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

Classification and Price Adjustments for First-Class Mail and Standard Mail Initiatives — **Docket No. R2011-1**

Comments of the American Catalog Mailers Association (ACMA)

(November 24, 2010)

Pursuant to Commission Order No. 588 (November 17, 2010), inviting comments by November 24, ACMA responds hereby. We view the matters at issue as important to our members and to the nation as a whole.

A. Introduction

On November 2, the Postal Service filed notice with the Commission of three price adjustments. Two of these, a reduction in the error tolerance for Move Update compliance and a Saturation (and High Density) Incentive, are argued to have price cap implications for Standard mail, the details being documented in USPS-R2011-1_Std_Mail_Worksheets.xls.

ACMA agrees (a) that the proposed reduction in the error tolerance for Move Update compliance, coupled with the attendant charge for non-compliance, if approved, should be viewed as a price increase, and (b) that rate authority should be used for it. When mailers are (or would be) charged more for continuing to do what they were doing before, that is certainly a price increase.

And we see the associated weighting system used by the Postal Service as it relates to Move Update to be appropriate.

On the other hand, we disagree that the Saturation Incentive is properly viewed as a price reduction. No mailers would have the option of spending less to purchase the same volumes they were purchasing before. And, if the Incentive *is* viewed as a price reduction, we disagree that it should be a basis for putting general rate authority into the bank, to be used to increase other Standard rates; rather, any reduction in price should be stated in dollar terms and put into a special account to be used only to increase rates for Saturation mailers.

More specifically, the Postal Service (a) estimates the *additional* future volume that will be brought about by the proposed Incentive, (b) attaches Incentive rates (numerator) and current rates (denominator) to that volume, and, recognizing also the unchanged rates for non-Incentive volumes, (c) thereby calculates a reduction in the average price of Standard mail. This reduction, after netting out the *increase* for the Move Update change, is proposed to be banked as additional unused rate authority, thus becoming available for use at Postal Service option in the future to increase the rates for other Standard mailers.[1]

The procedure followed by the Postal Service is at variance with accepted approaches to calculating price indexes. It is also at variance with the appropriate interpretation of Commission rules. It should be rejected. We do

[1] According to Commission Rule 3010.26(d), the vintage of the additional unused authority, for FIFO and the 5-year limitation purposes of Rule 3010.27, *would, if approved,* be the date of filing of the instant proposal (November 2, 2010).

not, however, oppose the Saturation Incentive. Standing on its own, without support from a rate increase for other Standard mailers, the Postal Service estimates that the Incentive is a good business decision that will stimulate more volume and make mail more attractive to these mailers. It should go forward without price-cap implications.

B. Discussion

To find the change in the average level of the prices faced by the mailers who purchase (or might purchase) the mail in a class, a representative *basket* of volumes is selected. These volumes are attached to (multiplied by) the prices involved, and are commonly called weights. If the number of dollars required to purchase these volumes increases, the average level of the prices of the mail represented is taken to increase accordingly.

For example, class 1 could be composed of three products, A, B, and C. The basket could contain 400 pieces of A, 600 pieces of B, and 800 pieces of C. If the postage required to purchase these 1,800 pieces is $1,000 in the base period and $1,100 at the new rates, it would be said that the average price level of the class increased 10 percent. Price decreases are handled similarly.

The notion of a basket is central to the estimation process. The volumes in it must be representative and they must be applied as weights to both the new and the current rates. In the formula, the volumes in the numerator (which *could* be purchased at the new rates) are always the same as the volumes in the denominator (which *were* purchased at the current rates).

Commission Rule 3010.23(d) specifies that the volume weights used, and thus the volumes in the basket, “shall be obtained from the most recent available 12 months of Postal Service billing determinants.” It then adds that “[t]he Postal Service shall make reasonable adjustments to the billing determinants to account for the effects of classification changes such as the introduction, deletion, or redefinition of rate cells,” and indicates that “[w]henever possible, adjustments shall be based on known mail characteristics.” It is the adjustments made by the Postal Service to the billing-determinant weights, and the use of the adjusted volumes to show a rate decline, that are at issue.

The purpose of making adjustments is to recognize that some of the mail may *qualify already* for the new rate. This already-qualified mail will clearly see a rate change, and adjusting the volume weights allows this change to be recognized.[2] But in the case of the Saturation Incentive, no mail qualifies already for the Incentive, so no adjustment should be made. The Incentive is merely an *option* for sending additional volume, if a threshold is met. The option could have been available in the base period, but wasn’t. The option is proposed to be available in the future period. In either case, the option is attached to the same published tariff.

As explained above, the essence of a price decrease is paying less postage for doing exactly what was being done before—purchasing a certain

[2] Note that if it is the case, it is appropriate and meaningful to take the volume in a new rate category to be zero in the base period. A zero volume level in the numerator and denominator means that the new rate has no influence on the index. This would be correct because no reference point would exist to help determine whether the new rate is higher or lower than before.

basket of volume. With or without the option of the Incentive, no mailer would be paying less for purchasing the volume he was purchasing before. Therefore, no price decrease exists. And this conclusion is independent of the exact volumes in the basket.

The notion of a price increase can also be viewed in terms of the theory of value, or, for mailers that are final consumers, utility theory. The mailers purchase a certain basket of volumes and thereby realize a certain level of value (benefit). They also part with a certain number of dollars. Under the Saturation Incentive, the same value from the same volume can be obtained by parting with the same number of dollars. How can this be viewed as involving a price change? We do not see that it can.

It is sometimes suggested that the basket used to estimate the size of a price change should contain future-period (new-rate) volumes instead of past-period (current-rate, or base-period) volumes. A price index using future-period volumes is called a Paasche index. Such indexes have several characteristics that should be considered. First, since buyers shift away from products with relatively large rate increases, leading to lower volumes for them, and since a Paasche index uses these lower volumes to give lower weight (than would a base-period index) to these high-price-increase products, a Paasche tends to report a lower rate increase than would a base-period index. For a given cap, then, a Paasche index tends to allow larger rate increases. Second, it can be shown that a regulated entity operating under a price cap and relying on a

Paasche index tends to set less efficient rates than it would if it relied on a base-period index.[3] Third, using a Paasche index presents the hurdle of not knowing the new volumes until the rates are known and of not knowing the new rates until the volumes are known.

In the case of the Saturation Incentive, the Postal Service approach gives the appearance of using future-period weights. The billing determinant volumes go with the rates in the basic rate schedule, which remain unchanged in the future period. These volumes are applied to the same rates in the future period (numerator) as in the base period (denominator), so they may be taken as future-period weights. Then a projection is made of the *additional* volume that might be brought about by the Incentive. This additional volume is future-period in nature. The numerator of the index becomes the billing-determinant volumes times the current rates plus the additional volumes times *the Incentive rates*. The denominator becomes the billing-determinant volumes times the current rates plus the additional volumes times *the current rates*. It is true that numerator is smaller than the denominator, but it is not clear that the ratio is a legitimate price index.

In the case of a rate decline, a Paasche index looks at the extent to which a future-volume basket can be purchased for less in the future period than it could have been purchased in the base period. The problem in the application to

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[3] For a discussion, with references to the literature, of the reduction in the efficiency of rates associated with the use of future-period volume weights, and thus with the use of Paasche indexes, *see*: Initial Comments of Time Warner Inc. in Response to Commission Order No. 26, September 24, 2007, pp. 6-10, Docket No. RM2007-1.

the Saturation Incentive is not that a slightly different basket would give a slightly different result. Rather, the problem is that the meaning of the rate attached to the *additional* volume in the numerator is quite different from the meaning of the rate attached to the *additional* volume in the denominator. The difference is a matter of *kind*, not of level. For this reason, the ratio cannot be taken as a measure of a rate decline.

This difference in meaning is fundamental. In the numerator, the additional-volume rate is part of an Incentive arrangement that is available only to volume beyond a specified threshold. In the denominator, the additional-volume rate is the published tariff available to all mailers. Suppose the USPS index suggests a rate decrease of 10 percent. If the budgets of mailers buying the market basket in the future period, under the Incentive arrangement, were adjusted upward to account for the rate decline, they would not be able to justify purchasing the same basket in the base period, under the published tariff.[4] The fact that the index is lower in the future period means only that the Incentive was not available in the base period, not that the rates are lower in the future period.

[4] Under a base-period index, a mailer with a budget adjusted by the amount of the rate change would be able to purchase the same basket in the future period by making purchase decisions in the usual way. That is, the value of each additional piece would be compared with the additional cost, and purchases would be made until the full basket is purchased. In the case of the Postal Service's Paasche-like index and the Saturation Incentive, a mailer with an augmented budget, as discussed in the text, would not be able to purchase the same basket in the base period by making purchase decisions in the usual way. As the value of each additional piece is compared with the additional cost, which is here the ordinary published tariff, not the Incentive, the mailer would stop purchasing before the full basket is obtained. This makes clear that the market-basket notion does not apply. Again, the difference is a matter of kind. In the numerator the mailer faces a declining block rate structure. In the denominator, he faces an ordinary schedule.

The Postal Service proposal fails as well on grounds of fairness. The argument for the Incentive says: "From an unchanged published tariff, we will allow a discount for additional volume. This additional volume will improve the finances of the Postal Service, help the mailers receiving the Incentive, and hurt no one. It is a gain without a downside." Given this, it seems unfair on its face to take another step and say: "As mailers use the incentive, we will gain contribution on the additional volume and at the same time will bank authority to charge more to other mailers in the class, perhaps in the future."[5]

And two strange features of the procedure proposed by the Postal Service should not go unnoticed. First, if the additional volume due to the Incentive turns out to be smaller than projected, the authority already put into the bank will be seen to be excessive, and it is not clear that there is a way to remove any of it. Second, if a *larger* Incentive is given, more additional volume will be projected; then these two larger figures will combine to bank *more* additional authority to increase the rates for others. This feature seems unfair, plus it shifts the focus away from the notion that the discount program should be designed to be profitable on its own or serve a greater or longer-term purpose.

The characteristics of discounts at the margin have come up before. In Summer Sale 2010 (Docket No. R2010-3, USPS Notice February 26, 2010), the Postal Service said it would "ignore the effect of the price decrease resulting from

[5] One could argue that when the base rates were being set, those from which the incentive is provided, a decision could have been made to give a lower base to the mailers who will be given the incentive at the margin. However, the Incentive program does not give lower base rates to mailers who will be given the incentive at the margin.

the program on the price cap for both future and current prices" (p. 10). The Commission acknowledged this *proposal to ignore* and found it "reasonable because ineligible mailers will not be charged higher rates based on the amount which otherwise would be banked from the program" (Order No. 439, April 7, 2010, p. 12). Similar questions arose in Dockets No. R2009-3 and R2009-5. The concern expressed by the Commission applies to the instant proposal as well.

C. Alternative Treatment

As a matter of principle, we believe it is wise to encourage the Postal Service to experiment in price reductions that lead to increased piece volume, incremental revenues, and additional contribution dollars. We also recognize that part of its willingness to do so is dependent on it not closing off future options. For instance, if a price incentive does not work, the Postal Service should not be prohibited from returning to the former rate position. Such a return would seem to be made more difficult if the price reduction resets the floor to a lower level, from which more banked authority would be available.

We believe Congress intended for rates to be limited by inflation. Mailers told Congress they wanted predictability in their postage costs. Mailers said the inability to plan and predict the magnitude of postal rates in the future was a disincentive to investment in the use of mail. While some wanted a CPI cap on total revenues, others argued that there should be a limit on each category or rate cell. A class-level test was ultimately selected, as a good balance of flexibility and constraint. Alternative mechanisms to redistribute price without any consideration to the principles considered under the cap, *viz*., the moderation of rates for postal customers, should be avoided as described herein. Yet, if innovation is to be encouraged, and the USPS is to avoid being penalized for trying novel approaches, how does this get reconciled in light of the rate cap and unused rate authority?

A solution to the dilemma raised might be to restrict new unused rate authority to the customers or products that generated it to start with. Thus, in the case at issue, any additional banked authority created by the Saturation Incentive, if there is any, should accrue to the customer or product that created it. Just as a real bank has money held in a variety of "accounts," the unused-rate-authority "bank" could have money segmented into accounts relating to specific postal customers or mail types. If the Postal Service finds that an effectively lower price regime for Saturation mailers is "good business," it will continue to offer lower effective rates through this Incentive or some other means. On the other hand, should it determine the modified rate structure is not good business, it has the ability to return to the prior rates without concern as to impact on the rate cap. Apples are kept with apples so the integrity of pricing system is preserved.

D. Conclusion

ACMA does not object to the approval of the Saturation Incentive. The Postal Service *should* consider innovations in pricing. We submit, however, that the proposed development of a price index, which is compared to the cap, is wrong. It is inconsistent with accepted index number theory. It is inconsistent with any market-basket notion of an average price change. It is at variance with the appropriate application of Commission rules. It is at variance with the idea that the Incentive program should not harm other mailers. It is arguably unfair. And if price effects *are* taken to exist, we believe the Postal Service should opt to ignore them, as it has on similar occasions in the past.

Respectfully submitted,
American Catalog Mailers Assn., Inc.

By: Hamilton Davison

Hamilton Davison
President & Executive Director
PO Box 11173 Hauppauge, NY 11788-0941
800-509-9514