Postal Regulatory Commission
Submitted 8/21/2009 4:05:15 PM
Filing ID: 64338
Accepted 8/21/2009

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

NOTICE OF PRICE ADJUSTMENT	Docket No. R2009-5

RESPONSES OF THE UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1
(August 21, 2009)

Chairman's Information Request (CHIR) No. 1 was issued on August 14, 2009. The request sought answers no later than August 21, 2009. Attached are the Postal Service's responses to the entire CHIR, Questions 1-4.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

R. Andrew German
Managing Counsel, Pricing and
Product Development

Daniel J. Foucheaux, Jr.
Chief Counsel, Pricing and Product
Support

_____
Elizabeth A. Reed

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-3179, FAX: -6187

RESPONSE OF UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1

1. The Postal Service estimates that the Program will result in about $43 million in incremental revenue and $24 million in incremental contribution. *Id*. at 7.

a. Please identify the calculations underlying these estimates. Please show all calculations, provide source references for all inputs, and explain all assumptions.

b. If the estimates do not utilize the Postal Service's estimated price elasticities (*See* USPS FY 2008 Demand Analysis Materials, January 16, 2009), please explain why not, and provide an alternate estimate based on the known elasticities. Specifically, the analysis should utilize the current own-price worksharing discount, and Standard Mail discount elasticities for First-Class Presort Letters. Please show all calculations, provide source references for all inputs, and explain all assumptions.

RESPONSE:

a. Please see the file entitled "FCM Incentive.xls" (filed on August 14, 2009) for revenue and contribution calculations.

We assumed a total growth rate of 2 percent based on discussions with mail owners and Mail Service Providers. These customers were about evenly split between those who felt they could grow volume, and those who would move up to First-Class Mail from Standard Mail. We also made inferences about participation based on Summer Sale data.

After projecting the total volume increase, we used FY 2008 First-Class Mail presort letter, flat, and presort card volume share to allocate between the shapes. Buy-up from Standard Mail was handled similarly, except that the volume shares used excluded card volume.

b. The estimated volume response to the Postal Service's proposed First-Class Mail Incentive Program was not estimated from the Postal Service's traditional demand elasticity model because the structure of the Program was not compatible with the general assumptions underlying the basic demand model. The aggregate price and discount elasticities employed within the Postal Service's traditional demand elasticity model are aggregates of the price response of all mailers to uniform changes to the price of mail within a relevant mail category. The volume implications of the Postal Service's proposed First-Class Mail Incentive Program deviate from this assumption in two critical ways.

First, and most critically, under the Postal Service's proposed First-Class Mail Incentive Program, price is dependent on volume. In the Postal Service's traditional demand elasticity model, volume is dependent on price. This creates a chicken-and-egg problem. In order to forecast mail volume, one must first estimate what the price response to the Postal Service's proposed First-Class Mail Incentive Program will be. But, in order to estimate the price response to the Program, one must estimate how much new volume will emerge that qualifies for the proposed discounts. This, of course, simply begs the question. Using the Postal Service's traditional demand elasticity model, the volume response to the Postal Service's proposed First-Class Mail Incentive Program is ultimately a function of the volume response to the Postal Service's proposed First-Class Mail Incentive Program.

The estimated own-price elasticity for First-Class workshared letters filed with the PRC on January 16, 2009, was -0.25. This means that a 20 percent reduction in the

price of First-Class workshared letters would be expected to increase total First-Class workshared letters volume by approximately 5 percent.[1] For the Postal Service's proposed First-Class Mail Incentive Program, however, the marginal response of the individual mailer is critical because it is only the marginal volume that is affected by the program.[2]

Because of the way that the Postal Service's proposed First-Class Mail Incentive Program is set up, it is also very likely to be the case that this Program will create no incentives for mailers to substitute between First-Class single-piece and workshared mail. In order to qualify for the program, a mailer must already be a user of First-Class workshared mail. Hence, no incentives are being created that could induce single-piece mailers to begin to workshare their mail. On the other hand, it seems highly unlikely that a user of First-Class workshared mail will be incented to begin to workshare mail that would have otherwise been sent at single-piece mail; if such mail could be workshared, the mailer would have almost certainly already had ample incentive to do so. That is, the nature of the Postal Service's worksharing discounts makes it extremely likely that the marginal response of individual mailers to the decision of whether to send mail single-piece or workshared will be to shift entire mailings from single-piece to workshared or vice-versa. But the Postal Service's proposed First-Class Mail Incentive Program provides no incentives for entirely new mailings of this nature, only for

[1] Note that the 20 percent reduction in price is only for mail above a threshold volume; hence, an own-price elasticity of -0.25 would not suggest a 5 percent increase in total mail volume, but merely a 5 percent increase in volume above the threshold level.

[2] This assumes that Program incentives are set such that threshold volumes are equal to forecasted volumes in the absence of the Program.

marginal volume increases for existing First-Class workshared letter mailers. Hence, it would not seem appropriate to consider the First-Class worksharing discount elasticity at all in attempting to model the impact of the Postal Service's proposed First-Class Mail Incentive Program on First-Class Mail volumes.

In summary, the price elasticity models are not applicable when discounts are applied to marginal volumes. This is because a yet-to-be-known volume response affects the measurement of the price change itself. For instance, if the mail volume doubles, the price change would be 10 percent, as the original volume would get no discount and the additional volume would get a 20 percent discount. If volume remained constant, the price change would be 0 percent. Therefore, as customarily applied to postal forecasting models, elasticities do not work.

RESPONSE OF UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1

2. In the discussion of potential risks from the proposal, two risks are identified: (1) overestimating the additional volume generated by the Program, and (2) underestimating the administrative costs. Notice at 7-8. Did the Postal Service consider the risk (identified in NSA dockets as a risk inherent in many performance-based optional tariffs) that the thresholds might underestimate the volume that participating mailers would have sent in the absence of the Program, leading to revenue leakage? *See, e.g.,* FY 2007 Annual Compliance Determination at 126-27. If so, please provide the results of that risk analysis.

RESPONSE:

The Postal Service did not perform a formal risk analysis, but did take steps to mitigate the risk in this regard. As part of the analysis to determine participation, the Postal Service reviewed total First-Class Mail presort volumes, presort volume by customer, and year-over-year performance for 2008 versus 2007 for the October - December period. To protect against volume shifts between mail preparers, the program has targeted mail owners. With that in mind, the Postal Service then backed out Mail Service Provider volumes and worked with a list of the top 200 mail owners, who account for 80 percent of the volume. It was found that more mailers had declining volumes than increasing volumes.

The threshold calculation was designed to hedge against providing a rebate on volumes that would have been sent in the absence of the Program. The threshold will require those companies who have been growing to realize growth over and above last year's volumes in order to participate, while also allowing those customers whose volumes have been declining to take advantage of the Program as well. The risk is further minimized as the rebate is only paid on the incremental volumes over and above the threshold.

RESPONSE OF UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1

3. The proposed formula for setting volume thresholds to determine eligibility for the

Program implicitly assumes that the volume trend for First-Class Presort mail between Fall 2007 and Fall 2008 will (in the absence of the proposed discounts) be repeated between Fall 2008 and Fall 2009. Please describe and provide the results of all analyses performed to evaluate the impact of the recent credit market crisis and subsequent government intervention (*e.g.*, TARP) on the volume trends of large users of First-Class Presort mail, such as banks, over the relevant periods. Please explain how the results of the analyses influenced the design of the formula for setting thresholds.

RESPONSE:

The trend analysis emanates partly from the impact of electronic diversion, and partly from the impact of the credit market crisis (which has accelerated a secular decline). In almost all previous recessions, most of which were not as severe and devastating as this one, it took almost a year for the economy to stabilize before business activity began to recover. Independent economists, including Paul Krugman, Chris Varvares and Nouriel Roubini, have all stated that recovery will be slow.

An Associated Press article dated February 23, 2009, and captioned "Leading Economists See U.S. Recession Deepening," states that:

> "the current recession, which started in December 2007, is posing a major challenge to Washington policymakers, including President Obama and Federal Reserve Chairman Ben Bernanke. That's because its root causes – a housing collapse, credit crunch and financial turmoil – are the worst since the 1930s and don't lend themselves to easy or quick fixes. 'As the news on the economy has darkened, so, too, have the forecasts,' said Ken Mayland, president of ClearView Economics. 'We are suffering a period of maximum stress on the economy.'"

The article further states that "the economy is expected to remain feeble this year – even with new efforts by the administration and Congress to provide relief."

RESPONSE OF UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1

In an article published in the May 27, 2009, issue of Manufacturers.net, the National Association for Business Economics (NABE) stated that:

> "For all of this year, forecasters said the unemployment rate should average 9.1 percent, a big jump from 5.8 percent last year and up from its current quarter-century peak of 8.9 percent. If NABE forecasters are right, it would be the highest since a 9.6 percent rate in 1983, when the country was struggling to recover from a severe recession. Some forecasters thought the unemployment rate could rise as high as 10.7 percent in the second quarter of next year. The NABE outlook from 45 economists was conducted April 27 through May 11."

The Administration has also cautioned that the recovery will take some time. Any turn around, according to most of the experts, will happen in the middle or latter part of 2010, by which time the First-Class Mail Incentive program will have expired.

The Postal Service consequently did not expect the TARP to immediately turn the economy around and reverse the First-Class Mail decline. The Postal Service anticipates that, at best, the situation will stabilize and hold steady. Thus, the First-Class Mail Incentive program was designed on the assumption that the observed trend will remain steady. Thus a 20 percent rebate could help stimulate incremental volumes from our mailing customers.

RESPONSE OF UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1

4. In discussing the impact on worksharing discounts, the Postal Service states that "the program's effect on the difference between single-piece and presort First-Class Mail prices is well within the scope of the law, to the extent that consideration is relevant." Notice at 13.

a. Please provide a comparison of the difference between single-piece and presort prices (*i.e.*, the automation Mixed AADC letter discount) with and without the proposed discounts, showing all calculations, providing source references for all inputs, and explaining all assumptions. If the resulting discount under the proposal exceeds the cost avoidance, then please identify the statutory exemption that applies and explain how it applies to this proposal.

b. Please explain what is meant by the phrase "to the extent that consideration is relevant" in the above quote.

RESPONSE:

a. Please see the attached spreadsheet entitled "FCM Incentive price differences.xls" for price differences. The price differences between single-piece letters and automation Mixed AADC letters, and between single-piece letters and Presort letters, exceed the cost differences for incentive-eligible pieces, as they do for non-incentive-eligible pieces. Note, however, that the incentive offered in this program is not a worksharing discount, nor is it intended to affect the underlying worksharing discounts within First-Class Mail. Instead, it is a temporary incentive intended to stem volume decline and, hopefully, encourage growth from business mailers. It is exactly analogous to the declining block rate discounts offered in various NSAs (with, in this case, only one block), which also, in some cases, increased the relative discount between single-piece and presort letters. Therefore, it is not subject to, and cannot be justified under, the worksharing discount provisions of PAEA. Instead, it should be evaluated in the same

way NSA discounts have been; that is, based on their likely efficacy in encouraging growth in volume.

b. As noted above, the incentives offered under this program are not worksharing discounts, so in the Postal Service's view, consideration of the worksharing provisions of the PAEA is not germane to this proposal.

RESPONSE OF UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1, QUESTION 4

First-Class Mail Letters, Flats, and Cards
Price and Cost Differences

Price Category	(Benchmark)	FY 2008 Unit Cost Difference (cents)	R2009-2 List Price Difference (cents)	FCM Incentive Price Difference (cents)	List Price Difference as a Percent of Cost Difference	Incentive Price Difference as a Percent of Cost Difference
Automation Letters						
Mixed AADC	(BMM Letters)	4.5	5.8	13.4	127.6%	295.8%
AADC	(Automation MAADC Letters)	2.2	2.2	1.8	102.0%	81.6%
3-digit	(Automation AADC Letters)	0.3	0.3	0.2	99.6%	79.7%
5-digit	(Automation 3-digit Letters)	2.4	2.2	1.8	90.4%	72.3%
Automation Flats						
ADC	(Automation MADC Flats)	8.4	12.2	9.8	145.6%	116.5%
3-digit	(Automation ADC Flats)	6.1	6.1	4.9	100.5%	80.4%
5-digit	(Automation 3-digit Flats)	16.2	16.2	13.0	99.9%	79.9%
Nonautomation Letters	(BMM Letters)	5.8	2.6	10.9	44.9%	187.8%
Automation Cards						
Mixed AADC	(Nonautomation Presort Cards)	2.9	1.5	1.2	51.8%	41.4%
AADC	(Automation MAADC Cards)	1.2	1.0	0.8	84.2%	67.4%
3-digit	(Automation AADC Cards)	0.2	0.2	0.2	124.9%	99.9%
5-digit	(Automation 3-digit Cards)	1.3	1.3	1.0	99.3%	79.4%

Source:
Unit cost differences and list price differences: PRC-R2009-2-LR1