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POSTAL REGULATORY COMMISSION
Washington, DC 20268-0001

Rate Adjustment Due to Extraordinary
Or Exceptional Circumstances : Docket No. R2010-4

REPLY COMMENTS OF THE GREETING CARD ASSOCIATION

The Greeting Card Association (GCA) files these Reply Comments pursuant to Order No. 485 and § 3010.65(g) of the Rules of Practice. In them we respond to certain issues raised in the initial comments of other participants. GCA's general position on the proposed exigency increase remains unchanged: that it does not qualify as reasonable, equitable, and necessary under the second branch of 39 U.S.C. § 3622(d)(1)(E), and that, in any event, only a substantially smaller increase could even be lawfully considered under the first branch ("extraordinary or exceptional circumstances") of that section.

Any rate increase, let alone the 5.6 percent average increase proposed by USPS, is unreasonable and inequitable when mailers and the general public are facing equivalent budgetary pressures and mailers are facing enormous pricing pressure in their own markets. Even so, the Postal Service's request exceeds the maximum lawful increase it can file under the "extraordinary or exceptional" clause of the Postal Accountability and Enhancement Act of 2006 (PAEA) because only that part of the 2008-2009 recession that exceeded past recessions on average can be judged as exceptional.

I. Presort vs. Single-Piece First-Class Rates

Several parties representing users of Presorted First-Class Mail[1] have used this proceeding to reiterate arguments that Presort rates should be kept low and, inferentially, that Single-Piece rates can be raised.[2] Insofar as this argument depends on the notion that the two products are entirely separate, having different cost and demand characteristics, the arguments on the other side have been thoroughly ventilated in the Benchmark rulemaking, Docket No. RM2009-3, and elsewhere.[3] GCA suggests that they be considered there and not in the present docket. Once again, however, as in our reply comments in the 2009 ACR, GCA feels compelled to respond to the benchmark issues raised in R2010-4. National Postal Policy Council (NPPC), in this Docket, devotes a full ten pages of its Initial Comments, (pp. 24-34) to such issues. For example, we will make clear, below, that the separate-product status of Single-Piece and Presort does not support the inferences bulk mailer representatives draw from it.

In the next section we will identify and describe these arguments, and subsequently we will provide criticism and rebuttal.

II. A. Old Arguments and Newer Arguments Made by Mailers

At the outset we note that the generic argument that an increase in Presort rates is counterproductive because it will only drive more Presort mail volume out of the system is hardly a new one, or a special reason today to treat

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[1] See Comments of the National Postal Policy Council in Opposition to Exigent Rate Increase ("NPPC Comments"), Comments of Discover Financial Services, Comments of the National Association of Presort Mailers on the Rate Adjustments Requested by the United States Postal Service Due to Extraordinary or Exceptional Circumstances. The Postal Service itself has adopted some of the same notions. See Kiefer Statement, pp. 12 et seq.

[2] USPS also attempts to make this argument in the Statement of James Kiefer. See Kiefer, p. 14, lines 17-21 and p. 15, lines 6-8.

[3] See Docket RM2009-3, Initial Comments of the Greeting Card Association (May 26, 2009), pp. 1-6; Comments of the Greeting Card Association (August 31, 2009), pp. 1-8; Docket ACR2009, Reply Comments of the Greeting Card Association (February 23, 2010), pp. 11 et seq.

Presort differently than any other price inelastic mail product. There is a negative impact on volume from any rate increase, but what distinguishes an inelastic product like Presort from an elastic one is that the loss of revenue on lost volume from a rate increase is less than the increase in revenue on the remaining volume at the new rate. The generic argument could be leveled at any past increase in Presort (or almost any other mail) from the entire history of general rate increases. It adds little or nothing to the current debate.

In this rate case, the National Postal Policy Council (NPPC), for example, attaches an affidavit recounting discussions with large financial mailers on the subject of rate-increase-driven reductions in mailed volume. Seven such companies are said, among them, to plan a reduction of 344 million pieces.[4] Yet, this is less than 0.8 percent of Presort letter volumes, which were 44.8 billion pieces in FY2009.[5]

What, therefore, are the relatively new arguments that are, to quote the USPS Statement of James M. Kiefer, "adding fuel to the diversion fire being led by businesses that use presort-priced mail."?[6]

One of course is that electronic diversion will lead mailers to abandon the use of the mail entirely if Presort rates are increased, and that there is such a "tipping point" beyond some rate increase where own price elasticity effects no longer apply. A related argument is that mailers initiate and lead the march to diversion, with consumers passively following in step. The "abandonment" argument is being used to press for lower Presort rate increases.

[4] Declaration of Arthur B. Sackler, attached to Comments of the National Postal Policy Council in Opposition to Exigent Rate Increase ("NPPC Comments").

[5] See Docket ACR2009, *Public Cost and Revenue Analysis.*

[6] Statement of James M. Kiefer on behalf of the United States Postal Service, p. 16, lines 9-10.

Another argument is that because Presort is the most “profitable” (i.e. the highest contribution) mail in the system, care should be taken to retain or grow Presort volume by keeping Presort rates and rate increases lower than products that make a smaller contribution. An offshoot of this argument is that if postal letter mail volumes are in a secular fall, in rate design it is better to let the lower contribution products fall in volume than Presort. Practically speaking, under PAEA’s price cap rules, the “high contribution” argument amounts to lowering Presort rates or rate increases and raising those for First Class Single Piece mail.

A final argument is that Presort and Single-Piece are two different products with separate cost and demand characteristics; and, that, as a result, Presort rates should be set on the basis of full attributable cost differences relative to Single-Piece, not by Single-Piece costs avoided by mail processing alone. While this argument actually does not “de-link” Presort rates from Single-Piece, it does change the basis for the comparison based on USPS costs. Not surprisingly, the cost difference between Presort and Single Price increases under this approach compared to the narrower costs avoided approach. This is a third reason stated by mailers as to why Presort rates should be lower than Single-Piece rates by more than mail processing costs avoided by doing the work in the private sector.

There are several reasons why these newer arguments made by mailers, no less than the old generic argument, fail to make their case for lower rates and rate increases for Presort mail. However, they do point to the need to change the way Presort rates are considered and measured.

II. B. The Shift in the Debate Over Presort Rates from Conversion of Single-Piece to Diversion of Mature Workshare Mail Has Important Implications for Ratemaking When It Comes to Presort

It is useful to frame this debate in a concept from economics called "opportunity costs." Opportunity costs focus on the choices that firms make relative to the next best alternative, and define the cost of that choice as the value of the next best opportunity. While the older debate over Presort rates focused on the opportunity costs to the Postal Service of conversion mail, the new debate clearly appears to center on what Presort rate will keep mailers continuing to send hard copy rather than diverting all their business to the Internet.

Focusing on the opportunity costs of mailers in choosing between hard copy or electronic means for operating their businesses, appears clearly to be the correct way of valuing mature Presort mail in determining its entry price into the USPS network.

The reason that conceptualizing and measuring a mailer's opportunity cost has become today's issue is because in the absence of any more conversion mail, worksharing volume entails a zero opportunity cost for the Postal Service. With conversion the opportunity cost of the Postal Service was positive, the cost of the "make or buy" choice for processing Single Piece mail. As noted in the Statement of James Kiefer:

> This kind of price effect—where the decision at hand is whether to mail or to abandon the mail as the primary communication tool with customers or potential customers—is a relatively recent phenomenon for many First-Class Mail presort mailers. Responding to it is a relatively recent challenge for the Postal Service and the Commission as well. [[7]]

The opportunity costs of Presort mailers in choosing hard copy or abandoning it altogether cannot be calculated from Postal Service costs. They can-

[7] R2010-4, Kiefer Statement, p. 19, lines 12-16.

not be measured today by the difference in full attributable costs between Single Piece and Presort, any more than they could have been measured by costs avoided in a bygone era when most Presort mail was conversion mail moved out of the Postal Service for upstream processing by the mailer or its agent.

"Delinking" the two products by basing rates on the full attributable USPS cost differences between Single-Piece and Presort is a complete shibboleth because it retains the "Presort versus Single-Piece" conceptualization developed for conversion mail and centered on the USPS opportunity cost decision. It is used by NPPC and other mailers or their association representatives simply to argue for a wider gap between USPS presort costs and Single Piece costs than can be achieved by using the narrower avoided cost approach. Yet, PAEA was designed to give the Postal Service greater flexibility in setting rates based on elevating demand-side considerations over its traditional cost based approach., In the case of Presort that is exactly what focusing on the mailer's opportunity costs enables it to do.

The opportunity cost of mailers includes the direct and indirect costs of mail processing by the mailer plus a rate of return on capital slightly above its next best opportunity. Basing Presort rates on the opportunity costs of the mailer rather than those of the Postal Service accomplishes exactly the same overarching goal,: having the least cost producer do the mail processing work up to the point where such entry entails marginal costs equal to the marginal revenue of the fringe entrant. Measuring the opportunity costs of *mailers,* and not those of USPS from the bygone era of conversion mail, is probably the only conceptually sound way of resolving the difficult issues in the still-undecided benchmark case, RM2009-3. We turn to these conceptual issues after explaining why the threat of abandonment as it is now framed by mailers and the Postal Service is largely hollow.

II. C. The Abandonment Argument Does Focus on the Opportunity Costs of Mailers But is Grossly Exaggerated Because It Neglects Several Fundamental Factors

First, Presort mail is not only high contribution mail for the Postal Service, but it is also extremely profitable mail for efficient mailers and their customers. The USPS Office of the Inspector General (OIG) estimates that for FY2008, worksharing discounts amounted to $15 billion, of which two-thirds, or $10.7 billion, was the "profit", and the remaining one-third, or $4.3 billion, was the mailers' private sector cost of barcoding and presorting the mail. The latter estimate was based on a Commission staff study.[8]

By this measure the market for workshared mail is very robust. So far as presort rates and abandonment are concerned, if the USPS OIG's estimate is even remotely in the ballpark, it would take a substantial rate increase for efficient Presort mailers before they began to view e-commerce as their most profitable mode of communicating with customers. As the OIG report notes:
"The PAEA pricing flexibility and the wide gap between Postal Service discounts and the mailer cost to workshare may create both an incentive and opportunity to set discounts at less than the avoided costs."[9]

Second, the abandonment argument fails to point out that in any market, firms have differing efficiencies, as represented in economics by an upward sloping supply curve. Any presort bureaus or direct mailers who leave the system altogether in response to a rate increase will be those marginal firms that are the least efficient, i.e., the highest cost producers along an industry supply curve. Moreover, exit in these situations does not necessarily or even primarily mean electronic diversion and abandonment of hard copy. Highly inefficient firms are

[8] U.S. Postal Service, Office of the Inspector General, "Assessment of Worksharing", RARC-WP-10-005, July 12, 2010, Table 2, p. 11. The PRC staff paper is: Cohen, R., Robinson, M., Waller, J., and Xenakis, S., "Worksharing: How Much Productive Efficiency, at What Cost and at What Price", M. Crew and P. Kleindorfer, eds., Boston, Kluwer Academic Publishers, p. 3.
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[9] "Assessment of Worksharing," July 12, 2010, p. 9.

likely to be as inefficient with electronic diversion as with hard copy. In these situations, a more efficient worksharing competitor is likely to absorb that mail, either by expanding their own operations or through consolidation.

Third, it has long been clear that large mailers derive many non-postage cost advantages from conversion of customer accounts to electronic management. The Postal Service's *Five-Year Strategic Plan, FY 2001-2005* contained a breakdown of estimated per-transaction savings from such a conversion:

Total potential savings		**$1.90**
Reduced float	0.15	
Reduced non-payments	0.25	
Reduced processing error	0.10	
Eliminated paper processing	0.90	
Saved postage	**0.40**	
Customer service	0.10 [[10]]	

Eliminating postage accounted for only 21 percent of the estimated savings from converting a customer to electronic billing and payment. If a mailer abandons hard copy mail for the Internet, postage rates alone are not going to have much influence.

Fourth, recent diversion to the Internet by major mailers has resulted from the recession and its impact on their sales. Falling revenue from lower sales levels puts pressure on business costs, especially fixed costs, and precipitates a review of all costs in a business, not just the cost of postage. Only to the degree that e-commerce is both (i) less expensive *and* (ii) equally or more profitable than presorting, will a mailer's partial or complete conversion to e-commerce in a recessionary, rising unit cost environment reflect non-price factors These factors

[10] Appendix 2, "Projecting Electronic Diversion for First-Class Mail in the H.R. 22 Simulation Model," p. A8, based on a briefing by PricewaterhouseCoopers, February 8, 2000.

tend to come into better focus during macroeconomic downturns: the speed of bill or statement delivery; the convenience; the security; and other factors.

Fifth, regarding the argument that mailers are initiating the diversion of mail to the Internet because of rate increases, it is not at all clear to what degree they are leading or following their customers. If it is not the mailer who is even initiating the diversion but, rather, the customer (for stamp price and non-price factors), then it is hard to argue that Presort rate increases are why mailers are *leading* the charge.

What is true is that in the past and even today, if one examines, e.g., a credit card statement under “Payment Options” or a similar heading, one is very likely to find descriptions of automatic or on-line payment programs beginning “If you enroll in this service . . . .” That is, the customer – not the bank or other bill sender – makes the initial decision to convert his/her account to an electronically-managed one.[11] (One would suspect this, in any case, from the exhortations to pay on-line which many financial and utility billers include on or with their statements.) In other words, the diversion decision may be influenced by the mailer in such ways, but over the course of increasing diversion in the past two decades, it has been made by the customer initially.

The proof of this is that electronic diversion of Single Piece First Class letter mail began no later than 1988, whereas Internet diversion for workshared mail only became significant no earlier than 1997, when it became important enough to be first measured by USPS. For half of the 1988-2009 period diversion has been measured by USPS, it was only significant for customers who initiated the switch from hard copy to the Internet for transactions and statements mail, starting in 1988. Mailers did not directly *cause* such conversions, because those who

[11] In the context of customer accounts, we will use “management” to mean the entire process of generating, receiving, and paying periodic bills.

paid the Presort rates were not the same persons who made decisions about account conversion.

Notwithstanding the above, it is true that in relatively recent years some mailers have initiated using online transactions both for the receipt of bills and statements by other businesses and households as well as the payment of bills and management of financial accounts by those customers. The “reply rides free” proposal in R2010-4 is an effort by the Postal Service to compete against mailer initiated diversion, much as the Forever Stamp was an effort in part to compete against consumer initiated diversion.

However, the real value of the current debate over abandonment is not so much that it is a “threat” requiring a predetermined response in lowering Presort rates or rate increases, but rather that it focuses the Presort ratemaking issue on the right concept of opportunity costs in a mature worksharing environment. What is the economic decision making process underlying such “abandonment” of hard copy mail and what are its implications for the determination of Presort rates?

II. D. The “Separate Products” Argument Supports Presort Rates Based on the Opportunity Costs Mailers Face, Not ‘Full Cost Differences” Based on USPS Opportunity Costs, Which Are Zero in the Absence of Conversion

Many of the arguments now being made by mailers about the “mature state” of their industry, and about bulk mail as a product separate from Single Piece, and the consequent need for de-linking the two rates are based on the recognition that there is little or no conversion mail left in the First Class collection mail USPS now processes. However, de-linking would *not* remove what NPPC claims in this case is “the vassal status of a workshared derivative of Single-Piece letters.”[12] It would only alter the “fealty” between Single-Piece and Presort from a cost avoided status to a “less feudal” full cost difference status. The Presort rate would still be based on USPS costs, and still based on comparisons

[12] NPPC Comments, p. 26.

with Single-Piece, essentially the same USPS opportunity cost concept that has informed Presort rates and discounts from the start of worksharing in the mid-1970s.

De-linking does not accomplish what mailers and the Postal Service claim it does in the “two product” environment. Such a “de-linked” ratesetting approach does not in the least “de-link” Presort from Single-Piece. It just changes the size of the links from smaller costs avoided ones to larger sized links based on USPS full attributable cost differences.   Rates for the remaining non-conversion Single Piece mail in the system always will be based strictly on USPS costs so long as only the Postal Service collects, processes and delivers Single-Piece. There is no more opportunity cost decision-making to be made by the Postal Service for remaining collection mail, especially as long as it remains adamant that Single-Piece prices do not influence consumer diversion. The only way First Class Pre-sort costs and rates can become truly de-linked from their Single-Piece ancestors is to stop using USPS-based opportunity cost measures. There is a strong rationale for doing so based on the “opportunity cost” concept in regulatory economics.

Since today’s Presort mail was never lost from USPS as conversion mail in the first place, it entails zero opportunity costs to the Postal Service; thus, unlike conversion mail, mature Presort mail is a windfall gain. An example from telecommunications de-regulation is highly applicable to Presort ratesetting in today’s mature worksharing environment.

> “The determination of the interconnection fee is based on the assumption that the entrant will divert traffic from the incumbent.” …. Suppose the entrant adds only new customers, then the charge it pays should not include them as the opportunity cost to the incumbent, particularly if there is excess network capacity.”[[13]]

[13]Noam, Eli, *Interconnecting the Network of Networks,* MIT Press, 2001, p. 89.)

Applying these regulatory principles to the postal environment of today and tomorrow, the argument made by mailers (i.e., entrants) s that they are no longer diverting traffic (i.e. the conversion of Single Piece mail) from the incumbent (i.e. the USPS). They have a separate product (i.e. new customers for bulk mail) that is not based on converting USPS Single Piece mail and that has its own cost characteristics and demand characteristics. Since the charge the entrant pays (i.e. the cost a mailer pays to the USPS for entering presorted mail into the network) can no longer be logically based on the opportunity cost to the incumbent (i.e. USPS measured costs, whether full USPS cost differences, or avoided costs), one has to turn to the entrant's own costs and opportunity costs to set the entry price for mature workshared mail it has originated on its own.

In summary, how should Presort mail be priced when the opportunity cost to the Postal Service for non-conversion workshared mail is zero? In a mature workshared environment where First Class bulk letter mail is originated by mailers, the answer clearly lies in focusing on the accounting costs and economic opportunity costs of mailers themselves. The continued use of USPS costs or cost differentials for setting Presort rates makes no business sense and is conceptually unsound when there is no more conversion mail.

II. E. Conclusion

Under PAEA, the added pricing flexibility USPS was granted means that over time the Postal Service is empowered to share in the profitability of worksharing along with mailers and their customers through the determination of Presort rates it sets. A recent paper by Prof. John Panzar for the USPS OIG highlights this aspect of the changed rate-setting environment under PAEA. "Thus, in this situation the Postal Service would have a profit incentive to reduce the worksharing discount below its initial ECPR level." [14]

[14] Panzar, John, "Postal Service Pricing Policies After PAEA", USPS OIG, RARC-WP-10-002, February 8, 2010, p. 13. Panzar is not correct, however, that this raises antitrust concerns if the

Sharing in the profitability of worksharing with mailers under PAEA's price flexibility rules for USPS is, arguably, why the proposed percentage rate increases on Presort in R2010-4 are higher than those for Single-Piece.[15] In a truly de-linked approach, this is not in the least unfair relative to Single Piece, whose costs are USPS – based.[16] At the margin shared profitability is far less likely to lead to abandonment of hard copy mail than it is to facilitate worksharing mail being presorted by the most efficient mailers.

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III. Extra Ounce Letter Rates for First Class Mail

Section 3622(d) (1) (E) requires, inter alia, that exigency increases be reasonable and equitable. The Commission's rules direct the Postal Service to show that they are "reasonable and equitable *as among types of users of market dominant products.*"[17] In this Docket, the Postal Service proposes to raise the extra-ounce rate for Single-Piece First-Class Letters by one cent, while the same rate for Automation Presort Letters would remain unchanged.

Neither the Postal Service's written submissions nor its testimony in the public hearings provides any statutorily adequate explanation of this disparity. We explained in our Initial Comments why it was unwise as well as inequitable[18], and we need not repeat that discussion here. Since the additional-ounce rate

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USPS OIG report is correct about the very high profitability of worksharing. High profitability also implies there are highly inefficient firms in the industry and flexible pricing by the Postal Service which moves volume from inefficient firms to the more efficient ones is not a denial of entry or cause of exit that is grounds for antitrust concerns.

[16] More than one party has spoken of an inconsistency between what the Postal Service says it needs to be concerned with in pricing Presort, and how it actually priced Presort in its exigent rate proposal. Under the argument made here, there is no such inconsistency at all because there is no longer any basis for comparing USPS costs and increasing costs for Single Piece with the opportunity costs worksharing mailers face in a mature industry.

[17] 39 CFR § 3010.61(a) (5) (italics added).

[18] See Initial Comments of the Greeting Card Association, p. 12.

presumably reflects some concern, however inexact, with weight-driven cost incurrence, it is not clear why it should be increased only for Single-Piece mail.

Under questioning by Commissioner Acton, Dr. Kiefer observed that "traditionally" the extra-ounce rate "has been used to sort of offset some of the impact of the lumpiness that is caused by the – you know, by the whole cent constraint."[19] Dr. Kiefer was commenting generally on extra-ounce charges, including those for parcels, and not with specific reference to the question we are discussing here. If, however, his remark were taken to suggest that weight-driven costs are *not* the primary determinant of the additional-ounce rate, it would not excuse the disparity. Since Automation Letters are not subject to a whole-cent constraint – for either the first or additional ounces[20] – there is no reason why their additional-ounce rate could not have been raised proportionately.

In fact, however, GCA believes that neither Single-Piece nor Automation Letters should be subjected to an increase for additional ounces. We have shown above that no increase for any mail is justified under statutory standards, and that only a substantially smaller increase than proposed could even be considered under the first branch of § 3622(d)(1)(E). The additional-ounce charges, therefore, should be left as they are.

IV. Jurisdiction to Determine the Exigency Question

Initial comments filed by Valpak discuss the issue of whether the Commission or the Postal Service is responsible for determining whether extraordinary or exceptional circumstances exist, but without offering a definite view.[21] GCA, as

[19] Tr. 3/414.

[20] Their additional-ounce differential is now, and would continue to be, 12.5 cents.

[21] Initial Comments of Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. ("Valpak Comments"), pp. 13 et seq. The Postal Service's its position is that such

explained in our Initial Comments, believes that the substantially less than the entire proposed increase could be lawfully considered under the "extraordinary or exceptional circumstances" standard. It is therefore appropriate to explain our views on this question, since our earlier filing assumed an answer.

It is true that the statute does not *explicitly* assign to the Commission the task of determining whether such circumstances exist. Valpak seems to distinguish between "develop[ing] procedures" – which it associates with the extraordinary and exceptional standard – and "determin[ing]" whether the adjustment is reasonable, equitable, and necessary. This does not, in our view, suggest that the Commission is not charged with applying the first standard. In doing so, it is simply deciding whether a matter before it falls within its jurisdiction under the statutory provision which the Postal Service has invoked. It is also worth noting that most of 39 U.S.C. § 3622 makes the Commission responsible for developing procedures – indeed, for "by regulation, establish[ing] . . . a modern system for regulating rates and classes[.]" Subsection (d) (1) (D), for example, directs the Commission to "establish procedures" for ordinary price-capped increases; no one doubts that the Commission – whether explicitly or not – has the authority to decide these cases.

It is likewise significant that the Commission's regulations under § 3622(d) (1) (E) treat the extraordinary or exceptional circumstances question in exactly the same way as the issues of reasonableness, equity, and necessity. Section 3010.61(a) sets out filing requirements separately for the issues of "extraordinary or exceptional circumstance(s)" (paragraph (3)), "why the requested increases are necessary" (paragraph (4)), and "why the requested increases are reasonable and equitable" (paragraph (5)). In each case, the rule requires the Service's filing to provide "a full discussion." Since no one disputes that the Commission must decide the reasonableness, equity, and necessity issues, it seems plain

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circumstances are clearly present, and so it argues that the issue need not be decided. Response of the United States Postal Service to Motion of the Affordable Mail Alliance to Dismiss Request, p. 11.

that the rule contemplates Commission decision of the extraordinary or exceptional circumstances issue too. Moreover, Rule 3010.61(a) (3) requires information on "how both the requested overall increase, and the specific increases requested, relate to those circumstances[.]" Such information would hardly be necessary if the Commission were meant only to accept as binding a decision by the Postal Service that extraordinary or exceptional circumstances existed.

Consequently, GCA essentially disagrees with Valpak's suggestion that the Commission's regulations do not clarify the jurisdictional question. While Valpak qualifies its view by saying that the rules do not "expressly clarify" the issue, it seems clear enough that the Commission expects its decisions to address the question of extraordinary or exceptional circumstances as well as the ultimate issue of appropriateness under the "reasonable, equitable, and necessary" criterion.

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Respectfully submitted,

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