

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

Annual Compliance Report)
) Docket No. ACR2007
)

COMMENTS OF
DIRECT MARKETING ASSOCIATION, INC. AND
PARCEL SHIPPERS ASSOCIATION, INC.
PURSUANT TO PRC NOTICE OF FILING OF ANNUAL COMPLIANCE REPORT

On December 28, 2007 the United States Postal Service (“the Service”) submitted its FY 2007 Annual Compliance Report (“ACR”) to the Postal Regulatory Commission (“the Commission”) pursuant to Section 3652 of the Postal Accountability and Enhancement Act (“PAEA”) ¹. The Commission published notice of this filing three days later, on December 31, 2007. In its notice, the Commission solicited public comments as required under Section 3653.

Direct Marketing Association (“DMA”) and Parcel Shippers Association, Inc. (“PSA”) are pleased to provide these comments. Much of the information that is seemingly required ² for an ACR is simply not available, since the Service’s data collection tools have not been revised to collect the relevant information for Fiscal Year 2007. Thus, these comments do not focus on issues such as quality of service or costs by product, which are required by the PAEA. However, the Service has provided estimates of costs avoided and discounts, and most of our comments focus on the relationships between discounts and costs avoided, a relationship that is controlled under the PAEA.

¹ Public Law 109-435.

² We say, “seemingly,” because the PRC has not yet conducted a rule-making on the required contents of an ACR, and, thus, it is not clear what the requirements actually are or will be.

I. Introduction – The Unusual Circumstances of this Annual Compliance Review

As a preliminary matter, and as the Service notes, this ACR covers FY 2007, a year in which the rates and the discounts were set not under the PAEA but under the previous law, the Postal Reorganization Act of 1970 (the “PRA”). All the current discounts were recommended by the Commission and approved by the USPS Governors. Their lawfulness is not in question. We agree with the Service that the requirement of the PAEA that discounts may not exceed cost avoidances except under certain circumstances simply does not apply for this year’s ACR. Thus, in this docket, it is irrelevant whether a passthrough – the ratio of the discount to incremental avoided costs – for a particular rate is 100 percent or 500 percent.

II. The Importance of a Proper Comparison between Discounts and Avoided Costs

Nevertheless, this ACR is important in several respects relating to the relationship between discounts and costs avoided, because these issues will be applicable to future ACRs and, in one instance, will have implications for future Notices of Rate Adjustment. Thus, it is appropriate to address them now.

First, concerning passthroughs in First-Class Mail Automation Letters, the Service has selected Automation Mixed AADC Letters as the benchmark for measuring the passthrough for Automation AADC Letters, has selected Automation AADC Letters as the benchmark for measuring the passthrough for Automation 3-digit Letters, and has selected Automation 3-digit Letters as the benchmark for measuring the passthrough for Automation 5-digit Letters. We agree. This approach is entirely appropriate: passthroughs should be measured at the margin. It is also appropriate that the Service did not calculate a passthrough for Automation Mixed AADC Letters: it would be inappropriate to measure the passthrough from any type of Single-Piece First-Class Mail to Automation letters, since Automation Letters and Single-Piece First-Class are in different products as defined by the Postal Service.

On the other hand, we strongly disagree with the Postal Service’s approach to the calculation of the discounts that are compared against avoided costs. Passthroughs – as described above – are the ratio of the discounts to the costs avoided. However, as calculated by the Postal Service, the avoided costs cover the period of the entire 12 months of FY2007, while the discounts cover the

period of only the last 4½ months of that Fiscal Year. To make meaningful the comparison between discounts and costs avoided, both sets of numbers (*i.e.*, both the numerators and the denominators) must be cover the same time period. Comparing discounts in one time period with costs avoided in another is incorrect and produces no sensible outcome. The results of any such comparison are driven by the time period selected for the measurement. Selecting values from differing time periods, allows ratios to be manipulated to produce virtually any desired result.

There are two possible approaches for fixing this deficiency: (1) either the full year's discounts could be used in the numerator (requiring the simple and appropriate weighting of the discounts by the volumes receiving those discounts), or (2) only the last 4½ months of avoided costs could be used in the denominator. We believe that the second approach is not practical, because the starting point for costs avoided, the CRA, is not produced for a 4½ month period. Thus, the first approach appears to be the only sensible alternative.

Uncorrected, this general error of comparing discounts in one time period with costs avoided in another could easily pass into Notices of Rate Adjustment. Under Order No. 43 – Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, the Service must provide “A schedule of the workshare discounts included in the proposed rates, and a companion schedule listing the avoided costs that underlie each such discount. The avoided cost figures must be developed from the most recent PRC Annual Compliance Report.” §3010.14 (5). Under the rules, the Service must also provide “Separate justification of all proposed workshare discounts that exceed avoided cost.” §3010.14 (6).

If, in its first Notice of Rate Adjustment, the Service were to file costs avoided from the ACR and compare these coststo the discounts it proposes, it wouldbe comparing discounts that are expected to be in effect the last 4½ months of FY 2008 and the first 7½ months of FY 2009 with avoided costs from FY2007. Such a calculation would involve a huge temporal mismatch between the discounts and the costs. It will be critical to update the costs avoided to the same time period as the discounts.

USPS unit costs usually increase over time for the simple reason that labor, transportation, and other costs typically increase faster than productivity. (In fact, one might argue that the price cap is set at the CPI rather than the CPI minus an X factor for just this reason.) And, as unit costs increase, so too do cost avoidances. Thus, avoided costs are almost certain to be larger in the last 4½ months of FY 2008 and the first 7½ months of FY 2009 than they were in FY 2007. Fortunately, §3010.14 (5) allows for a valid comparison, stating “The avoided cost figures must be developed from the most recent PRC Annual Compliance Report.” The rule does not say “they must be the same as” but rather says “must be developed from.”

We suggest that the proper way to “develop” future-year avoided costs from the avoided costs shown in an ACR is to inflate each of the ACR cost avoidances by the CPI used in the cap calculations. This is a simple process, easy to calculate, and would produce a simple estimate of cost avoided for the period that the new rates and discounts will be in effect. The Postal Service uses much this same procedure in estimating out-year costs for NSAs, so the approach is not without precedent.

One alternative to this CPI adjustment approach would be to produce a full “roll forward” of costs and costs avoided, but such an approach is overly complex and would return the Service to the rate setting days of the PRA – a situation to be avoided at all costs! The other alternative, simply disregarding the fact that costs and cost avoidances increase over time, ignores reality and provides a downward bias to the discounts with no attendant benefits.

Each ACR will provide an opportunity to compare actual discounts with actual costs avoided. This opportunity should not be wasted – especially now. Following a major shift in rate relationships within classes of mail based upon the shape of that mail, it is imperative to ensure that discounts for those very classes of mail are not skewed due to a comparison error. We are just now seeing the mail volume effects of the R2006-1 rates, and the public, the mailers and the Postal Service cannot afford inaccurate price signals. The PAEA was passed to create a 21st Century Postal Service. Let us not impede it.

Finally, because the ACR does provide this opportunity for review based on actual rather than hypothetical results, DMA believes that in the filing of Notices of Rate Adjustment and the setting of rates and discounts, the requirement that discounts should not exceed avoided costs should be viewed as a “soft cap” rather than a hard one.

III. The Annual Compliance Report Demonstrates the Need to Reevaluate the “Appropriate Share” Requirement

The financial data reported in the Annual Compliance Report (ACR) reinforce concerns that DMA and PSA raised in a prior docket devoted to implementing regulations under the PAEA.³ In that docket, PSA and DMA expressed concern that even a small loss in Postal Service competitive product volume, which could be caused by factors beyond the Postal Service’s control (such as competitor pricing strategies), may cause the Postal Service to be out of compliance with the 5.5% appropriate share requirement proposed and subsequently adopted by the Commission. *See* 39 CFR §3015.7.

As DMA pointed out in reply comments:

In short, by exercising its market power, UPS could put the USPS competitive products into a death spiral from which the Postal Service would be unable to escape, at least until the 5-year review under Section 3633(b). It is enormously hard to be viable in competitive markets when your competitors have as much or more control over your prices as you do. A lot of damage to the interests of the general public could have occurred in the interim.

Docket No. RM2007-1, Direct Marketing Association, Inc. Reply Comments Pursuant to PRC Order No. 26 (filed 10/9/2007) at 8.

Similarly, in its initial comments PSA said:

This problem is magnified because the 5.5 percent appropriate share requirement provides no reasonable margin of safety to account for the risks discussed above. Rather than setting the appropriate share requirement below historical levels that would build in such a margin and provide the Postal Service with some limited downward pricing flexibility, the proposed appropriate share requirement is equal to competitive products’ average historical (FY 2005 and FY 2006) share.

³ Docket No. RM2007-1, Regulations Establishing System of Ratemaking.

Docket No. RM2007-1, Comments of the Parcel Shippers Association in Response to the Commission's Order No. Proposing Regulations (filed 9/24/2007) at 4.

The last rate case (under the *old system*) resulted in a double-digit rate increase for competitive products last May. This is generally higher than corresponding price increases publicly announced by competitors during the same time frame. Nevertheless, this ACR suggests that competitive products' FY 2007 share of institutional costs in FY was only 5.65 percent, just marginally more than the 5.5 percent appropriate share requirement. ACR at 28. What this means in practical terms is that if Postal Service competitive product volumes had been just three percent less, they would have produced insufficient revenue to meet the 5.5 percent appropriate share requirement with the result that even before the Postal Service adjusted even one competitive product rate under the *new* ratemaking system it would have failed to comply with the PAEA appropriate share requirement.

In an earlier proceeding PSA warned that the competitive position of the Postal Service on the competitive product side is "fragile."⁴ A conclusion of a recent Federal Trade Commission (FTC) report, mandated by the PAEA supports this view. According to the FTC "the USPS's unique legal status likely places it at a net competitive disadvantage relative to private carriers."⁵ This net competitive disadvantage makes the Postal Service very vulnerable to competitor pricing strategies.

The combination of the razor thin margin of compliance demonstrated by this ACR, and the findings of the FTC suggest it would be appropriate for the Commission to reevaluate its appropriate share requirement as the PAEA permits it to do.⁶ Ironically, the comments of one Postal Service competitor in Docket No. RM2007-1 argue such a reevaluation of the appropriate share requirement may be in order.

⁴ Docket No. RM2007-1, Comments of the Parcel Shippers Association (filed 4/6/2007) at 3.

⁵ "Accounting for Laws that Apply Differently to the United States Postal Service and Its Private Competitors," *A Report by the Federal Trade Commission* (December 2007) at 55.

⁶ See 39 U.S.C. § 3633(b), authorizing the Commission to establish and "from time to time thereafter revise" its rules to prevent subsidization of competitive products.

“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. P.L. 109-435, § 703(d). 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 preferential legal treatment, on top of their attributable costs and their appropriate share of institutional costs. The Commission will be in a better position to quantify this requirement when it receives the FTC’s report. Until the Commission is able to do so, we suggest that it require that competitive products recover an additional amount above attributable and institutional costs to account for the Postal Service’s advantages.”

Docket No. RM2007-1, Comments of United Parcel Service in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking (filed June 18, 2007) at 9.

Finally, the Annual Compliance Report (ACR) suggests, and it is common knowledge within the industry, that there are likely to be major changes to the Postal Service’s costing systems in the near future. *See, e.g.*, ACR at 2, 27. For example:

The Postal Service will begin measuring costs by product, rather than by subclass.

The Postal Service is in the process of estimating “group-specific” costs that are incremental to competitive products as a whole.

The Commission may establish dockets to review and potentially adjust the costing methods used to attribute and distribute costs to products.

These adjustments to costing systems are likely to have an effect on the estimated cost of competitive products and thus the estimated share of institutional costs that these products bear. Put differently, if measured using the adjusted methods, the historical share of institutional costs (which was the basis of the PRC’s determination of appropriate share) borne by competitive products might have been only 4.5 percent, not the 5.5 percent originally estimated. Taking this example a step further, had the revised systems been in place in FY 2005 and FY 2006, the appropriate share requirement would likely have been 4.5 percent, not 5.5 percent.

Once costing methods have been adjusted, the PRC should adjust the appropriate share requirement to hold competitive products harmless for the impact of adjustments in how costs are measured. For example, if the costing adjustments erode the estimated share of institutional costs

borne by competitive products by ten percent, then the appropriate share should be adjusted downward by the same percentage.

Respectfully submitted,

Dana T. Ackerly II
Covington & Burling LLP
1201 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
Telephone: 202-662-5296
Facsimile: 202-778-5296
email: dackerly@cov.com
Counsel for Direct Marketing
Association, Inc.

Timothy J. May
Patton Boggs LLP
2550 M Street, NW
Washington, DC 20037
Telephone: (202) 457-6050
Facsimile: (202) 457-6315
Email: tmay@pattonboggs.com

James Pierce Myers
Attorney at Law
1211 Connecticut Avenue, NW
Suite 620
Washington, DC 20036
Telephone: (202) 331-8315
Facsimile: (202) 331-8318
Email: jpm@piercemyers.com
Counsel for Parcel Shippers Association

January 30, 2008