dominant products and competitive products. GCA Comments (September 24, 2007) at 7-8. The PAEA intentionally separates the rate setting process for market-dominant products from that for competitive products. GCA's recommendation would inappropriately wed them back together.

PAEA authorizes the Postal Service Board of Governors to set rates for competitive products so long as they comply with the "cross-subsidy" rules specified in § 3633(a) of the PAEA – which require only that each competitive product cover its incremental costs, and competitive products as a whole pay *at least* an appropriate share of institutional costs. Given this, the way that the Commission could affect rates for competitive products would be through adjusting the appropriate share.[15] Doing so as part of an exigency filing, however, would be entirely inappropriate given the purpose of the appropriate share requirement. In Order No. 26 (para. 3058), the Commission explained its thought process in determining the appropriate share.

> In attempting to quantify an appropriate contribution, the Commission is mindful of the risks of setting it too high, particularly at the outset of the new system of regulation. The market is competitive; the Postal Service's market share is relatively small; and the Postal Service needs some flexibility to compete. On the other hand, the Commission has an obligation to preserve competition by not establishing a markup so low as to give the Postal Service an artificial competitive advantage.

The Commission's logic makes clear that the appropriate share requirement was and should (in the future) be set at a level that promotes fair competition, not at a level that is driven by the profitability (or lack thereof) of market-dominant products. Thus, an exigent circumstance should not dictate a change to the appropriate share, and requiring the Postal Service to file information regarding whether an exigent rate increase is reasonable and equitable between market-dominant and competitive products would be superfluous.[16]

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[15]Dictating specific rates that USPS must charge for competitive products would encroach upon USPS discretion. The Postal Service, of course, could raise prices for competitive products rates to whatever level the market will bear, without an exigency filing.

[16] PSA notes that the Commission has stated its intention to revise the appropriate share requirement when necessary, such as if products are added or deleted from the competitive product lists or market conditions change. Order No. 26, Para. 3061. Proceedings focused on these more relevant issues are the more appropriate forum for adjustments to the appropriate share requirement.

3. Negotiated Service Agreements and Contract Rates

The Postal Regulatory Commission (PRC) should reject the OCA and the NAA position that PAEA only authorizes negotiated service agreements (NSAs) that increase overall contribution to institutional costs. OCA Comments (September 24, 2007) at 4; NAA Comments (September 24, 2007) at 2-3. The foundation for their position is purportedly § 3622(c)(10) of the PAEA. OCA's and NAA's reading of this Section of the PAEA, however, is faulty for two reasons.

First, NAA and OCA ignore the fact that § 3622(c)(10) of the PAEA explicitly allows for NSAs that meet one of two alternative conditions. The first condition is, as recognized by NAA and OCA, that the agreement "improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service." The second alternative condition, which both parties ignore, is that the agreement "enhance the performance of the mail preparation, processing, transportation, or other functions." Given its "either/or" construction, § 3622(c)(10) clearly authorizes market-dominant NSAs that meet the latter condition, enhancing performance, but not the former.

Second, it must be emphasized that § 3622 in general and § 3622(c)(10) in particular relate only to market-dominant products. The authority for the Postal Service to enter into contract rates for competitive products[17] derives from § 3632(b)(3) of the PAEA, which explains procedures for competitive "Rates or Classes Not of General Applicability." This section of the PAEA does not include the same types of constraints on contract rates as § 3622(c)(10) does for market-dominant product NSAs. Rather, the only constraints (other than a 15-day notice period) on contract rates are the rules specified in § 3633(a) of the PAEA.

PSA also strongly opposes the calls of some parties (most notably, NAA and Valpak) for the involvement of external parties in the pre-implementation review of NSAs and the potential spillover of these calls into the review process for contract rates. In addition to jeopardizing the streamlined review timelines established by the PAEA and the confidentiality of proprietary

[17] As discussed in previous comments, PSA refers to negotiated service agreements (NSAs) as contract rates because this is the term used in the parcel shipping industry for such agreements, which are the primary way that bulk parcel shippers do business with USPS competitors.

information, we are concerned that this will require shippers to continue "to run [the] gauntlet of challenge and delay before getting a deal done"[18] that has been the hallmark of the NSA review process to date. The concerns of external parties regarding NSAs and contract rates are more properly addressed through the complaint process.

4. Proposed List of Market-Dominant Products

PSA does not take issue with the Postal Service's proposal to separate the Standard Regular subclass, Bound Printed Matter subclass, and First-Class Mail class into shape-based products. United States Postal Service Submission of Initial Mail Classification Schedule in Response to Order No. 26 (September 24, 2007) at 8. The Commission, however, should be vigilant to ensure that the Postal Service's defining each mail shape as a separate product does not result in the abandonment of the Commission-established "neutral starting point" that each piece of mail (and thus each shape of mail) within a subclass should make the same unit contribution in favor of a focus on equalizing the percentage markup on each shape. As the Commission found in R2006-1, like efficient component pricing, setting rates in a manner that equalizes unit contribution promotes productive efficiency. Abandoning this principle thus would result in less efficient preparation.

> [C]ontrary to what the Commission articulated in R2000-1 about the neutral starting position for rate design, the Commission now believes, and with good evidence, that the neutral starting position should equal the per-piece contribution because this promotes productive efficiency. R2006-1 Op., para. 4032.

[18] PSA Comments (June 18, 2007) at 13.

Conclusion

As we said in our initial comments, PSA believes that the Commission's proposed rules, particularly if amended as we proposed, have intuited Congress' intention exactly right as to how the Postal Service should behave in the future. We trust that the Commission will ignore the suggestions advanced by UPS, GCA, NSA, OCA, NAA and Valpak, suggestions that would seriously derail the PRC's very sound regulations for the proper operation of the Postal Service in the future.

Respectfully submitted

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