Postal Regulatory Commission
Submitted 11/9/2012 4:28:59 PM
Filing ID: 85636
Accepted 11/9/2012

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

NOTICE OF MARKET-DOMINANT PRICE ADJUSTMENT	Docket No. R2013-1

REPLY COMMENTS OF THE UNITED STATES POSTAL SERVICE

(November 9, 2012)

In Order No. 1501,[1] the Commission solicited comments on the Notice of Market-Dominant Price Adjustment (Notice) filed by the United States Postal Service (Postal Service) on October 11, 2012. The Public Representative (PR) and Valpak submitted comments on November 1, 2012. The Postal Service hereby provides reply comments concerning certain criticisms of its Standard Mail Contribution Model (Contribution Model), filed as USPS-LR-R2013-1/7.

Introduction

Summarizing an argument made by Valpak, the PR states that the Postal Service's Contribution Model suffers from certain shortcomings, including "ignoring the products' [Flats and Letters] elasticities"[2] The PR goes on to conclude that "those Valpak arguments have merit."[3] Similarly, Valpak focuses much of its comments on attacking the Contribution Model for implicitly assuming "that neither Flats nor Letters

[1] Docket No. R2013-1, Order No. 1501: Notice and Order on Planned Rate Adjustments and Classification Changes for Market Dominant Postal Products, at 16 (October 15, 2012).
[2] Docket No. R2013-1, Public Representative Comments in Response to United States postal Service Notice of Market Dominant Price Adjustment, at 15 (November 1, 2012) ("PR Comments")
[3] *Id*. at 16.

exhibits any elasticity of demand whatsoever with respect to changes in price."[4] Valpak goes on to conclude that the Contribution Model is therefore "wholly unable to measure changes in contribution under different scenarios – the very purpose for which it was offered."[5] Valpak ultimately offers its own contribution model (incorporating hypothetical price elasticities of demand) that purports to contradict the results presented by the Postal Service's model.[6]

These comments appear to misunderstand the Contribution Model's underlying purpose, and mistakenly discredit the model using the assumption that it was designed produce an all-encompassing forecast of net-contribution impacts. Rather, as the Postal Service has previously explained, the Contribution Model was constructed to demonstrate that that there is a real tension between long-run financial stability and imposing above-average price increases on Flats to achieve 100 percent cost coverage.[7] This risk arises from the circumstance that Flats volume, unlike Letter volume, is in systemic decline. While the Postal Service agrees that the inclusion of own-price elasticities of demand would make the Contribution Model more comprehensive, they are not necessary in order to support the Postal Service's overarching arguments.

To illustrate this point, the Postal Service has attached three versions of an "after-rates" model that incorporates the various hypothetical scenarios proposed by Valpak. These models are filed as USPS-LR-R2013-1(7) Alt1.xls, USPS-LR-R2013-

---

[4] Docket No. R2013-1, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on the United States postal Service Notice of Market Dominant Price Adjustment, at 19 (November 1, 2012) ("Valpak Comments").
[5] *Id*. at 22.
[6] *Id*. at 24-28.
[7] Docket No. R2013-1, United States Postal Service Notice of Market-Domniant Price Adjustment, at 22 (October 11, 2012).

1(7) Alt2.xls, and USPS-LR-R2013-1(7) Alt3.xls (hereafter Alt 1, Alt 2, and Alt 3), and show that, in the long-run, above-average price increases for Flats (at the expense of larger price increases for letters) will have a negative impact on contribution.

Alternative Contribution Models

First, Alt 1 replicates one of Valpak's hypothetical scenarios, including -0.6 for Flats and -0.2 for Letters. Consistent with Valpak's findings, Year 1, Scenario 2, offers more contribution than Scenario 1. However, unlike the original Contribution Model and Valpak's analysis, Alt1 does not stop at Year 1, and contains projections for multiple years. This improvement recognizes that pricing is a dynamic exercise with dynamic, lasting effects. Indeed, by Year 2, Scenario 1 already generates more contribution than Scenario 2. By Year 3, the cumulative impact of Scenario 1 exceeds that of Scenario 2.

Alt 1 demonstrates that, due to the unique nature of the price cap, when an opportunity to increase the price of Letters is forgone, the ability of Letters to contribute to institutional costs is permanently impaired. Though contribution can normally be enhanced by applying the greater price increase to the product with the lower elasticity (Letters, in this example), this principle is subverted in Year 1 by Flats' negative contribution margin. A bigger price increase drives away more loss-making Flats volume. Beginning in Year 2, however, this effect loses its strength, as the potency of driving away loss-making Flats is diminished by both the lower level of Flats volume and the improved Flats contribution margin. Meanwhile, Letters rack up gains in Scenario 1 (compared to Scenario 2), as the benefit of a higher price level beginning in Year 1 has a compounding effect.

Alt2 presents another of Valpak's hypothetical scenarios, a Flats elasticity of -0.2 and a Letters elasticity of -0.6. In this case, the single-year tipping point is Year 5 and the cumulative tipping point is Year 7. Despite the deferred impact, the same principle applies: Constraining the Letters price increase introduces contribution risk in the long-run. Finally, Alt3 presents an intermediate case, an equal elasticity (as in Valpak's Table 6) of -0.35 for Flats and Letters. The single-year tipping point is Year 3 and the cumulative tipping point is Year 4.

Several important conclusions can be drawn the Alt 1, Alt 2, and Alt 3 scenarios. First, the risk that the Postal Service has described — that, in the face of a price cap, contribution in the future can be compromised if price increases on products with relatively sustainable volume are held in check — is real. This is true, regardless of the PR's and Valpak's speculations about the impact of elasticities. Second, pricing requires a long-run perspective. To focus on every rate filing as a discrete and one-year event (as Valpak does in its proposed contribution model) runs the risk of severely miscalculating the impacts of pricing decisions in the long-run.

Additionally, the application of a price cap also sets the Postal Service apart from examples in the private sector. In this vain, Valpak states that "the losses incurred on the Standard Mail Flats product in each of the four prior fiscal years show that the Postal Service should have increased the price of Flats much more and much sooner, just as any rationally operated business enterprise would have done." The Postal Service not only disagrees with this statement for the reasons stated above, but also disagrees for two additional reasons. First, it is the rare enterprise in the private sector that is subject to a price cap. Such comparisons are therefore not particularly helpful or even meaningful. Second, even if, hypothetically, such an enterprise were subject to a price cap, the “rational” response would not be to boost price increases on the money-losing product at the direct expense of price increases on the money-making product, especially if, like Standard Mail Letters, the money-making product has a low price elasticity of demand. Rather, the rational response would be to terminate the money-losing product and raise prices on the money-making product. Unsurprisingly, Valpak does not raise this potential response, nor does the Postal Service advocate it, in light of its obligations and responsibilities to the mailing public.

Conclusion

Due to the numerous factors that it must balance, Postal pricing is part science and part art, and should not be held hostage to overly mechanistic processes. As the Postal Service has previously stated, it believes that the proposed prices for Standard Mail Flats and Letters represents the best balance between the need to improve Flats’ cost coverage and the need to protect the Postal Service’s long-term contribution (an thus, financial stability). Of course, as volume trends and other factors change each year, the Postal Service will reevaluate its pricing proposals to ensure that they achieve the best balance. For these and the forgoing reasons, the Postal Service respectfully requests that the Commission reject the criticisms of its Standard Mail Contribution Model and approve the Standard Mail pricing proposals presented in this Docket.

Respectfully submitted,

UNITED STATES POSTAL SERVICE
By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Pricing & Product Support

____

John F. Rosato

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1135
(202) 268-8597, FAX: -6187