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

TRANSFERRING COMMERCIAL STANDARD MAIL PARCELS TO THE COMPETITIVE PRODUCT LIST	Docket No. MC2010-36

REPLY COMMENTS OF THE UNITED STATES POSTAL SERVICE
(October 15, 2010)

In Order No. 521,[1] the Commission solicited comments on the Request of the United States Postal Service to Transfer Commercial Standard Mail Parcels to the Competitive Product List.[2] The Public Representative and the Parcel Shippers Association (PSA) submitted comments. The Postal Service hereby provides its reply comments.

The Public Representative "does not find a compelling legal basis for opposing the Postal Service's request" but offers several reasons why it "cannot support approval of the Request at this time."[3] The PSA believes that the Request is premature and asks the Commission to deny the Request because, in its view, "[t]he record simply does not establish that commercial Standard Mail Fulfillment Parcels are not market-dominant products as defined by the statute."[4] The Postal Service first addresses the arguments offered by the PSA and then addresses the concerns raised by the Public Representative.[5]

[1] Notice and Order Concerning Transfer of Commercial Standard Mail Parcels to the Competitive Product List, Order No. 521, Docket No. MC2010-36 (Aug. 20, 2006).
[2] Hereinafter referred to as the "Request."
[3] Public Representative Comments, at page 2.
[4] PSA Comments, at page 3.
[5] As in the Request, in order to avoid confusion, the Postal Service refers in these Reply Comments to the product being transferred as "commercial Standard Mail Fulfillment Parcels."

I. The PSA Is Mistaken In Asserting That Commercial Standard Mail Fulfillment Parcels Meet The Statutory Definition Of A Market-Dominant Product.

The PSA's central contention is that commercial Standard Mail Fulfillment Parcels meet the statutory definition of market-dominant products, as set forth below:

> The market-dominant category of products shall consist of each product in the sale of which the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products.[6]

To support its contention, the PSA makes the following arguments: (1) volume projection data filed by the Postal Service in Docket No. R2010-4 "show only a relatively small drop in volume" following the price increases requested in that docket; (2) the competitive advantages that flow from the Postal Service's universal delivery network and mailbox monopoly suggest that commercial Standard Mail Fulfillment Parcels are market-dominant; (3) because the Postal Service has roughly an eighty percent share of the under-one-pound ground parcel market, commercial Standard Mail Fulfillment Parcels are market-dominant "in an economic sense;" (4) the fact that commercial Standard Mail Fulfillment Parcel prices are much lower than UPS and FedEx prices, particularly where UPS and FedEx surcharges apply, suggests that commercial Standard Mail Fulfillment Parcels are market-dominant.

A. Commercial Standard Mail Fulfillment Parcels Do Not Meet The Statutory Definition Of A Market-Dominant Product Because Raising Their Prices Substantially Above Costs Carries A Risk Of Losing A Significant Level Of Business to Competitors.

The Postal Service would like to begin its response to the PSA's comments by explaining why commercial Standard Mail Fulfillment Parcels do not meet the statutory

[6] 39 U.S.C. § 3642(b)(1).

definition of a market-dominant product; this explanation should largely refute the PSA's four points above. The Postal Service will then specifically address each of the four points separately. As the PSA notes, the Postal Service currently has roughly eighty percent of the market share for under-one-pound ground parcels, while its competitors have roughly twenty percent.[7] At the same time, the Postal Service's prices are significantly lower than its competitors' prices.[8] If the FedEx and UPS surcharges listed in Appendix A of the PSA's Comments are accurate for those carriers' bulk mailers, then the price differential between the Postal Service and UPS and FedEx is even greater.

For example, looking at the Zone 2 prices listed on page 5 of Attachment B of the Request, the difference between the Postal Service and UPS's prices is $1.23. If one takes the example of an under-one-pound ground parcel shipped to a residential address in Zone 2, and if one assumes the accuracy of the UPS Residential Surcharge provided in Appendix A to the PSA's Comments, the differential between the Postal Service and UPS's prices jumps to $3.43.[9] Similarly, using the PSA's list of surcharges for FedEx, an under-one-pound ground parcel going to a residential address in Zone 2 would cost $3.42 more to ship via FedEx than via the Postal Service. These two price differentials of $3.43 and $3.42 increase in Zones 3 through 8, up to a price differential in Zone 8 of $4.23 for UPS and $4.27 for FedEx.

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[7] Request, at Attachment B, page 5; Response to Question 2(a) of Chairman's Information Request No. 1.

[8] Request, at Attachment B, page 5. The tables in the center of the cited page provide a sample comparison of the Postal Service's commercial Standard Mail Fulfillment Parcel prices to the best available bulk prices that the Postal Service has been able to find for UPS and FedEx's comparable products.

[9] The differential would be even greater if any of the other UPS surcharges listed by the PSA apply.

Despite such huge price differentials between the Postal Service's prices and UPS and FedEx's prices, UPS and FedEx are still managing to capture roughly 20 percent of the under-one-pound ground parcel shipping market. In other words, customers shipping one-fifth of under-one-pound ground parcel volume find that the value they receive by utilizing the Postal Service's competitors outweighs the fact that they are paying more than double (and at times nearly triple) the prices they would pay if they chose the Postal Service. If, because of increased Postal Service prices, the price differentials were to decrease significantly, it is an axiom of basic economics that there would be a risk of more customers shifting their business to UPS and FedEx because the value proposition of using UPS and FedEx will have increased.

As noted in the revised projections filed in Docket No. R2010-4, if the Postal Service were to increase Standard Mail Not Flat-Machinable (NFM) and Parcel prices by 23.3 percent, the collective cost coverage for these product categories would rise to 97.5 percent.[10] The statutory definition of market-dominant products in 39 U.S.C. § 3642(b)(1) states that, for a product to be considered market-dominant, the Postal Service must be able to set the product's price "substantially above costs" without risking losing a significant level of business to other firms providing similar products. Because the 23.3 percent increase would bring the product at issue here to just under 100 percent cost coverage, it would take a price increase "substantially" above 23.3 percent for the resultant price to be considered "substantially above costs." Unfortunately, the statute does not define "substantially." For the sake of argument, if it would take roughly a 25 percent price increase to bring the product to 100 percent cost

[10] *See* Attachment to Further Revised Response of the United States Postal Service to Follow-Up Question Posed by PSA, Docket No. R2010-4 (Sept. 8, 2010).

coverage, it is fair to say that one example of a price increase substantially above costs would be to double the 25 percent increase to 50 percent. If the Postal Service were to increase the price of commercial Standard Mail Fulfillment Parcels by 50 percent,[11] it is inconceivable that the Postal Service would not at the very least *risk* losing a significant level of business to UPS and FedEx, given that UPS and FedEx already command one-fifth of the market share at prices that are considerably higher than the Postal Service's prices. If parties object that the hypothetical price increase used in this exercise is too large, the Postal Service is confident that, using whatever price increase the Commission considers to be "substantially above costs," the Commission will conclude that there is at the very least a risk that the Postal Service would lose a significant level of business to UPS and FedEx. Therefore, the Commission should find that commercial Standard Mail Fulfillment Parcels fail to satisfy the statutory definition of a market-dominant product.

B. The Volume Projection Estimates Provided In Docket R2010-4 Are Based On A Price Increase That Is Below Costs; The Estimates Show That A Price Increase Above Costs Would Carry With It The Risk Of Loss Of A Significant Level Of Business.

To return to the PSA's four points, the PSA's first point is that the volume projection data provided in Docket No. R2010-4 "show only a relatively small drop in volume" after the requested rate increases. The PSA thus asserts that the Postal Service's projections illustrate that a large price increase does not result in significant loss of business. The volume projection data referenced by the PSA show that a 23.3 percent rate increase for Standard Mail NFMs and Parcels would result in volume

[11] Note that this is a theoretical example; the Postal Service does not intend to raise commercial Standard Mail Fulfillment prices by 50 percent.

declining from a projected 705 million pieces to a projected 678 million pieces.[12] In other words, volume would decline by a little over 3.8 percent. The statute asks whether the price increase would risk a "significant loss of business" to competitors.[13] If "business" is defined in terms of revenue, then certainly a 3.8 percent decline in volume would lead to the loss of a significant level of business. If "business" is defined strictly as volume, it is debatable whether 3.8 percent constitutes a "significant" level of volume.

However, 39 U.S.C. § 3642(b)(1) asks whether a price increase "substantially above costs" would risk a significant loss of business. The price increase used in the Docket No. R2010-4 volume projections results in a price that is still below costs. If this below-cost price increase of 23.3 percent leads to a nearly four percent change in volume, it is inevitable that a price increase "substantially above costs" – for example, the fifty percent price increase posited earlier – would at the very least *risk* a significant loss in business, both in terms of revenue and volume.

C. The Competitive Advantages Noted By The PSA Have No Bearing On Whether The Product Meets The Statutory Definition Of A Market-Dominant Product.

The PSA also argues that the Postal Service's universal delivery network and mailbox monopoly translate into significantly lower delivery costs and competitive advantages over competitors. Even assuming that this is true, it nonetheless has no bearing on whether commercial Standard Mail Fulfillment Parcels meet the statutory definition of a market-dominant product. The central question at issue here is whether a price increase substantially above costs would lead to the Postal Service risking the loss of a significant level of business to its competitors. The fact that the Postal Service

[12] *See* Attachment to Further Revised Response of the United States Postal Service to Follow-Up Question Posed by PSA, Docket No. R2010-4 (Sept. 8, 2010).
[13] 39 U.S.C. § 3642(b)(1).

has certain competitive advantages over its competitors does not change that calculus. All of the Postal Service's competitive products benefit from the universal delivery network; the competitive advantages that flow from the universal delivery network do not change the fact that such products properly belong on the competitive product list. Similarly, many competitive products benefit from the mailbox monopoly; for example, lightweight Priority Mail benefits from the mailbox monopoly, as a letter carrier can generally place a lightweight Priority Mail piece in the mailbox and not have to incur the added cost of walking to the customer's door. This advantage over the Postal Service's competitors does not translate into lightweight Priority Mail becoming a market-dominant product. Thus, the existence of the universal delivery network and mailbox monopoly do not render commercial Standard Mail Fulfillment Parcels market-dominant.

D. The PSA's Construction Of Market-Dominant "In An Economic Sense" Has No Basis In The Statute.

The PSA also argues that commercial Standard Mail Fulfillment Parcels are market-dominant "in an economic sense" because the Postal Service has roughly eighty percent of the market share. The PSA's use of the term market-dominant "in an economic sense" has no basis in the statute; the statutory question is whether a price increase substantially above costs would risk a significant loss of business to competitors. In addition, the fact that the Postal Service's roughly eighty percent market share is inextricably linked to its below-cost prices means that any purported dominance "in an economic sense" is artificial. Furthermore, the fact that the Postal Service's competitors have managed to capture one-fifth of the market share despite Postal Service prices that, using the PSA's surcharge information, are less than half of the competitors' prices means that there are vigorous competitors ready, willing, and well-positioned to capture more market share if the Postal Service's prices rise.

E. The PSA's Assertion That The Price Differential Between The Postal Service And Its Competitors' Prices Render The Product Market-Dominant Has No Basis In The Statute.

The PSA's final argument is that the fact that commercial Standard Mail Fulfillment Parcel prices are much lower than UPS and FedEx prices, particularly where UPS and FedEx surcharges apply, suggests that commercial Standard Mail Fulfillment Parcels are market-dominant. Again, returning to the statute, the relevant question is whether raising the Postal Service's prices substantially above costs would lead to the risk of a significant loss of business to competitors. Nowhere does the statute require that, for a product to be considered competitive, its prices be in line with competitors' prices. As described earlier, the significant differential between the Postal Service and its' competitors' prices highlights the strength of the Postal Service's competitors in capturing one-fifth of the market share.

II. The Concerns Raised By The Public Representative Can Be Addressed By The Postal Service And Should Not Cause The Request To Be Rejected.

The Public Representative "does not find a compelling legal basis for opposing the Postal Service's request" but offers several reasons why it "cannot support approval of the Request at this time": (1) Consideration of the Request is premature because the Request is predicated upon the classification changes and rate increases requested in Docket No. R2010-4; (2) the Postal Service has not performed studies quantifying the level of price increases or service debasement that would be necessary to risk a loss of significant business to competitors; (3) the addition of commercial Standard Mail Fulfillment Parcels to Parcel Select is inconsistent with the Parcel Select rate structure;

(4) Standard Mail nonprofit pricing has not been addressed; and (5) the Postal Service's arguments regarding the current difficulties of reaching negotiated service agreements are baseless. The Postal Service addresses each of these concerns below.

A. The Postal Service Will File The Necessary Classification Changes Shortly; The Postal Service Will Raise Lightweight Parcel Select Prices Upon Approval Of The Request In Order To Ensure Compliance With Section 3633.

First, the Public Representative is correct in stating that the Request cannot be approved without the classification changes requested in Docket No. R2010-4. The Postal Service intends to file a request for the classification changes proposed in Docket No. R2010-4 for Standard Mail NFMs and Parcels by October 29, 2010. The Postal Service understands that the Commission cannot approve this Request until those classification changes are approved. The Postal Service believes that the Public Representative is incorrect in stating that the Request cannot be approved until the rate increases requested in Docket No. R2010-4 are approved. The Public Representative states that the rate increases must go into effect prior to approval of the Request to ensure that there are no violations of subsections (a)(1) and (2) of Section 3633, which, respectively, prohibit the subsidization of competitive products by market-dominant products and require that each competitive product covers its attributable costs.

Compliance with Section 3633 is evaluated through the Annual Compliance Review process and is ultimately determined as part of the Commission's Annual Compliance Determination. If the Postal Service's Request is approved, the Postal Service will raise the prices of Lightweight Parcel Select shortly after the transfer in order to ensure that Parcel Select continues to cover its attributable costs and to ensure that competitive products are not subsidized by market-dominant products.[14] Thus, approving the Request will not result in any violations of Section 3633. If the Commission were to adopt the Public Representative's interpretation that Section 3633 compliance is evaluated at the moment a transfer to the competitive product list occurs, then products that are improperly classified on the market-dominant list but priced below costs could never be transferred to the competitive product list.

B. Evaluating Whether There Is A Risk Of Loss Of Business To Competitors Does Not Require A Formal Study

Turning to the Public Representative's second concern, it is true that the Postal Service has not performed any formal studies to quantify the level of price increases or service debasement that would be necessary to cause a loss of significant business to competitors. The definition of market-dominant products in 39 U.S.C. § 3642(b)(1) is structured such that if any of the four listed actions (setting prices substantially above costs, raising prices significantly, decreasing quality, or decreasing output) carries with it the risk of losing a significant level of business to competitors, then the product in question is not a market-dominant product. The Postal Service's Request is premised on the first of the four actions – the Request depends upon whether raising prices substantially above costs would carry the risk of losing a significant level of business to other firms. The statute does not require that raising prices substantially above costs necessarily lead to the loss of business to competitors; it only requires that there be the risk of such loss.

[14] As a practical matter, even without a price increase, Lightweight Parcel Select may not have an effect large enough to cause Parcel Select to no longer cover its attributable costs. Further, at current prices, Lightweight Parcel Select is incapable of having an effect large enough to cause competitive products as a whole to require subsidization from market-dominant products.

Thus, while a formal study would undoubtedly be helpful in quantifying what level of business would shift to the Postal Service's competitors in response to a price increase substantially above costs, evaluating whether there is a risk that a significant level of business may shift to competitors in response to such a price increase does not require a formal study. The information that the Postal Service has provided regarding the current marketplace for under-one-pound ground parcels demonstrates that raising prices substantially above costs carries with it the risk of losing a significant level of business to competitors As discussed in response to the PSA's comments, given that the Postal Service's competitors have already captured one-fifth of the market for under-one-pound ground parcels despite having prices considerably higher than the Postal Service's prices, it is inconceivable that a Postal Service price increase "substantially above costs" would not at least *risk* the loss of further business to those competitors.

C. The Postal Service Concedes That The Transfer Will Result In A Somewhat Inconsistent Parcel Select Rate Structure, But This Should Not Result In Denial Of The Request.

The Public Representative's third concern is that the addition of commercial Standard Mail Fulfillment Parcels to Parcel Select is inconsistent with the Parcel Select rate structure. The Postal Service agrees that Lightweight Parcel Select will be structured differently than the rest of Parcel Select. This discrepancy can be remedied in the future, for example in the manner that the Public Representative counsels. Nonetheless, the discrepancy between the structure of Lightweight Parcel Select and the rest of Parcel Select is a somewhat minor issue and should not cause a denial of the Postal Service's Request.

The Public Representative also expresses concern that, when presented with the dual structure, "mailers will be enticed to reduce postage expenditures by attempting to conform mailings to the Lightweight Parcel Select Requirements." The Public Representative states that there is no information as to how much volume may migrate from Parcel Select to Lightweight Parcel Select, and warns that significant migration could have an adverse impact on overall Parcel Select revenue. The Postal Service notes that this problem already exists today. Mailers with pieces that weigh just under one pound are currently enticed to use commercial Standard Mail Fulfillment Parcels because of the associated price savings. Whatever migration currently exists may in fact be lessened, in light of any price increases the Postal Service institutes. Therefore, there is no risk of an adverse impact on Parcel Select revenue.

D. The Postal Service's Revised Response to Question 11(c) of Chairman's Information Request No. 1 Addresses Nonprofit Pricing

The Public Representative's fourth concern is that the effect of the requested transfer on nonprofit Standard Mail Fulfillment Parcels has not been properly explained and resolved. Specifically, the Public Representative expresses concern that "[t]here is no way to know whether the selection of the new 'benchmark' [for calculating nonprofit Standard Mail Fulfillment Parcel prices] will be benign, or have a substantial impact on nonprofit rates at this time." The Postal Service understands how its original response to Question 11(c) of Chairman's Information Request No. 1 may have caused the Public Representative's concern.[15] The Postal Service believes that its corrected response to

[15] The Postal Service's original response to Question 11(c) mistakenly stated that nonprofit Standard Mail Fulfillment Parcel prices would be set in relation to some other "subclass" on the market-dominant product list.

Question 11(c)[16] and the following explanation of nonprofit Standard Mail Fulfillment Parcel pricing should address the Public Representative and nonprofit mailers' concerns.

As explained in the Postal Service's revised response to Question 11(c) of Chairman's Information Request No. 1, with the recent transition to the Mail Classification Schedule, which has resulted in the elimination of subclasses, the Commission interprets section 3626(a)(6) to link the prices for nonprofit pieces to the prices for commercial pieces at the *class* level. Accordingly, nonprofit Standard Mail Fulfillment Parcel prices are not currently calculated as a percentage of commercial Standard Mail Fulfillment Parcel prices, and they certainly will not be calculated in that manner after the transfer either. Rather, nonprofit Standard Mail Fulfillment Parcel prices are currently set to ensure that the average revenue per-piece for nonprofit Standard Mail as a whole is as close as practicable to 60 percent of the average revenue per-piece for commercial Standard Mail. After the transfer, nonprofit Standard Mail Fulfillment Parcels will continue to be set consistent with this broader requirement.

Therefore, the transfer of commercial Standard Mail Fulfillment Parcel to the competitive product list will not have any dramatic effect on nonprofit Standard Mail Fulfillment Parcel prices. Pricing changes that occur for commercial Standard Mail Fulfillment Parcels after the transfer need not be echoed in prices for nonprofit Standard Mail Fulfillment Parcels. Further, the transfer will not result in nonprofit Standard Mail Fulfillment Parcels becoming an "orphan" product without any sort of pricing reference point. Nonprofit Standard Mail Fulfillment Parcel prices will be set in a reasonable

[16] The Postal Service's corrected response to Question 11(c) is being filed concurrently with these Reply Comments today.

fashion that takes into consideration prices for other market-dominant parcel and non-parcel shaped pieces, the needs and concerns of customers who use nonprofit Standard Mail Fulfillment Parcels, the need of the Postal Service to price its Standard Mail Parcels product to cover its costs while remaining within the price cap, and the impact that nonprofit Standard Mail Fulfillment Parcels prices have on the required 60 percent revenue per-piece ratio for Standard Mail as a whole.

E. The Ability To More Easily Negotiate Agreements With Mailers Would Be A Benefit Of The Transfer But Is Not The Reason That The Transfer Should Be Approved.

The Public Representative's final concern is that the Postal Service's arguments regarding the current difficulties of reaching negotiated service agreements are, in the view of the Public Representative, baseless. The Public Representative states that Postal Service or customer preferences for a particular review process for agreements are not compelling. The Public Representative also questions why the Postal Service would like to be able to enter agreements that provide discounts for a product that is already not covering its costs, unless the Postal Service is positioning the product for price increases. The Public Representative questions whether the Postal Service's concerns regarding negotiated agreements are actually fueling its Request, or whether instead "there is some rational business reason … that has not been explained."'

In the Request, the Postal Service offers its and its customers' concerns regarding a more streamlined review process for negotiated agreements not as the central reason for approving the requested transfer but rather to highlight a benefit that the transfer would have. The Postal Service does not have a hidden business reason for requesting the transfer. As the Public Representative notes, it would not make sense for the Postal Service to provide customers discounts below costs. The benefits of more streamlined review of negotiated agreements are predicated on the Postal Service first instituting rate increases that bring prices above costs. It is no secret that the Postal Service intends to raise the prices for commercial Standard Mail Fulfillment Parcels if the Request is approved.

When prices for Lightweight Parcel Select are above 100 percent cost coverage, the streamlined review process for competitive products will have the benefit of allowing the Postal Service to more easily negotiate more profitable agreements with its customers. This benefit, however, is not the reason that the Commission should approve the Request. The Commission should approve the Request because commercial Standard Mail Fulfillment Parcels do not meet the statutory definition of a market-dominant product.

III. Conclusion: The Postal Service's Request Satisfies The Criteria Set Forth In Section 3642 For Transferring A Product From The Market-Dominant Product List To The Competitive Product List.

The Postal Service's Request and its supporting materials demonstrate why the transfer of commercial Standard Mail Fulfillment Parcels from the market-dominant product list to the competitive product list would satisfy the applicable criteria set forth in section 3642. In response to the Postal Service's Request, the overarching argument raised by the PSA has been that commercial Standard Mail Fulfillment Parcels fall within the definition of a market-dominant product under 39 U.S.C. § 3642(b)(1). The Postal Service has demonstrated here in its Reply Comments that the product does not fall within the statutory definition of a market-dominant product because raising the product's prices substantially above costs carries with it the risk of loss of business to competitors. The Public Representative, which has stated that it “does not find a compelling legal basis for opposing the Postal Service’s Request,” has raised five secondary concerns regarding the Request. The Postal Service has addressed each of those five concerns herein. The Postal Service therefore asks that the Commission approve its Request.

Respectfully submitted,

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