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UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners: Ruth Y. Goldway, Chairman;
Tony L. Hammond, Vice Chairman;
Mark Acton;
Dan G. Blair; and
Nanci E. Langley

Notice of Price Adjustment
Standard Mail Incentive Pricing Program

Docket No. R2010-3

ORDER APPROVING STANDARD MAIL VOLUME INCENTIVE PRICING PROGRAM

(Issued April 7, 2010)

I. EXECUTIVE SUMMARY

The Commission approves the Postal Service plan to conduct a Standard Mail Pricing Initiative during the summer of 2010. This initiative is a refinement of a similar discount program offered during the summer of 2009 that allows an opportunity to continue developing data to better design and evaluate future price changes. The Commission finds it is appropriate for the Postal Service to continue to exercise its pricing flexibility to encourage the growth of Standard Mail volumes.

The Postal Accountability and Enhancement Act (PAEA) of 2006, Pub. L. 109-435 120 Stat. 3218 (2006), directed the Commission to establish a system for regulating Postal Service rates that would achieve certain objectives. Two of those objectives are central to this Commission decision. One objective is to allow the Postal

Service pricing flexibility. Another objective is to assure adequate revenues to maintain financial stability.

The Postal Service intends to offer qualifying mailers discounts of 30 percent on volume increases of more than 5 percent over summer 2009 Standard Mail letter and flat volumes. Some of the mail that would be eligible for the new discount is already failing to cover its direct costs. The Postal Service presents a new technique for projecting mailer response to proposed discounts. Relying on this new technique, it estimates a range of possible outcomes from a loss of $3.5 million to a gain of $25.3 million. Other estimates presented on the record or developed using established methodology forecast potential losses from this program ranging from $0.8 million to $49.6 million.

The potential loss in contribution is counter-balanced by the initiative's utility. This case presents an opportunity to observe participating Standard Mail users' responses to short-term price changes, while simultaneously monitoring other non-participating mailer behavior. Unlike a general rate change, the panel data that this initiative may generate has the ability to inform the Postal Service and the Commission on the effect on volume of short-term price changes. The data will also be useful in further refining the Postal Service's trend analysis or the Commission's elasticity analysis used to predict mailer response to price changes.

As explained more fully in the body of this Order, the Postal Service initially failed to document its rate adjustment submission with basic information sufficient to verify the volume, revenue, and cost projections for this type of incentive program. This failure necessitated extending the time for the comments from interested participants and hindered the Commission's analysis. This Order directs the Postal Service to collect and provide data from this initiative that should permit significant, in-depth analysis of the short-term impact of rate discounts on Standard Mail volume.

The Postal Service is attempting to navigate through exceptionally difficult financial times. As detailed in the Commission's recent 2009 Annual Compliance Determination,[1] if current cost and revenue trends remain unchanged, the Postal Service may have insufficient cash to meet its obligations before the end of calendar year 2010. Offering new discounts under these circumstances represents a risk. However, it also is an attempt by management to bolster flagging volumes while learning about market reactions to price adjustments.

The Commission believes that the PAEA, which favors pricing flexibility, necessarily allows the Postal Service to offer new discounts even in troubled financial times. Further, the Commission notes that losses that may result from this program are, by themselves, unlikely to seriously worsen the financial situation of the Postal Service. The PAEA policy favoring pricing flexibility coupled with the opportunity to gather additional data useful to the design of future initiatives balance potential financial losses of the initiative in this instance.

[1] Docket No. ACR2009, FY 2009 Annual Compliance Determination, March 29, 2010 (2009 ACD).

II. INTRODUCTION

A. Overview

On February 26, 2010, as authorized by the Postal Service Governors, the Postal Service filed with the Commission a notice of price adjustment announcing its intention to adjust prices for Standard Mail letters and flats, in the form of a Standard Mail Incentive Pricing Program (2010 Incentive Program), pursuant to 39 U.S.C. 3622 and 39 CFR part 3010.[2] The 2010 Incentive Program is similar to another volume incentive program, introduced in May 2009,[3] and subsequently approved by the Commission.[4] The planned implementation date of the 2010 Incentive Program is July 1, 2010. The planned expiration date is September 30, 2010.

The 2010 Incentive Program, like the 2009 program that preceded it, represents an initiative by the Postal Service to exercise pricing flexibility under the PAEA. The 2010 Incentive Program also provides the Postal Service with an opportunity to improve the development of future price adjustments by generating data for measuring the impact of short-term price changes on mailing behavior.

The Postal Service claims that the primary objective of the program is to generate incremental Standard Mail volume and revenue. It estimates volume will increase between 311 million and 1.1 billion new pieces. The Postal Service, through the program, intends to provide existing and new customers an opportunity to grow mail volume with limited investment. The program may also benefit the Postal Service because additional volume would utilize short-run delivery capacity during the summer

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[2] United States Postal Service Notice of Market-Dominant Price Adjustment, February 26, 2010 (Notice).

[3] Docket No. R2009-3, United States Postal Service Notice of Market-Dominant Price Adjustment, May 1, 2009.

[4] Docket No. R2009-3, Order Approving Standard Mail Volume Incentive Pricing Program, June 4, 2009 (Order No. 219).

months. The program also presents an opportunity for the Postal Service to improve its data systems and enhance relationships with customers. Notice at 2-3.

B. Procedural History

In Order No. 416, the Commission established Docket No. R2010-3 to consider the Postal Service's filing, established March 18, 2010 as the date for interested persons to submit comments on the price adjustments, and appointed Public Representatives pursuant to rule 3010.13(a)(4) to represent the interests of the general public in this proceeding.[5]

On March 3, 2010, the Public Representatives filed a motion to defer the comment deadline because the Postal Service had not supported its filing with adequate data.[6] On March 10, 2010, the Postal Service filed in opposition to the Public Representatives' Motion, claiming that the Notice provided sufficient supporting data for the public to perform analyses and offer meaningful comments on the 2010 Incentive Program.[7] In addition, the Postal Service agreed to respond to the Public Representatives' questions. The responses have been useful in evaluating the planned administration of the proposed incentive program.

Chairman's Information Request No. 1 was issued to clarify the basis of the Postal Service's estimates underlying its 2010 Incentive Program.[8] The Postal Service

[5] Notice and Order Concerning Standard Mail Volume Incentive Pricing Program, March 2, 2010 (Order No. 416). The deadline for comments was subsequently extended to March 22, 2010. Order Concerning Comment Deadline, March 16, 2010 (Order No. 422).

[6] Motion of the Public Representative to Defer Deadlines, March 3, 2010 (Public Representatives' Motion).

[7] Response of the United States Postal Service in Opposition to Motion of the Public Representative to Defer Deadlines, March 10, 2010.

[8] Chairman's Information Request No. 1, March 9, 2010 (CHIR No. 1).

response was submitted on March 16, 2010.[9] Chairman's Information Request No. 2 was issued March 22, 2010, and responses were received on March 24, 2010.[10]

On March 10, 2010, the Public Representatives filed a motion asking the Commission to issue an information request seeking information on the effect of Standard Mail Regular Flats on the program's estimated contribution and other improvements in the Postal Service's data offerings.[11] On March 17, 2010, the Postal Service agreed to submit responses to the questions without the need for a Commission order directing responses.[12] On March 22, 2010, the responses were filed. By the revised comment deadline of March 22, 2010, the Commission received seven comments on the 2010 Incentive Program.[13] Those comments are addressed in the "Commission Analysis" section.

[9] Response of the United States Postal Service to Chairman's Information Request No. 1, March 16, 2010 (Response to CHIR No. 1). A Motion of the United States Postal Service for Late Acceptance of the Responses to Chairman's Information Request No. 1, March 16, 2010, was submitted with the response. The Commission grants the motion for late acceptance.

[10] Chairman's Information Request No. 2, March 22, 2010 (CHIR No. 2); Response of the United States Postal Service to Chairman's Information Request No. 2, March 24, 2010 (Response to CHIR No. 2).

[11] Public Representative Motion for Issuance of Information Request, March 10, 2010.

[12] Response of the United States Postal Service to Public Representative Motion for Issuance of Information Request, March 17, 2010.

[13] Comments of the American Catalog Mailers Association in Support of the 2010 "Summer Sale" (ACMA Comments), and Comments of the Direct Marketing Association and the DMA Nonprofit Federation in Support of the United States Postal Service 2010 "Summer Sale" (DMA Comments). Both were filed on March 18, 2010. Comments of Robert W. Mitchell on Proposed Summer Sale 2010 (Mitchell Comments), Comments of Pitney Bowes Inc. (Pitney Bowes Comments), Comments of the Public Representatives (Public Representatives Comments), Comments by Starcrest Products of California, Inc. (Starcrest Comments), and Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments Regarding Standard Mail Volume Incentive Pricing Program (Valpak Comments) were all filed on March 22, 2010.

III. STANDARD MAIL INCENTIVE PROGRAM

A. Postal Service Filing

The 2010 Incentive Program will give eligible mailers a 30 percent postage rebate on qualifying Standard Mail Letters and Flats above a predetermined customer-specific threshold agreed upon by the mailer and the Postal Service. Notice at 4. The proposed threshold is the amount of Standard Mail each participating company sent using its Permit(s), Ghost Permit(s), and through its Mail Service Provider (MSP) during FY 2009 Quarter 4 (July 1 to September 30, 2009) plus 5 percent (SPLY + 5 percent). *Id.* Participants must exceed this company-specific threshold to be eligible for any rebate. The Postal Service forecasts an average volume in FY 2010 Quarter 4 over SPLY of less than 1 percent; therefore, to receive a rebate, a participant's volumes must grow significantly more than average. *Id.*

To ensure against mailers shifting June volume to July, or October volume to September, the Postal Service proposes an additional volume threshold for June through October 2010, using the same SPLY + 5 percent formula. If the actual volumes for that period do not meet the respective month's threshold (SPLY + 5 percent), the difference will be deducted from the 2010 Incentive Program qualifying volume. *Id.* This revised qualifying volume will not be known until after adjustments are calculated for any June and October volumes below the threshold that are deducted from the initial qualifying volume.

Eligibility. Eligibility for the 2010 Incentive Program requires qualifying mailers to have mailed 350,000 or more Standard Mail Letters and Flats between July 1 and September 30, 2009 through one or more permit imprint advance deposit account(s) owned by the company or through permits set up on behalf of the company by a MSP. *Id*. at 3. Approximately 3,525 customers will be eligible to participate in the sale, representing 67 percent of the Standard Mail volume. To participate, documentation specifying that the applicant is the owner of the mail is required. *Id.* MSPs are not eligible, and participating mailers are not eligible for any other concurrent postal incentive program that would result in multiple discounts. *Id.* at 3-4.

The Postal Service notes that the volume threshold is lower than last year and will result in eligibility for about 400 additional customers. *Id.* at 9. It asserts that additional costs for increased labor or technology solutions to administer the program, and the risk that the discount would apply to mail that would be sent regardless of the incentive, prohibit accepting every mailer of Standard Mail. *Id.*

Program administration. The Postal Service plans to mail a letter to all eligible Standard Mail customers that will provide instructions on program operation. Mailers who wish to apply may also contact *summersale@usps.gov*. The Postal Service and the mailer must agree and certify threshold volumes prior to full enrollment. Certified volumes will be used to calculate the rebates due at the end of the 2010 Incentive Program with data from Postal One! and CBCIS. Each mailer is to certify, similar to the certification required by PS Form 3600, Postage Statement, the data used to calculate the volume thresholds and rebates. *Id.* at 5.

The rebate will be calculated on the average revenue per piece for all eligible mail volume during the program multiplied by the incremental volume above the threshold as adjusted for June and October volumes. Rebates, after adjustments, will be added to the company's Trust Account.

B. Continuing Evaluation of 2009 Standard Mail Incentive Program

The results of the 2009 Standard Mail Incentive Program (2009 Incentive Program) are useful in evaluating the proposed 2010 Incentive Program. Order No. 219 required the Postal Service to report a substantial amount of data on program volumes, rebates paid, and costs, within 15 days of crediting rebates to the 2009 Incentive Program participants. Order No. 219 at 14. These data were necessary for the

Commission and others to evaluate the success of the 2009 Incentive Program, and provide an additional basis for future programs.

The Postal Service filed its Notice in this proceeding while it was still completing data submissions on the 2009 Incentive Program.[14] The data reported on the 2009 Incentive Program raise important questions about the ability of the Postal Service to adequately administer the program. Additionally, the Postal Service utilizes a new method employing trend analysis to develop assumptions regarding mailer response to short-term price changes. This methodology produces different results from the methodology the Commission uses to test the financial results for negotiated service agreements (NSAs).

On March 29, 2010, the Commission issued its 2009 ACD, which reviewed the 2009 Incentive Program to determine whether its rates and fees comport with the applicable provisions of title 39. 39 U.S.C. 3653(b). The Commission determined that a new docket is required to evaluate the best method of measuring contribution from this type of pricing incentive. 2009 ACD at 88.

C. Chairman's Information Requests

Chairman's Information Request No. 1 sought to clarify the basis of the Postal Service's estimates underlying its 2010 Incentive Program.

CHIR No. 1 requested that the Postal Service provide support for volume and revenue estimates including how the estimates were developed, a breakdown of volumes and revenues by Standard Mail product, details for each eligible mailer and in the aggregate for each category of Standard Mail, estimated own-price volume responses, volume migration from First-Class Mail, and revenue per piece. CHIR No. 1 also requested the source for the statement that catalogers provide 40 percent of their

[14] By cover letter to the Commission, the Postal Service filed "FY 2009 Summer Sale Data Collection Report," and associated ZIP and Excel files, February 26, 2010.

volume in Standard Mail Flats and 60 percent of their volume in Carrier Route flats. Finally, CHIR No. 1 requested supporting data for the estimated contribution of between $-3.5 million and $25.4 million.

In its Response to CHIR No. 1, the Postal Service provided its estimate of anyhow volume and estimated contribution from the 2010 sale.[15] This information should have been provided with the initial filing.[16] The Commission extended the date for comments to allow interested persons to review and analyze this essential information. *See* Order No. 422.

Chairman's Information Request No. 2 sought clarification of the Postal Service Response to CHIR No. 1. The Postal Service provided confirmation and explanation of terms and the basis for some underlying assumptions, including its basis for assuming that the implicit own-price elasticities of "Growing Customers" is more accurate than previously filed elasticity estimates.

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[15] Mail above the discount threshold that would be sent absent the discount is termed "anyhow volume" and the discounts on such volume are termed "leakage." In this docket, the Postal Service refers to anyhow volume as "loyalty growth volume" and leakage as "rebate for loyalty."

[16] *See, e.g.,* Order No. 219 at 2, n.3 ("Any such future proposals must be accompanied by the requisite financial (cost, revenue, and volume) data underlying them."). *See also* Docket No. R2009-5, Order Approving First-Class Mail Incentive Pricing Program, September 16, 2009, at 3 (Order No. 299) ("The Commission finds it necessary to underscore that future pricing adjustment filings must be fully supported and documented to enable the Commission to adequately assess their merits in timely fashion."), at 20-21 ("In future proposals of this nature, the Commission expects the Postal Service to apply accepted analytical principles and fully present all calculations, document all inputs, and explain all assumptions in the initial filing.") *See also* Public Representatives Comments at 15.

IV. COMMISSION ANALYSIS

39 CFR part 3010. The Postal Service represents, in conformance with the notice requirements of 39 CFR 3010.14(a)(3), that it will issue public notice of the price changes at least 45 days before the planned implementation date via several additional means, including a press release, notice on its website (*http://www.usps.com*) and its Postal Explorer website, and in future issues of *MailPro*, the *Postal Bulletin*, and the *Federal Register*. The Postal Service identified an official available to provide prompt responses to requests for clarification from the Commission. Notice at 2.

Rule 3010.14(b)(9) requires the Postal Service's notice to include every change to the product descriptions within the Mail Classification Schedule (MCS) necessitated by the planned price adjustments. The Postal Service presented proposed changes for the 2009 Incentive Program in Appendix A to its notice in Docket No. R2009-3 based on draft MCS language developed by the Commission in cooperation with the Postal Service. The Postal Service states that its current proposal is covered by the current MCS; thus, its Notice does not include a new schedule of proposed MCS language. *Id*. at 1, n.1.

Workshare discounts. The Postal Service states that to the extent the program affects Standard Mail workshare discounts, it will shrink them, keeping discounts with passthroughs of 100 percent or less in compliance, and bringing passthroughs over 100 percent closer to compliance. *Id.* at 14. The Commission again finds, as it did in Order No. 219 for the summer 2009 Incentive Program, that the effect on workshare discounts will be limited. This conclusion is supported by the expected mail mix, the relatively small net impact of the volume likely to be induced by the program, and the applicability of the rebate program to all workshare discount tiers.

Preferred rates. Preferred rate Nonprofit Standard Mail Letters and Flats will be eligible for the 2010 Incentive Program, and the rates will change proportionately, thus maintaining the statutory ratio between prices. Again, as determined in Order No 219, based on the Postal Service's estimate of the mail mix of the incremental volume, the statutory differential is not likely to be affected. *See* Order No. 219 at 11, Notice at 15.

Impact on the price cap. Rule 3010.14(b)(1)-(4) requires price adjustments to comply with the price cap limitations in the PAEA. The Postal Service intends to treat the program in a manner mathematically analogous to the procedure in rule 3010.24 consistent with the 2009 Incentive Program. It will exclude the effect of the price decrease on the price cap for both future and current prices and therefore has not made the calculations of cap and price changes described in rule 3010.14(b)(1)-(4). Notice at 10. The effect on the price cap is as if all the discounted incremental volume paid the applicable full postage. No opposition has been raised to this approach.

The Commission finds the proposed treatment is reasonable because ineligible mailers will not be charged higher rates based on the amount which otherwise would be banked from the program. *See* Order No. 219 at 10. It is also reasonable given the program's short duration and uncertainty over the amount of new volume to be generated. *See* Order No. 299 at 10.

Costing. The Postal Service has applied the same short-run costing methodology, where applicable, as it did in the 2009 Incentive Program. The Postal Service believes there is excess capacity to process additional volume so that, in the short-run, additional volume will incur reduced additional attributable costs that may be below the unit long-run attributable cost of Standard Mail. Appendix A to the Notice includes an explanation of the Postal Service's assessment of excess capacity and attributable costs. Notice at 7. Unlike the 2009 Incentive Program, the Postal Service presumes that the increased volumes may incur some additional carrier costs to deliver the incremental volumes, but the Postal Service does not expect short-run cost increases in buildings, new equipment, and vehicles. *Id*.

In approving last year's program, the Commission noted the Postal Service's reliance "on secular and cyclical effects on mail volumes to support its conclusions…represents a reasonable attempt to maintain volume-related efficiencies." Order No. 219 at 8. That conclusion remains applicable to this year's program. Nevertheless, as the Commission cautioned in Order No. 219, this use of short-run marginal cost to justify a change in price raises methodological issues that may warrant further examination in a separate proceeding following completion of the analysis of this program. *Id*. at 8-9.

Discount threshold. The reported experience in administering the 2009 Incentive Program indicates the certification of volumes used to calculate the rebates due at the end of the program is subject to modification for various reasons. In some cases, simple adjustments in one month to account for reporting errors in the data for a previous month can result in uncertainty about the certified base volumes or the volumes mailed during the incentive period. The determination of ownership of base volumes for purposes of certification included errors or misunderstandings during the 2009 Incentive Program.

Problems also arose from the complex calculation of the threshold volumes in the 2009 Incentive Program. The Postal Service has ameliorated the complexity of the calculation that required comparing volumes from two calendar periods. For the 2010 Incentive Program threshold, the Postal Service simply requires a flat 5 percent growth rate over the volume mailed during the three summer months of the 2009 Incentive Program period, subject to one adjustment for low June and/or October volumes. However, this threshold creates other issues. Ownership issues are still potentially a problem. More importantly, the 2010 Incentive Program requires that to qualify for a discount, each mailer must exceed what amounts to an average growth rate of 5 percent for the Standard Mail products that it mails.

The Postal Service recognizes that the 5 percent growth threshold will not eliminate all anyhow volume. Some mailers may still receive significant discounts on volume they would have sent even if no discount was offered. On the other hand, mailers who do not grow by 5 percent may not benefit from the program, despite the incentive, because it may be far beyond their potential summer-to-summer growth rate. The 5 percent threshold appears a reasonable effort to balance these concerns.

Mitchell is concerned that in applying a derived demand relationship, the conditions underlying the question must be consistent with the data behind the demand relationship. Mitchell Comments at 3. He contends that the accuracy of predicted anyhow volume is paramount in calculating contribution, but is unknown. *Id*. at 5. Further, he contends the Commission's use of after the fact volumes and market elasticities, similar to what it has used in past NSA analyses, overestimates the mailer's response because it presumes the mailer mailed all year with the discounted lower rate applying to all volumes sent. *Id*. at 6. He also believes that given swings in the economy and seasonal patterns, the method used by the Postal Service to calculate anyhow volume has almost no chance of being accurate. *Id*. at 8. He concludes that the threshold for 2010 benefits those mailers with large growth rates, but will not be available to those with low growth rates while mailers with moderate growth of 5 percent may utilize the program. *Id.* at 16. Mitchell also concludes the 2010 Incentive Program threshold will be a "substantial disadvantage" to mailers who received rebates in 2009. *Id.*

The Public Representatives analyze the reported data from the 2009 Incentive Program and conclude the mailers who most benefitted from the discounts experienced their lowest volumes in quarters immediately prior to the sale period. Public Representatives Comments at 5-6. Thus, mailers receiving discounts had lower thresholds by 25 percent on average. *Id*. at 8.

Starcrest, a participant in the 2009 Incentive Program, contends the threshold formula for the 2010 Incentive Program discriminates because it makes participation unreasonably difficult for the relatively few mailers who took advantage of the 2009 Incentive Program. Starcrest argues the threshold creates unfair competition in favor of those who did not participate in the 2009 Incentive Program and proposes a downward adjustment based on prior program incentive volume. Otherwise, Starcrest recommends disapproval of the program. Starcrest Comments at 3-4.

ACMA contends that the threshold of 5 percent over last summer's volume is excessive, citing the recent economy, depleted cash available for volume increases, and increased migration of mail to other substitutes. ACMA Comments at 2. Although supporting this program, DMA suggests, due to falling volumes, using a threshold of 95 percent or 90 percent in the future. DMA Comments at 2.

The Commission finds the 5 percent threshold is a reasonable exercise of Postal Service pricing flexibility. The wide variation in growth patterns for individual mailers from year to year due to both cyclical and secular reasons suggests the difficulty in developing a formula to avoid anyhow volume qualifying for a discount. Further analysis of this program will assist in determining its viability and in designing future programs.

Discrimination issues. The Public Representatives analyze the reported 2009 Incentive Program results as well as the available data for the 2010 Incentive Program to consider to what extent the Postal Service incentive program maximizes net contribution and encourages equitable competition in the marketplace. Public Representatives Comments at 3. They conclude that the profit incentive is not balanced by the requirement for "'fair and equitable rates'" and that the rates cause "'undue discrimination in the marketplace,'" because the program excludes some mailers based on historical volumes, and allows others to receive discounts on anyhow volume. The Public Representatives contend the contribution of the 2010 Incentive Program will be inadequate. *Id*. at 4, 19. The Public Representatives also suggest opening participation to all mailers by substituting a $1,000 registration fee for the minimum volume requirement to eliminate discrimination and to offset the administrative cost of the program. *Id*. at 4.

ACMA and DMA also propose including more mailers in future programs. ACMA suggests reducing administrative costs to allow participation by more catalog mailers. ACMA Comments at 2-3. DMA would like this flexible approach to rates to grow volume in “all shapes, sizes, weights, zones and products.” DMA Comments at 1. DMA encourages expansion of the program to smaller mailers by using better strategies to reduce administrative costs and elimination of measurement of anyhow volume to calculate contribution. *Id*. at 2. DMA also suggests a longer term incentive program of two or three years to facilitate mailer planning. *Id*. at 2-3.

Based on the data available to the Commission and the Postal Service’s responses to the Public Representatives’ questions, the eligibility requirement appears reasonable and not unduly discriminatory. The Postal Service should explore opportunities to expand its incentive programs to include the maximum number of mailers consistent with their efficient administration and maximization of contribution. One option raised by comments would be to explore including all mailers and charging a participation fee. Currently, administrative costs are incurred by the Postal Service for all participating mailers, including those that are unsuccessful in growing their volumes. By charging a participation fee, the Postal Service could ensure that administrative costs are covered by the mailers that seek to benefit from the program.

Standard Flats and nonprofit products that do not recover costs. The Postal Service notes that the 2010 Incentive Program includes Standard Mail Flats and Non-Profit products that did not make a positive contribution in Docket No. R2009-3. Notice at 7. In support of those products’ inclusion, the Postal Service says this initiative must be viewed as a whole, citing Appendix A to the Notice. It says that excluding Standard

Mail Flats from the 2010 Incentive Program would change the dynamics of the sale for a large portion of catalog mailers. Where Standard Mail Flats are residual pieces after all possible Carrier Route volumes are qualified, their exclusion will reduce customers' incentives and potentially result in unintended consequences. *Id.* The Postal Service further states that long-term competitive benefits of including Standard Mail Flats in the 2010 Incentive Program can result in more catalogs being mailed as evidenced by their large incremental growth above the baseline during the 2009 Incentive Program. *Id*. at 7-8.

ACMA and DMA support including Standard Mail Flats in the program as catalog mailers use both Standard Mail Flats and Carrier Route in many mailings. ACMA Comments at 2, DMA Comments at 2. Valpak and the Public Representatives disagree. Valpak argues that the Postal Service should not incentivize additional volume of a product which does not cover its attributable cost, particularly without clear indication that the inclusion of Standard Mail Flats yields positive results. Valpak Comments at 2-3. The Public Representatives also favor excluding Standard Mail products that do not cover attributable costs. Public Representatives Comments at 17-19.

The Commission finds inclusion of Standard Mail Flats within the 2010 Incentive Program consistent with the exercise of Postal Service pricing flexibility. There may be a loss generated by the Standard Mail Flats product during the program, but other advantages are foreseen by the Postal Service. The inclusion of Standard Mail Flats in the program is consistent with the intent to design a program encouraging volume growth, not only directly, but indirectly through additional mail resulting from discounted mail. The inclusion of Standard Mail Flats and Nonprofit products also provides an opportunity for the Postal Service to measure the response of additional types of mailers to short-term price changes.

Estimated financial impact. According to the Postal Service, the 2010 Incentive Program is expected to provide incremental revenue of about $34 million to $157 million from new volume. Notice at 6. Based on the 2009 Incentive Program, the Postal Service does not expect a significant shift from First-Class Mail. *Id.*

The Postal Service cites several inherent risks that may affect the financial outcome of the 2010 Incentive Program. These include overestimating the volumes generated by the incentive, underestimating the administrative costs, and the risk that a large portion of rebates would be paid on volumes that would have been mailed without the incentive. *Id*. at 8-9.

In this proceeding, the Commission has analyzed the volumes of each Standard Mail product mailed by individual mailers to determine growth trends. This was compared to the Postal Service's estimate of the expected thresholds for each of the eligible mailers. The Commission's analysis of growth for individual mailers has determined that the estimated anyhow volumes for some participating customers exceeds the 5 percent threshold level of the proposed program. Thus, the program, as designed, will offer discounts for more anyhow volume than the Postal Service implicitly anticipated. Using this methodology, revenue leakage for anyhow volume in excess of the 5 percent threshold for individual customers results in a contribution somewhat less than the $-3.5 million to $25.4 million predicted in the Postal Service's filing. *Id*. at 8.

In response to CHIR No. 1, the Postal Service provided details of its estimate of the financial effect of the incentive. The Postal Service begins by identifying and summarizing the volume sent in the summer of 2009 by mailers who will be eligible for the incentive. It then assumes, based on its experience in the 2009 Incentive Program, that 50 percent of that volume was sent by mailers who will participate, and further assumes that 50 percent of the volume of participants was sent by those who will earn discounts. The Postal Service then evaluates the impact of three after-rates volume scenarios, assuming that the mailers who earn discounts ("growers") send volumes 20, 30, or 40 percent (Low, Middle, and High Growth) above the levels of the same period last year (SPLY).[17]

In a departure from its previous analysis of threshold-based volume incentive discounts, the Postal Service develops an independent estimate of the volume sent by growers that would be sent in the absence of the discount (before-rates volume). This is a key component for the analysis of this type of incentive as it is necessary to distinguish between the positive effects of discounts in generating incremental volume (which increases contribution to the Postal Service) and the negative effects of discounts that are paid for mail that would have been sent without the incentive.

The Postal Service presents a new approach to estimating the before-rates volume. Rather than applying an estimated price elasticity to an after-rates volume, it utilizes a trend-based estimate based on data from the 2009 Incentive Program. The thresholds in that incentive were set for each mailer by applying its year-over-year volume trend to the volume it sent in the summer of 2008. Volumes sent in the summer of 2009 that exceed that threshold were eligible for discounts.

In its evaluation of the 2009 incentive, the Postal Service estimated the portion of discounted volumes that were anyhow volume by calculating a “spring threshold” for each mailer using a technique parallel to that used to set the summer threshold. For some mailers, actual spring 2009 volumes exceeded the “spring threshold.” The sum of this volume, which the mailer trends did not anticipate, represents 7.07 percent of the SPLY (spring 2008) total volume of participants in the 2009 Incentive Program. Response to CHIR No. 1, question 1(b).

Since this unanticipated growth occurred in the absence of a discount, the Postal Service assumes that a similar “anyhow” growth trend also occurred in the summer of

[17] The Postal Service’s model utilizes average revenues for each product and estimated short-run unit costs by product. It then uses average product revenues and costs weighted by the mix of volumes sent by eligible mailers in 2009.

2009 (when the discounts were in effect). The Postal Service estimates anyhow volume for the 2009 incentive by applying the 7.07 percent assumption to the total SPLY (summer 2008) volume of participants. The Postal Service's estimate of anyhow volume for the 2010 incentive is similarly developed by applying the 7.07 percent assumption to total SPLY (summer 2009) volume of participating mailers.[18] The difference between the after-rates volume for each scenario (20, 30, and 40 percent above SPLY) and the estimated anyhow volume is incremental volume sent in response to the discount incentive, which generates additional contribution to the Postal Service. Subtracting the total amount of discounts from the contribution from incremental volume, the Postal Service estimates a net decrease in contribution of $3.4 million for the Low Growth scenario, a net increase in contribution of $11.0 million for the Middle Growth scenario, and a net increase in contribution of $25.3 million for the High Growth scenario. All estimates exclude the estimated administrative costs of $930,000. Response to CHIR No. 1, file "(2010-02-14) Summer Sale 2 (using 7.07% loyalty) Links to CHIR1.xlsx".

The Public Representatives present an alternative evaluation model in their comments that, in many respects, follows the approach taken by the Postal Service. The primary difference from the Postal Service's methodology is in the level of aggregation at which the trend-based approach to estimating before-rates (and anyhow) volumes is applied. Where the Postal Service applies its trend-based anyhow volume factor to aggregate volumes, the Public Representatives develop an estimate of anyhow volume using a more disaggregated analysis of mailer volume trends.

[18] The Postal Service adjusts downward the amount of anyhow volume to account for the effects of the adjustments to thresholds that may occur as a result of June and October volumes. The model assumes that these adjustments will mitigate 17.7 percent of total discounted volume. This is twice the percentage that was mitigated by the October adjustment in the 2009 incentive, based on the application of two monthly adjustments and the extended lead time before implementation. Response to CHIR No. 2, question 1.

The Public Representatives analyze volume data from mailers who did not participate in the 2009 Incentive Program, noting significant variations in growth trends among mailers. They assert that, by failing to account for the wide distribution of growth rates, the Postal Service understates the likely volume of anyhow mail. In their alternative model, they divide the volume of participants into six groups based on the distribution of historical growth trends.[19] Assuming that the same distribution of growth trends continues for 2010, the model estimates before-rates volumes for each group. Once before-rates volumes have been estimated, the model uses the same approach as the Postal Service to calculate the estimated net impact on contribution using the same three after-rates volume scenarios. The results are a $25.9 million loss for a 20 percent volume increase, a $13.3 million loss for a 30 percent volume increase, and a $0.8 million loss for a 40 percent volume increase. Public Representatives Comments at 15-16.

Analysis of methodologies. The Commission commends the Postal Service for its efforts to identify new and creative tools for estimating the effects of volume discount incentives on the Postal Service's finances, and for recognizing the importance of designing incentives that maximize beneficial volume increases while minimizing the potential for losses from discounts on mail that would be sent anyway. The Public Representatives' comments are useful for analyzing and attempting to refine the Postal Service's approach.

The Public Representatives' analysis is relevant in light of the Postal Service's proposal to set mailers' thresholds at 5 percent above their SPLY volume, as opposed to last year's approach of basing the thresholds on each mailer's own volume trend. Because of this change, there is an increased risk that the wide variation in mailers' volume trends will undermine the potential benefits of the incentive. Of the volume sent

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[19] Recipients of 2009 discounts are excluded from the calculation of distribution percentages to avoid conflating volume growth in response to the 2009 incentive with volume growth trends.

by mailers eligible for the 2010 Incentive Program who did not participate in the 2009 Incentive Program, over 30 percent was sent by mailers that increased their volume over SPLY, with 13 percent sent by mailers that increased their volume by more than 40 percent over SPLY. *Id*. at 16. This suggests that many mailers are likely to realize significant discounts on volumes that will be sent regardless of any discount incentive. By applying its trend-based approach for estimating before-rates volumes in the aggregate, the Postal Service's estimates do not fully reflect this risk.[20]

The trend-based approach to estimating before-rates and anyhow volume, as proposed by the Postal Service and modified by the Public Representatives, differs significantly from the elasticity-based approach of the Commission's accepted methodology. The new approach develops estimated before-rates volume based on historical trends and implies a different elasticity for each possible after-rates volume, while the established approach applies a fixed elasticity and implies a different before-rates volume for each possible after-rates volume.

Despite these differences, the results of a trend-based approach can be translated into an implied elasticity to facilitate comparisons and discussion. Based on the size of the discount, and the estimated before- and after-rates volume, the

[20] The problems with applying a uniform threshold to mailers with differential growth rates are also discussed by Mitchell. *See* Mitchell Comments at 13-14.

elasticities implied by the Postal Service's Low, Middle, and High Growth scenarios are -0.228, -0.497, and -0.751, respectively.[21]

In the absence of reasonably supported alternate elasticities, the Commission's accepted methodology uses the elasticities from the Postal Service's Demand Analysis that are most applicable.[22] In this case, the most applicable elasticity is -0.145, which is the average current own-price elasticities of Standard Regular and Enhanced Carrier Route mail, weighted by the eligible mailers' volume mix.[23] Applying this elasticity to the each of the after-rates volumes in the Low, Middle, and High Growth scenarios, the estimated effect of the incentive on Postal Service contribution is a loss of $11.0 million, a loss of $30.3 million, and loss of $49.6 million, respectively.

The Postal Service explains that it finds its implied elasticities preferable because they are based on experience from the 2009 Incentive Program, evaluation of historical data, and discussions with customers. It states that exclusive reliance on the historical estimates for price changes that are short in duration and large in magnitude may not yield reliable results. Response to CHIR No. 2, question 2.

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[21] To facilitate comparison with the elasticities presented in the Postal Service's Demand Analysis, these are developed assuming a demand curve with a constant elasticity. The demand elasticities implied by the Postal Service's different response rates of 20, 30 and 40 percent on SPLY volume can be developed assuming a constant elasticity demand specification of the form $Q = \alpha P^e$. In past omnibus rate proceedings, the Commission relied on this model structure to develop its before- and after-rates volume forecasts. Let the before-rates volume estimate, based on the undiscounted rate, be written as $Q_0 = \alpha P_0^e$ and the after-rates volume estimate, based on the discounted rate, be shown as $Q_1 = \alpha P_d^e$. The ratio of the after- and before-rates volume estimate is then $Q_1/Q_0 = P_d^e/P_0^e = (P_d/P_0)^e$. Given the different values for Q_1/Q_0 assumed by the Postal Service and the same value for P_d/P_0 of 0.7, then three different elasticities are implied for each contribution scenario. These values can be calculated by taking logs of both sides of $Q_1/Q_0 = (P_d/P_0)^e$ and solving for e. The calculations are presented in Library Reference PRC-R2010-3-LR-1.

[22] FY 2009 Market Dominant Demand Analysis Materials, January 20, 2010 (Demand Analysis).

[23] *See* Response to CHIR No. 2, question 2. The current elasticities are used because they exclude the lag effects of quarters subsequent to a price change.

The Commission has consistently acknowledged the shortcomings of applying the Demand Analysis elasticities beyond the purpose for which they are designed.[24] However, it continues to seek improvements in the support and justifications for the use of different assumptions. The Commission has already announced in its 2009 ACD that it will initiate a rulemaking to fully explore the merits of alternate methods such as those presented by the Postal Service and the Public Representatives. 2009 ACD at 88. This will allow interested parties to have an opportunity to comment on this important topic.

The facts of this particular incentive program provide an opportunity for the Postal Service to generate robust data about mailers' response to short-term price changes. Because the 2010 Incentive Program will not be utilized by every eligible mailer, it will also provide an opportunity to compare participating mailer behavior with non-participating mailer behavior across industries. This comparative panel data, [25] if robust, may allow the Postal Service and the Commission to apply new analyses to better understand the effects of short-term changes in price for Standard Mail products. Better understanding of these effects is likely to result in future pricing initiatives that benefit the Postal Service.

Objectives and factors. The Postal Service states that the program does not substantially alter the degree that Standard Mail prices already address seven of the nine objectives in section 3622(b) of the PAEA and 11 of the 14 factors in section 3622(c). Notice at 10-11. In addition, the program is an example of increased pricing flexibility and provides an incentive for added volumes to enhance financial stability. Nevertheless, this program also poses risks that could increase projected losses and negatively impact overall financial stability.

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[24] Some of the potential differences between individual responses to large temporary price changes and collective responses to smaller permanent changes are discussed in Mitchell Comments at 1-9.

[25] Panel data consists of both time series and cross-section data.

On balance, and recognizing the continuing evolutionary nature of these incentive programs, the Commission is satisfied that the program can be viewed as a reasonable exercise of Postal Service pricing flexibility.

The Commission recognizes that the Postal Service is likely to realize less net contribution as a result of the 2010 Incentive Program. Counterbalancing this potential negative, the Postal Service is exercising its pricing flexibility and proposing a new pricing framework through which it may gain additional insight into mailers' responses to short-term price changes. This program is designed to provide incentives that encourage growth during a period of dramatic cyclical and secular decline in volume.

Data collection and program evaluation. The Postal Service did not propose a data collection plan with its filing. The Public Representatives suggest that the Postal Service provide the same data it collected for the 2009 Incentive Program in Docket No. R2009-3 plus additional data. In considering the data needed to evaluate fully the program results in a reasonable amount of time, the Commission concludes that the following information is required.

By November 1, 2010, the Postal Service shall provide the following:

1. For each eligible Standard Mail user and in the aggregate, volumes and revenue by month from October 2006 through September 2009 for all Standard Mail letters by product and flats by product, further broken out into commercial and nonprofit categories; and

2. The threshold for each eligible Standard Mail user with supporting calculations that show how the threshold was derived from the monthly volume data. Since the approved threshold is based on a formula that uses monthly data as an input, any adjustments that result from the enrollment process shall be reflected in the underlying monthly volume data.

By December 29, 2010, the Postal Service shall provide the following:

1. For each eligible Standard Mail user, volumes and revenue by month from October 2009 through October 2010 for all Standard Mail letters by product and flats by product, further broken out into commercial and nonprofit categories;

2. For all mailers for which rebates have been paid, information on any rebates paid, with supporting calculations;

3. For each eligible mailer, the Postal Service shall provide monthly permit volumes for First-Class presort letters, cards, and flats;

4. The year-end short-run volume-variable cost by each Standard Mail letter and flat product;

5. The actual administrative costs of the program; and

6. The monthly information identified in paragraphs 1, 3, and 4 above, on an aggregated basis.

Information on rebates settled after the above deadlines shall be provided to the Commission in subsequent reports. For an example of the format for presenting this required information, *see* Order No. 219, Appendix A. When filing the above information, the Postal Service may mask mailer identities by using a generic identification number. However, the Postal Service shall file under seal the names of mailers associated with the identification numbers used.

This data collection plan will provide information that will allow the Postal Service and the Commission to more effectively evaluate future short-term price changes.

V. ORDERING PARAGRAPHS

It is Ordered:

1. The Commission approves the 2010 Standard Mail Incentive Pricing Program.

2. The proposed Mail Classification Schedule language for the Standard Mail Incentive Pricing Program, as described in the body of this Order, is included in the Mail Classification Schedule subject to minor editorial changes as may be necessary for development of the Mail Classification Schedule.

3. The Postal Service is to report on the 2010 Standard Mail Incentive Pricing Program as directed within the body of this Order.

4. All outstanding motions, not specifically addressed in the body of this Order, are hereby denied.

By the Commission.

Judith M. Grady
Acting Secretary