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

Notice of Market-Dominant Price Adjustment — **Docket No. R2013-1**

COMMENTS OF PITNEY BOWES INC.

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I. INTRODUCTION

Pursuant to Order No. 1501, Pitney Bowes Inc. (Pitney Bowes) respectfully submits these comments in response to the United States Postal Service's (Postal Service) October 11, 2012 Notice of Market-Dominant Price Adjustment (Notice). These comments address the following issues: (1) compliance with the statutory price cap, (2) the timing of the Notice, (3) First-Class Mail prices, and (4) promotions.

II. DISCUSSION

A. Compliance with the Annual Limitation

This year the Postal Service calculated an annual limitation of 2.570 percent. *See* Notice, Attachment C. Subject to the concerns regarding the recovery of foregone revenue in connection with the proposed pricing promotions (discussed below), it appears that the planned price adjustments for First-Class Mail, measured using the formula in part 3010.23(b), are at or below the annual limitation established in part 3010.11 and part 3010.28. *See* 39 C.F.R. §§ 3010.11, 3010.23(b), and 3010.28.

B. Timing of the Price Adjustment

The Postal Service filed notices of the proposed price adjustments for Market Dominant and Competitive products simultaneously. Each Notice gives more advance notice (108 days) than the law requires for either category of products (45 days and 30 days, respectively). *See* 39 U.S.C. §§ 3622(d)(1)(C) and 3632(b)(2); 39 C.F.R. §§ 3010.10(a) and 3015.2. Pitney Bowes commends the Postal Service for filing the concurrent Notices and for providing substantial advance notice to enable the mailing community to prepare for the price changes.

C. First-Class Mail Prices

1. First-Class Mail Letters

The price adjustments in First-Class Mail Letters represent a missed opportunity for the Postal Service and the postal system. Once again, the Postal Service has failed to use its pricing flexibility under the PAEA to incentivize the most efficient, least costly, most profitable, and most price sensitive products.

The proposed prices favor less efficient Single-Piece Letters, and disproportionately burden more efficient, profitable and price sensitive First-Class Mail products. The first ounce Single-Piece Letters increase is 2.2 percent. In comparison, the first ounce 5-Digit Automation Letters increase 2.9 percent. These pricing signals compound the error of the past several adjustments. The cumulative increase for first ounce Single-Piece Letters over the past three pricing adjustments was 4.5 percent. The CPI increase over the same period was 6.9 percent. The cumulative price increase for first ounce 5-Digit Automation Letters over the same period was 7.5 percent.

As pointed out by numerous parties in prior proceedings, this approach is financially self-defeating.[1] The law requires the Postal Service to comply with a revenue-based price cap across products within each class, but because the unit contributions differ among products, not all revenue under the cap is equal. The Postal Service should seek to improve its financial position by growing its most profitable and most price sensitive products. In First-Class Mail, every piece of presort mail that the Postal Service can generate or keep in the system makes, on

[1] *See* PRC Dkt. No. ACR2011, DMA Comments (Feb. 3, 2012) at 3-4; PRC Dkt. No. RM2009-2, DMA Comments (Sept. 11, 2009) at 5-6.

average, an additional six cents.[2] The case for below average price increases for the most efficient and most profitable products is further bolstered by the fact that those products, First-Class Mail Presort Letters, are more price sensitive than Single-Piece Letters.[3]

The Postal Service's proposal to pass through less than the full measure of avoided costs for 5-Digit Automation Letters also represents a missed opportunity. The Postal Service Notice presents the passthrough for 5-Digit Automation Letters as 96.3 percent. However, because the Postal Service again proposes to set the AADC and 3-Digit Automation Letters prices equal, the effective passthrough from the mailer's perspective is the difference in price between AADC to 5-Digit. Taking into account this price difference, the real passthrough is 86 percent, substantially below 100 percent of the workshare-related avoided costs.[4] Passing through less than the full value of the costs avoided results in higher prices for the most finely-presorted, efficient, and profitable First-Class Mail product, 5-Digit Automation Letters. And because price matters, this will unnecessarily discourage the Postal Service's largest customers from mailing.

The Postal Service provides no reason in its Notice for why it persists in placing a disproportionate burden on Presort Letters. Nor does it explain why it persists in setting the discount for 5-Digit Automation Letters well below 100 percent of the costs avoided. Two

[2] *See* FY 2011 Annual Compliance Determination Report (DATE), at 16 (the unit contribution of First-Class Mail Presort Letters / Cards (23.2 cents) is more than six cents greater than the unit contribution of First-Class Mail Single-Piece Letters / Cards (17.0 cents).

[3] *See* PRC Narrative Explanation of Econometric Demand Equations for Market Dominant Products Filed with Postal Regulatory Commission on January 20, 2011 (Jul. 1, 2011), pp. 35 and 39.

[4] The Commission recently initiated a rulemaking to consider whether a change in analytic principle is necessary to ensure that workshare-related cost savings are being measured from the appropriate reference point within presort rates. *See* PRC Dkt. No. RM2018-6, Order 1510 (Oct. 23, 2012). This proceeding takes on added importance because the Postal Service has combined the AADC and 3-Digit rates in First-Class Mail Cards and in Standard Mail, and has suggested that this may be a permanent change in presort rate design. *See* USPS Notice at 36, n.25 ("[i]n the future [there will be] one, yet to be determined, sortation level between Mixed AADC and 5-digit.").

justifications have been suggested elsewhere. One is that the Postal Service is pricing in response to volume trends; another is that it is pricing to excess capacity. Neither is appropriate.

In its justification regarding Standard Mail Flats prices, the Postal Service presents a contribution model (USPS-LR-R2013-1/7) that purports to demonstrate that applying above-average increases to products with declining volumes will always hurt profitability. Perhaps a similar pricing to volume trends approach is influencing First-Class Mail Letter pricing. If so, that is a mistake because the assumptions underlying the flats model are theoretically unsound and, as applied to First-Class Mail Letters, demonstrably incorrect.[5]

The Commission recognized the complexity involved here in Commission Information Request (CIR) No. 1. The impact of alternative pricing proposals on profitability depends not only on volume trends, but also the relative profitability and price sensitivity of individual products. And in the case of First-Class Mail Letters, it has been repeatedly demonstrated that because Presort Letters are more profitable and more price sensitive than Single-Piece Letters, applying below-average price increases to Presort Letters would significantly improve USPS profitability.[6]

In the last price adjustment, the Postal Service was explicit that it was deviating from efficient pricing to make use of excess capacity in its mail processing operations.[7] The current Notice is not so explicit, but the price signals are the same and the Postal Service continues to make public statements to the effect that it is pricing to excess capacity. For example, a Postal Service executive recently justified the MAADC letter price – which increased by a fraction of the increase imposed on 5-Digit mail – by stating that it would bring more mail processing in-house, a purported benefit given the Postal Service's excess capacity in mail processing

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[5] *See* PRC Dkt. No. R2013-1, Commission Information Request No. 1 (Oct. 18, 2012) at 2-3.
[6] *See* n.2 *supra*.
[7] *See* PRC Dkt. No. R2012-2, Notice of Market-Dominant Price Adjustment (Oct. 21, 2011) at 35.

operations.[8] While setting the MAADC-AADC passthrough equal to 100 percent is reasonable, this justification is troubling. Pricing to excess capacity is self-defeating because it will further accelerate mail volume declines. The only way the Postal Service can ensure that mail remains an effective, price-competitive communications medium for its largest commercial customers is through pricing that drives efficiency and achieves the lowest combined costs. The Postal Service must reduce excess capacity in its network rather than price to it.

A shift in the Postal Service's pricing policy that results in setting discounts at less than costs avoided not only results in inefficiency, it raises competition policy concerns in competitive upstream postal markets. In comments to the Commission last year Dr. John Panzar observed:

> Reducing discounts below Postal Service avoided costs is a form of exclusionary pricing. This vertical price squeeze would exclude more efficient competitors from performing upstream services. This would have a short-term negative effect on the productive efficiency of the postal sector and a longer-term negative effect of slowing or reversing the shift in value added from the Postal Service to the private sector.[9]

Pricing to volume trends and excess capacity is also inconsistent with the objectives and factors of the modern rate system under the PAEA. The Postal Service's pricing flexibility is not unconditional. Market dominant prices must be developed with "consideration for the qualitative rate and classification objectives and factors identified in sections 3622(b) and 3622(c)."[10] The proposed First-Class Mail prices fails to give adequate consideration to the profitability and economic efficiency concerns expressed under sections 3622(b)(1) (incentives to increase efficiency), 3622(b)(5) (assure adequate revenue), 3622(c)(1)(value of mail service

[8] The price for Mixed AADC letters has several problems. First, the MAADC discount is economically inefficient. The passthrough from Single-Piece to Mixed AADC is only 93.2 percent. Second, the changes in the MAADC price over the last three price adjustments have resulted in dramatic fluctuations in the MAADC-AADC discount, creating unpredictability and instability among Presort rates. Because the MAADC-AADC cost avoidance has been stable during the same period, these fluctuations were inappropriate and unnecessary.

[9] PRC Dkt. No. ACR2011, Comments of Dr. John Panzar (Feb. 3, 2012) at 5.

[10] PRC Dkt. No. RM2009-3, Order No. 536 (Sept. 14, 2010) at 16.

provided), 3622(c)(3)(effect of rate increase on mailers), 3622(c)(4)(available alternatives to mail), and 3622(c)(5)(prices reflecting degree of mail preparation). *See* 39 U.S.C. §§ 3622(b)(1) and (5), 3622(c)(1) and (3)-(5).

The Postal Service should use its pricing flexibility to drive efficiency and lowest combined costs for the postal system. It should also use its pricing flexibility to maximize its contribution by promoting and incenting its most efficient and most profitable products. The proposed First-Class Mail prices fall short on both counts.

2. Single-Piece "Residual" Letters

Pitney Bowes appreciates the Postal Service's efforts to respond to mailer concerns by introducing a new 48 cent price for single-piece "residual" letters weighing up to 2 ounces. *See* Notice at 15. The Postal Service defines residual letters as "letters which for one reason or another do not meet the presort requirements and end up paying the single-piece price." *Id*. The proposal is intended to "solve a logistical problem" imposed on mailers required to undertake the additional work of separating out the one and two ounce pieces that fall out of the presort stream to ensure correct payment for the additional ounce postage. As proposed, the new "residual" price solves this problem for pieces at or below two ounces, but further refinements are necessary to avoid the very same problem for residual pieces weighing more than two ounces. Pitney Bowes urges the Postal Service to work with the mailing industry to develop a comprehensive solution applicable to all mail weighing more than one ounce.

3. First-Class Mail Flats

The Postal Service filing overstates the First-Class Mail ADC Automation Flat passthrough as 178.6 percent. *See* R2013-1, USPS-LR-1, CAPCALC-FCM-R2013.xls, "Passthrus – FCM Auto Flats," cell H9. The problem is the Postal Service's use of outdated cost avoidance figures. Specifically, the Postal Service uses the 5.6-cent cost avoidance reported in the FY 2011 Annual Compliance Determination (2011 ACD).[11] *See id.*

The Commission subsequently approved a revised model (Docket No. RM2012-2) that produces an 8.8 cent cost avoidance. *See* RM2012-2, PRC-RM2012-2-LR1, Rev_FCM.Prsrt.Flats.with.NDC.Alt.xls, "CRA ADJ UNIT COSTS," cell G37. Additionally, model changes proposed by the Postal Service in Docket No. RM2012-8 would increase this cost avoidance further, to 10.8 cents, *see* RM2012-8, FCM.Prsrt.Flats.1023.xls, "CRA ADJ UNIT COSTS," cell G37, resulting in a passthrough of 92.6 percent.

To avoid similar confusion in future proceedings, the Commission should consider revising its rules, *see* 39 C.F.R. § 3010.14(b)(5), to require that the cost avoidance estimates presented in future rate adjustment notices are derived using the most recent Commission-approved methodology.

D. Price Cap Implications of Promotional Pricing

The Postal Service proposes six promotions during calendar year 2013. *See* Notice at 6-9. Pitney Bowes supports the Postal Service's innovative use of its pricing flexibility to increase the value of mail and to further integrate mail and emerging mobile and ecommerce technologies. Pitney Bowes also commends the Postal Service for providing a full calendar year schedule of promotions, which will make it more likely interested mailers can participate. *See* Notice at 7. There are, however, several technical issues that we urge the Commission to consider.

In the past, promotional discounts, like negotiated service agreements (NSA), were structured to ensure that all other mailers were held harmless if revenues were lost due to a

[11] *See* PRC Dkt. No. R2013-1, Chairman's Information Request No. 1 (Oct. 23, 2012).

promotional sale or NSA.[12] In this case, the Postal Service seeks to factor the estimated foregone revenue from the noticed promotions into the price cap calculation. *See id*. at 9. In essence, the cost of these promotions would be borne by all mailers. Although the revenue foregone off-set in this case is relatively modest ($33.4 million), this change in approach, if approved, would set an important precedent, and raises several policy questions.

First, these promotions are no longer a win-win proposition for the Postal Service and mailers. The promotions effectively pick winners (those benefiting from the promotional incentives) and losers (those asked to pay more to recoup projected foregone revenue). Second, this approach raises at least one technical issue for calculating the price cap. The Postal Service seeks to offset price breaks for promotional mail by effectively pushing up the cap (increasing prices) on non-promotional mail. If the Postal Service overstates the anticipated foregone revenue the offsetting increases could result in an impermissible price increase in violation of the CPI price cap.

The Commission has previously observed that complex changes of this nature often cannot be effectively considered and resolved within the time constraints of a rate adjustment proceeding.[13] Accordingly, Pitney Bowes recommends that the Commission approve the promotions while reserving on the technical and policy issues presented by the Postal Service's proposal for a more thorough examination in a separate proceeding.

[12] *See* 39 C.F.R. § 3010.24(a).
[13] *See* PRC Dkt. No. RM2012-6, Order No. 1510 (Oct. 23, 2012) at 12.

III. CONCLUSION

Pitney Bowes appreciates the Commission's consideration of these comments.

Respectfully submitted:

/s/

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