

UNITED STATES OF AMERICA  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

Before Commissioners:

Ruth Y. Goldway, Chairman;  
Robert G. Taub, Vice Chairman;  
Mark Acton;  
Tony Hammond; and  
Nanci E. Langley

Periodic Reporting

Docket No. RM2012-6

ORDER REVISING BENCHMARK USED TO CALCULATE THE  
COSTS AVOIDED BY AUTOMATION FIRST-CLASS 5-DIGIT LETTER MAIL

(Issued June 18, 2013)

I. INTRODUCTION AND SUMMARY

On July 12, 2012, Pitney Bowes Inc. (Pitney Bowes) filed a petition to initiate an informal rulemaking to change the analytical principle that defines the benchmark which is used to calculate the Postal Service costs that are avoided when mailers convert less finely sorted automation First-Class letters to 5-digit letters.<sup>1</sup> Specifically, it notes that, as of January 2012, the Postal Service stopped offering a discount for First-Class letters sorted to the 3-digit level. Accordingly, Pitney Bowes proposes that the current benchmark for First-Class 5-digit letters, *i.e.*, First-Class 3-digit letters, be replaced by a hybrid of Automated Area Distribution Center (AADC) and 3-digit letters that reflects

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<sup>1</sup> Petition of Pitney Bowes Inc. for the Initiation of a Proceeding to Consider Proposed Changes in Analytic Principle, July 12, 2012 (Petition).

their relative volumes. For reasons explained below, this Order adopts Pitney Bowes' proposed change.

Pitney Bowes and two associations of presort mailers also note that as of January 2013, the Postal Service ceased offering a discount for sorting Standard Regular letters to the 3-digit level. They argue that the rationale supporting the adoption of a hybrid benchmark for First-Class 5-digit letters should apply to Standard Regular 5-digit letters as well. Because Pitney Bowes' petition does not formally propose to change the benchmark for Standard Regular 5-digit letters, there may be considerations affecting such a change that have not been fully addressed in the comments in this docket. Accordingly, in this Order, the Commission is soliciting an additional round of comments on the desirability of making a parallel change to the benchmark for Standard Regular 5-digit letters before it rules on that suggestion.

To understand the function of benchmarks in calculating the costs that worksharing avoids, it is necessary to understand the set of worksharing relationships that are presumed to exist among the various rate categories of presorted First-Class letter mail. This set of relationships is described as the "presort tree."

For automation First-Class letters, the presort tree consists of four presort tiers. Each has an associated benchmark, which is the adjacent, less-finely sorted tier. The workshare-related cost of the benchmark is the starting point for calculating the Postal Service costs that each more finely-sorted tier avoids. The table below is the presort tree populated with the avoided costs and passthroughs associated with current (Docket No. R2013-1) rates.

Presorted First-Class Mail Letters				
<u>Benchmark</u>	<u>Workshare Category</u>	<u>Avoided Cost</u>	<u>Discount</u>	<u>Passthrough</u>
		(\$ / piece)	(\$ / piece)	
Metered Letters	Automation Mixed AADC Letters	0.059	0.055	93%
Automation Mixed AADC Letters	Automation AADC Letters	0.021	0.021	100%
Automation AADC Letters	Automation 3-digit Letters	0.004	0.000	0%
Automation 3-digit Letters	Automation 5-digit Letters	0.025	0.024	96%

The current presort tree uses a 3-digit piece as the benchmark piece for calculating the costs that sorting to the 5-digit level would avoid. Pitney Bowes' petition notes that in January 2012, the Postal Service eliminated the opportunity for a mailer of Mixed Automated Area Distribution Center (MAADC) or AADC letters to earn a larger discount for sorting further to the 3-digit level. Petition at 2. Pitney Bowes argues that since there is no longer either a requirement or incentive for presorting First-Class letters to the 3-digit level, the rationale for using 3-digit presort as the benchmark for calculating the cost avoided by presorting to the 5-digit level needs to be re-examined. *Id.* at 2-3. It observes that since these changes, there has been a partial reversion of 3-digit volumes to the AADC Automation category. Nevertheless, it notes 3-digit letters remain a substantial share of presort First-Class letters overall. Pitney Bowes asserts that this migration from the 3-digit category will continue as long as there is no general requirement to sort mail to 3 digits where feasible, and no discount available for doing so. Therefore, Pitney Bowes argues, an improved benchmark for the automation 5-digit letter category would be a hybrid of the costs of AADC letters and 3-digit letters, weighted by their relative volumes.<sup>2</sup>

## II. THE POSTAL SERVICE'S JURISDICTIONAL OBJECTION

The Postal Service's initial response to Pitney Bowes' petition asserted that the petition was not an authorized use of Periodic Reporting Rule 11 (39 C.F.R. § 3050.11).<sup>3</sup> Rule 11 authorizes the Postal Service, the Commission, or interested persons to request that an informal rulemaking be initiated to change the analytical principles that the Postal Service applies when it estimates and reports on the various dimensions of Postal Service performance that are the focus of the Postal Accountability and Enhancement Act (PAEA) regulatory scheme, *i.e.*, costs, volumes, revenues, rates, and service attainment. See 39 U.S.C. § 3652(a)(1).

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<sup>2</sup> Comments of Pitney Bowes Inc., December 7, 2012, at 2 (Pitney Bowes Comments).

<sup>3</sup> Response of the United States Postal Service to Petition for Initiation of Proceeding, July 12, 2012 (Postal Service Response to Petition).

The Postal Service noted that rule 11 authorizes the public to petition to make changes to “analytical principles.” It also asserted that it has sole discretion to attach a discount for worksharing to a rate category. Therefore, the Postal Service argued, the Commission and the mailing public should defer to it in deciding when and how revisions to workshare benchmarks should be made. *Id.* at 2-3.

In Order No. 1510, the Commission rejected the Postal Service’s argument that an analytical principle must be a mathematical model or formula.<sup>4</sup> It noted that under rule 1(c), an analytical principle includes a “theory, precept, or assumption.” It observed that the First-Class Automation letter presort tree assumes that the economically sound approach to calculating the costs avoided by worksharing is to first, identify the portion of the less workshared category that is most likely to convert to the more workshared category to qualify for a larger discount, and then to use that portion of the less workshared category as the benchmark for calculating the cost avoided by the more workshared category. The Commission concluded that Pitney Bowes’ petition was appropriate because it asks the Commission to re-examine the specific economic assumption that 3-digit mail is the group of less workshared mail that is most likely to convert to 5-digit mail.

### III. VIEWS OF THE PROPONENTS OF A HYBRID BENCHMARK

#### A. Pitney Bowes

Pitney Bowes asserts that the PAEA requires that workshare discounts accurately reflect the amount of Postal Service costs that are avoided as a result of mailers’ worksharing activities. It argues that to do this, it is necessary to accurately identify the less workshared mail that will be converted to more workshared mail (in this instance, 5-digit mail) in response to a discount. Under the Commission’s methodology, the group of less workshared mail that is identified as the most likely to convert to 5-digit

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<sup>4</sup> Notice of Proposed Rulemaking on Analytical Principle Used in Periodic Reporting (Pitney Bowes Inc. Proposal One) October 23, 2012, at 8 (Order No. 1510).

mail serves as a benchmark. The costs of the benchmark that are shed when that mail is sorted to the 5-digit level are considered to be the best measure of the costs that 5-digit mail avoids. Pitney Bowes argues that if the benchmark is no longer representative of the mail that is most likely to convert, the avoided cost estimate will be wrong. If the avoided cost estimate is wrong, Pitney Bowes warns, the economic efficiency of the 5-digit discount and its compliance with the requirements of the PAEA will be misjudged.<sup>5</sup>

Currently, the cost of processing 3-digit letters is the benchmark for calculating the costs avoided by sorting letters to 5 digits. Pitney Bowes argues that since the Postal Service eliminated the discount for 3-digit letters in January 2012, mailers are gradually abandoning the 3-digit tier by shifting to AADC or consigning the mail to consolidators who, after aggregating mail to sufficient density, sort it to 5 digits.

Pitney Bowes shows that of the mail that can be sorted to 5-digits (AADC and 3-digit mail) AADC's share grew from about one-fifth of the total when the discount was first eliminated (Quarter 1 of 2012) to about one-half by Quarter 3 of 2012. Pitney Bowes observes that this is consistent with its own experience as a presort bureau. It says that due to the lack of a price incentive, it has shifted what would have been 3-digit mail to AADC mail or consolidated it with the mail of other clients to allow the mail to be sorted to the 5-digit level. It continues to make up 3-digit trays only for mail destinating in the local service area at the Postal Service's request. Pitney Bowes Comments at 8.

Pitney Bowes argues that as long as no discount is offered for sorting letters to 3 digits, the importance of AADC mail as a source of 5-digit mail will grow, and the current 3-digit benchmark will become increasingly unrepresentative of the mail most likely to convert to 5 digit. Largely because the Postal Service continues to require some local mail to be sorted to 3 digits, Pitney Bowes recognizes that 3-digit mail will remain an important source of 5-digit mail. It argues that to be representative of the

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<sup>5</sup> See Docket No. ACR2012, Comments of Pitney Bowes, February 1, 2013, at 4-6.

mail most likely to convert to 5-digit mail, the benchmark must be changed to a volume-weighted hybrid of AADC and 3-digit mail.

Pitney Bowes says that the move to a hybrid benchmark should be made as a part of ACR 2012, because FY 2012 is the year in which the prices of AADC and 3-digit mail were equalized. *Id.* at 9. It says that if parallel changes are made in Standard Regular letters (eliminating the requirement to sort to 3 digits and the discount for doing so) a parallel change should be made to the benchmark for 5-digit Standard Regular letters. It says that a volume-weighted hybrid benchmark for Standard Regular letters should be made part of the FY 2013 ACR because that is the year in which the AADC and the 3-digit rate will have been equalized. *Id.*

Pitney Bowes asserts that there is Commission precedent to support the use of a hybrid benchmark. It cites several instances in which the Commission averages the costs of subgroups of mail to obtain a cost estimate for evaluating rates and revenues associated with the larger group of mail. Pitney Bowes Comments at 5-7.

#### B. The Presort Mailer Associations

The National Postal Policy Council (NPPC) is an association of large business users of presorted First-Class letter mail. The National Association of Presort Mailers (NAPM) is an association of both mail owners and presort bureaus which account for over 30 percent of presort First-Class letter mail volume. Both associations support Pitney Bowes' petition to adopt a hybrid benchmark for 5-digit First-Class letters.<sup>6</sup> They also support Pitney Bowes' suggestion that a hybrid benchmark be adopted for 5-digit Standard Regular letters.<sup>7</sup>

NPPC notes that the Postal Service eliminated the discount for sorting First-Class letters to the 3-digit level in January 2012. It observes that in the year that followed, the volume of 3-digit letters fell by approximately 1 billion pieces while the

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<sup>6</sup> Comments of the National Postal Policy Council, January 7, 2013, at 3-4 (NPPC Comments); Comments of the National Association of Presort Mailers, January 7, 2013, at 2 (NAPM Comments).

<sup>7</sup> NPPC Comments at 2; NAPM Comments at 7-8.

volume of AADC letters increased by approximately 1 billion pieces. NPPC concludes that this reflects the response of its members to elimination of the discount for sorting letters to 3 digits. Based on feedback from its members, NPPC asserts where its members incur any added costs for sorting their mail to 3 digits, they revert such mail to the AADC level, or give it to presort houses that combine it with the mail of other clients to be entered as 5-digit mail. NPPC Comments at 2-3. It argues that an accurate estimate of avoided costs must begin with a hybrid benchmark that reflects the fact that the discount for sorting letters to 5 digits now gives mailers an incentive to convert both AADC and 3-digit mail to the 5-digit level.

Like NPPC, NAPM asserts that the costs avoided by the various levels of worksharing must be accurately estimated to determine whether Postal Service discounts are consistent with the requirements of the PAEA. It conducted a survey of its members to see how their mailing patterns have changed after the discount for presorted First-Class 3-digit letters was eliminated. NAPM Comments at 2. The survey results corroborate the anecdotal evidence of NPPC's members.

### C. The Public Representative

The Public Representative presents a graph that shows the volume trends for AADC and 3-digit presort First-Class letters from FY 2010 through FY 2012.<sup>8</sup> The graph shows that the relative shares of AADC and 3-digit mail were stable until Quarter 1 of FY 2012 when the discount for 3-digit letters was eliminated. It shows rapid growth in AADC volume and an equally rapid reduction of 3-digit volume after Quarter 1. The Public Representative also presents tables showing the volume of AADC mail and 3-digit mail as percentages of the volume of the two combined. They show that over the course of FY 2012, AADC's share of combined volume grew from about one-fifth to about one-half of the total. He agrees with the other proponents of a hybrid benchmark that this equalization of the volumes of AADC and 3-digit mail can be explained as a

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<sup>8</sup> Comments of the Public Representative, January 7, 2013 (Public Representative Comments).

response to the elimination of the discount for 3-digit mail. He also agrees that a hybrid benchmark is needed to capture the fact that the transition from 3-digit to AADC preparation will occur over time.

The Public Representative recommends that in constructing the hybrid benchmark for immediate use, the Commission should use the relative volumes from FY 2012 Quarters 3 and 4. He argues that the volumes from these two quarters better reflects the current volume distribution trend for AADC and 3-digit mail. For FY 2013, however, he recommends that the Commission use volume distributions for the entire fiscal year.

#### IV. THE GREETING CARD ASSOCIATION OPPOSITION

The Greeting Card Association (GCA) opposes Pitney Bowes' petition to revise the benchmark for presorted First-Class 5-digit letters. In its comments, GCA argues that to be valid, the benchmark must be a current rate category of presort First-Class letters that is recognized in the Mail Classification Schedule (MCS).<sup>9</sup> It follows, according to GCA, that the benchmark cannot be changed until the Postal Service applies for and receives Commission approval of a mail classification change that eliminates the 3-digit rate category from the MCS. GCA asserts that as long as the 3-digit tier is recognized as a distinct rate category in the MCS, has distinct avoided costs, and any volume, no matter how small, 3-digit letters must remain the exclusive benchmark for 5-digit letters. *Id.* at 7.

GCA contends that the principle of Efficient Component Pricing (ECP) underlies the PAEA's requirement that workshare discounts not exceed the costs that worksharing saves the Postal Service. It asserts that the Commission's method of analyzing avoided costs requires an assumption that the individual mailpieces in a particular workshare rate category have uniform workshare-related cost characteristics. Therefore, sorting any mail in that rate category to the next presort level will avoid the

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<sup>9</sup> Comments of the Greeting Card Association, January 7, 2013 at 3-11 (GCA Comments).

same cost. Consistent with this assumption, GCA asserts that an avoided cost associated with 5-digit letter mail must be a pure one. It must use either an AADC piece or a 3-digit piece, but not both. GCA argues that a hybrid benchmark would be based on a mail piece “that does not exist in the real world,” and therefore violates the Commission’s benchmark system for implementing the principle of ECP. *Id.* at 11.

GCA asserts that a negative effect of applying ECP “on a category-wide” rather than a piece basis is that the cost that would be avoided by converting benchmark mail to 5-digit mail would change as the relative volumes of the components of a hybrid benchmark change. *Id.* at 12. It objects that there is no economic reason that the 5-digit discount should vary as the relative volumes of the benchmark components vary. *Id.* GCA also assumes that if a hybrid were used as the benchmark for 5-digit mail, the costs of that hybrid would become the measure of the workshare-related costs of the AADC tier. According to GCA, this would make the estimate of the costs avoided by converting Mixed AADC mail to AADC mail vary as the relative volumes of AADC and 3-digit letters vary. This, it asserts, would add to the negative economic and administrative effects of switching to a hybrid benchmark for 5-digit letters. *Id.* at 14.

GCA also asserts that using a hybrid benchmark would have negative revenue effects. It suggests that the presort mailers are motivated less by principle than by expediency, noting that the effect of adopting a hybrid benchmark would be to increase the avoided cost estimated for 5-digit mail. Based on FY 2012 data, GCA estimates that if all 3-digit letters were to shift to AADC, using a volume-weighted hybrid benchmark would increase the unit avoided cost of 5-digit letters by \$0.0037. It weights this unit cost avoidance by FY 2012 5-digit volumes to conclude that a new hybrid benchmark consisting of all AADC mail would raise the section 3622(e) limit on the 5-digit discount by about \$75 million. If the Postal Service were to expand the 5-digit discount by that amount, GCA argues, it would lose \$75 million in revenue. It says that under current circumstances, the Postal Service can ill afford additional revenue losses. *Id.* at 14.

GCA warns that if the Commission were to adopt a hybrid benchmark, it would establish what GCA views as a precedent that could lead to the blending of AADC with Mixed AADC, or even a blending of Mixed AADC with machinable Nonautomation presort as future hybrid benchmarks for 5-digit letters. *Id.* at 15. It also warns of taking de-averaging of costs within rate categories to their logical extreme, where data become too thin to be reliable. *Id.* at 18-20.

## V. THE POSTAL SERVICE'S RIPENESS OBJECTION

In October 2011, the Postal Service eliminated the discount that it had offered to mailers for sorting automation First-Class letters to the 3-digit level without proposing to eliminate the 3-digit rate category in the MCS and without proposing to revise the benchmark for calculating the cost avoided by sorting such mail to the 5-digit level. Its rationale for taking that approach was that it was considering changes to its mail processing network that could necessitate new or different sortation levels than are reflected in the current presort tree.<sup>10</sup> In January 2013, in this docket, the Postal Service reaffirmed this rationale for not proposing to eliminate the 3-digit letter rate category or to discontinue its use as the benchmark for 5-digit letters.<sup>11</sup> In its reply to the comments of Pitney Bowes and the Greeting Card Association, the Postal Service states that the mail processing network rationalization that it anticipated in the fall of 2011 has begun and is expected to continue “into at least 2014.” It states that:

there is a significant possibility. . .that, in the near future, the Postal Service will alter the levels of sortation available for First-Class Mail Presort Letters, including possibly replacing one or more current levels with a plant “scheme” sort. . .In light of these near-term possibilities, the Postal Service sees no need to alter the benchmark for calculating the 5-Digit passthrough at this time, and furthermore does not believe that it is

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<sup>10</sup> See Docket No. R2012-3, United States Postal Service Notice of Market-Dominant Price Adjustment, October 18, 2011, at 13-14.

<sup>11</sup> United States Postal Service Comments on Pitney Bowes and Greeting Card Association Pleadings, January 22, 2013 (Postal Service Reply to Comments).

necessary to immediately resolve the differences in interpretation raised by Pitney Bowes, Inc. and the Greeting Card Association (GCA).

Postal Service Reply to Comments at 1. It continues:

While GCA's policy argument regarding the possibility of revenue loss is speculative, GCA seems to have correctly stated the Commission's traditional approach to analyzing workshare cost avoidances. Adherence to that approach in the context of the revised worksharing structure that may result from Network Rationalization would obviate the need for the hybrid approach proposed by Pitney Bowes.

*Id.* at 2.

## VI. COMMISSION ANALYSIS

There are important public benefits from accurately calculating the cost avoided by sorting less refined automation First-Class letters to the 5-digit level. The Commission concludes that these benefits can be achieved while network rationalization is underway without jeopardizing the stability of the presort First-Class Mail discount structure, or making the administration of those discounts overly complicated or unwieldy.

The Commission also concludes that there are no legal obstacles to adjusting the benchmark for 5-digit letters to reflect the elimination of the discount for 3-digit letters and the resulting changes in customers' mailing patterns. With respect to GCA's suggestion that the Commission should avoid a result that expands the Postal Service flexibility to increase discounts for perceived public policy reasons, the Commission believes that accurate measures of avoided cost should be applied objectively.

This Order adopts a hybrid benchmark for 5-digit automation First-Class letters. Based on the record in this docket, there is no apparent reason for concluding that the elimination of a discount for First-Class cards or Standard Regular letter mail sorted to the 3-digit level should be approached differently. However, the Commission believes that it would be premature to approve a hybrid benchmark for 5-digit mail of either of

these categories because there hasn't been sufficient focus in this docket on the need for, and the effects of, such changes. To ensure that the merits of such changes are thoroughly reviewed, this Order will solicit public comments that focus on making parallel revisions to those benchmarks.

Both GCA and Pitney Bowes assume that if a hybrid AADC/3-digit benchmark is employed for automation First-Class 5-digit letters, then the workshare-related costs of that same hybrid also should be used as the end point when measuring the costs that are avoided by sorting Mixed AADC letters to the AADC level.<sup>12</sup>

Using a weighted average of AADC mail and 3-digit mail as a hybrid benchmark for sorting mail to the 5-digit level does not logically imply that a change is needed in the reference point that is used to measure the costs avoided by sorting less workshared letters to the AADC level. A workshare benchmark reflects the mail most likely to convert to a workshare category. The workshare category AADC mail remains unchanged. The discount for AADC mail remains available. There is no indication on this record that the group of mail most likely to convert to AADC is no longer Mixed AADC letters, or that the amount of costs that are avoided when Mixed AADC letters are further sorted to the AADC level has been affected by eliminating the discount for 3-digit letters. Consequently, the Commission finds no reason to make any change in the calculation of the costs avoided by AADC letters.

#### A. Accurate Cost Avoidance Measurement

Five-digit automation First-Class letters provide more net revenue for the Postal Service than any other single rate category. Therefore, it is important to ensure that such mail is priced in a way that is both consistent with the PAEA, and consistent with the goal of economic efficiency, which relevant portions of the PAEA are designed to promote. Section 3652(b) of the PAEA requires that the Postal Service calculate a per-item avoided cost and a passthrough for each category of workshared mail. This

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<sup>12</sup> GCA Comments at 14; Docket No. ACR2012, Pitney Bowes Comments at 5.

calculation allows the Commission to draw conclusions regarding the compliance of the 5-digit discount with the limit on the size of workshare discounts imposed by section 3622(e). In doing so, it serves as the standard against which the productive efficiency of the 5-digit discount can be evaluated.

The Commission agrees with GCA's observation that "it is. . .real-world mailer behavior. . .which accounts for the costs to the Postal Service of the mail actually in the system, and hence also for the level of savings available through additional worksharing."<sup>13</sup> If the avoided cost calculation uses a discredited assumption about what the likely source of 5-digit mail is and, therefore, makes an incorrect assumption about the costs that sorting to 5 digits avoids, it will prevent a meaningful analysis of the efficiency effects of the 5-digit discount, and that discount's compliance with the limit on the size of discounts in section 3622(e).

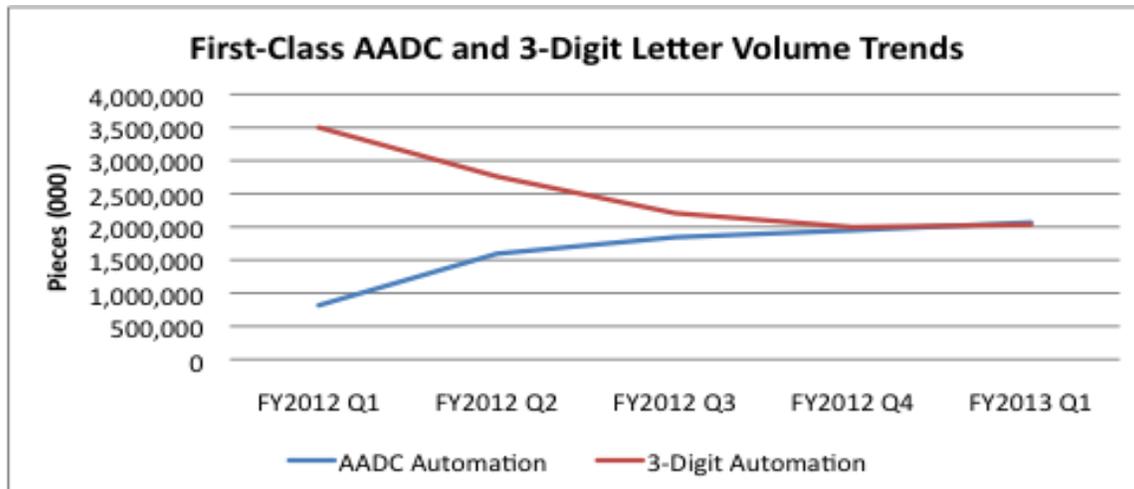
The assumption underlying the current presort tree for automation First-Class letters is that the source of 5-digit mail is mail that would be sorted to 3 digits in the absence of a 5-digit discount. The evidence in this docket convincingly demonstrates that this assumption has been discredited by the rapid migration of 3-digit mail to AADC mail that is contemporaneous with the elimination of the discount for 3-digit mail.

As the Public Representative demonstrated, in Quarter 1 of FY 2012, when the discount was eliminated, the combined volume of AADC and 3-digit mail consisted of 80 percent 3-digit mail and 20 percent AADC mail. This volume distribution was roughly consistent with the assumption that 3-digit mail is the mail that is most likely to convert to 5-digit mail. By the end of FY 2012, the volume of 3-digit and AADC were equal.<sup>14</sup> As can be seen from the figure below, equalization of the shares of 3-digit and AADC mail continues through Quarter 1 of FY 2013.

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<sup>13</sup> GCA Comments at 8, n.16.

<sup>14</sup> Public Representative Comments at 2.



According to the anecdotal and informal survey evidence presented by the presort mailers, the cause of this partial reversion of 3-digit mail to the AADC level is the elimination of the discount for converting less finely presorted letters to the 3-digit level. According to this evidence, this reversion remains partial primarily because the Postal Service still requires automation presort letters destined to local addresses to be sorted to 3 digits.<sup>15</sup>

This evidence invalidates the assumption on which the current benchmark is based that 3-digit letters are the group that is most likely to convert to 5-digit letters in response to a 5-digit discount. The evidence now indicates that 3-digit and AADC mail are equally likely to be the source of 5-digit mail. The current 3-digit benchmark, therefore, no longer accurately represents the mail that is most likely to convert to 5 digits. Continued use of this unrepresentative benchmark will yield an inaccurate avoided cost calculation. The Commission concludes that the benefits of employing a representative benchmark are more substantial than the risk or inconvenience of having to make periodic revisions to that benchmark.

<sup>15</sup> Pitney Bowes Comments at 8; Pitney Bowes Reply Comments at 5; NPPC Comments at 3; Comments of NAPM at 5-7.

Since the migration of 3-digit mail to AADC is a response to the elimination of the discount for 3-digit mail, and the apparent limit to that migration is largely due to the continuing requirement to sort local mail to 3 digits, the need to reflect the shifting balance between the two will likely persist until the Postal Service completes the process of network rationalization sometime in FY 2014 or beyond.<sup>16</sup> Rather than base compliance determinations on a misleading estimate of the costs avoided by sorting First-Class automation letters to 5 digits for this length of time, the Commission concludes that the public interest is better served by using a volume-weighted hybrid benchmark that reflects the relative shares of AADC and 3-digit mail that currently exist.

In deciding how to define what relative shares are “current” for this purpose, the Commission finds merit in the Public Representative’s suggestion that the period used should reflect a time when mailers have had ample time to adjust to the elimination of the discount for 3-digit mail. Therefore, the relative volume shares that are considered “current” will be initially defined as the average of the Revenue, Pieces, and Weights (RPW) shares of First-Class AADC and 3-digit letters over the four most recently reported quarters. When an annual average volume ratio for FY 2013 as a whole becomes available, it will be considered “current” for purposes of calculating the hybrid benchmark. It will remain the “current” benchmark until each ensuing complete fiscal year of volumes is reported. Library Reference PRC-RM2012-6-LR1 illustrates how the hybrid benchmark will be calculated. If an event should occur that arguably alters the current balance of incentives and disincentives to presort First-Class letters to either the AADC or the 3-digit level to a substantial degree (e.g., reinstating a discount for sorting to 3 digits, or eliminating all administrative requirements to sort to 3 digits), the opportunity will be available to file a petition for making an appropriate change to the benchmark.

Although the results of the benchmark calculation could change each year as the relative volumes of AADC and 3-digit mail change, this is not a substantial concern.

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<sup>16</sup> The Postal Service has indicated that network rationalization will continue at least into FY 2014. Postal Service Comments on Pleadings, at 1.

Avoided costs based on benchmarks that are defined in the conventional way (*i.e.*, the adjacent, less-refined tier) typically change each year as well. Although avoided costs typically change from year to year, discounts based on those avoided costs may or may not change. Using a hybrid benchmark for 5-digit mail will be no different than using a conventionally-defined benchmark in this regard. Concerns about the stability of discounts based on a hybrid benchmark that reflects the “current” shares of AADC and 3-digit mail, therefore, are not a significant obstacle to use of a hybrid benchmark.

#### B. Legal Impediments to Using a Hybrid Benchmark

GCA argues that benchmark selection is essentially a pricing and classification exercise. It argues that to properly perform the role that the Commission assigns to benchmarks in analyzing avoided costs, a benchmark must be the adjacent, less-workshared category of the rate category whose discount is under review. GCA concludes that changes to benchmarks must be preceded by the elimination of cost differences exhibited by benchmark mail or the elimination of all of the volume of such mail. It asserts that these changes must be reflected in the presort tree and memorialized in the MCS. GCA Comments at 3-8. GCA further contends that the workshare-related costs of a benchmark must be those observed at the piece level. At that level, it asserts, benchmark costs must be uniform throughout the benchmark rate category, rather than be a weighted average of the cost of heterogeneous groups of mail. *Id.* at 11.

Pitney Bowes maintains that the Commission’s authority under section 3652 to establish an appropriate benchmark is not contingent on “classification artifacts within a given presort tree.” Pitney Bowes Reply Comments at 3. It argues that benchmark selection is essentially a costing exercise rather than a pricing or classification exercise. As such, it asserts, benchmark selection is well within the Commission’s prerogatives under section 3652(a) to determine the methods to be used to calculate the costs avoided by worksharing. Determining those methods, it says, is a necessary step in evaluating the Postal Service’s compliance with the various requirements of the PAEA,

including the cap on the size of workshare discounts established in section 3622(e). *Id.* at 3-5. The Commission agrees.

The selection of a benchmark is a factual determination that seeks to identify the group of less-workshared mail that is the most likely to convert to the more workshared group under examination, given a sufficient rate incentive.<sup>17</sup> Because this factual determination is fundamentally a costing exercise, it does not depend on the structure of the MCS. Revisions to it may be made based on changes in patterns of use of the mails, including those induced by changes in workshare incentives. A prominent instance in which this was done is the Commission's recent revision of the benchmark used to calculate the costs avoided by the initial tier of automation First-Class letter mail. The Commission changed that benchmark from Bulk Metered Mail (BMM) to all metered, Information Based Indicia (IBI), and Postage Validation Imprinter (PVI) letters.<sup>18</sup>

The Commission agrees with Pitney Bowes that the purpose of limiting workshare discounts to the amount of Postal Service costs that the mailer's worksharing avoids is to provide an economically efficient price signal to the mailer—one that will encourage the mailer to perform worksharing only when it is the least-cost producer. Therefore, in determining what group of mail is most likely to be converted to 5-digit mail in the presence of a 5-digit discount, the controlling consideration is not whether a less-workshared group of mail still has volume or still imposes distinct costs on the Postal Service. The controlling consideration is what incentives and disincentives drive a mailer's decision to sort one group of mail or another to the 5-digit level. Pitney Bowes Reply Comments at 4.

The Postal Service has eliminated the administrative requirement that a mailer of First-Class letters sort its mail to the 3-digit level if the density of its mailing allows. It

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<sup>17</sup> See Order No. 1510, at 9-10; Order No. 536, Docket No. RM2009-3, Order Adopting Analytical Principals Regarding Workshare Discount Methodology, September 14, 2010, at 20-21.

<sup>18</sup> See Order No. 1320, Docket No. RM2010-13, Order Resolving Technical Issues Concerning the Calculation of Workshare Discounts, April 20, 2012, at 30.

has also eliminated the rate incentive to perform that sort. Pitney Bowes argues that, under this circumstance, a rational mailer will not sort its mail to 3 digits if in doing so it incurs extra costs. A mailer will choose to sort its mail to the AADC level or to consign its mail to a consolidator who can combine it with other mail to achieve the density necessary to sort the mail to 5 digits. As Pitney Bowes validly observes, the distinction between AADC mail and 3-digit mail is no longer relevant. *Id.*

The record shows that there is still a substantial volume of First-Class letters that are mailed at the 3-digit level by mailers who can do so without additional cost, or who need to comply with customized mailing agreements with the Postal Service to sort local mail to 3 digits. See footnote 17 *supra*. Given the current set of incentives and disincentives to sort less-refined letter mail to 3 digits, an accurate measure of the cost avoided when mailers sort letters to 5 digits must take into account the fact that there are now two major sources of 5-digit letters, and a hybrid benchmark of AADC and 3-digit letter mail is needed to reflect that fact. Although it may be desirable, there is no requirement that the MCS be structured to coincide with all of the incentives and disincentives to workshare particular groups of mail that have a bearing on the selection of benchmarks.

Finally, the suggestion that if the Commission adopts a hybrid benchmark for 5-digit automation First-Class letters, it should simultaneously adopt a hybrid benchmark for 5-digit Standard Regular letters, was unopposed on this record. The same analysis that leads the Commission to approve the change in the First-Class letters benchmark may well be applicable in other areas such as First-Class cards and Standard Regular letters. However, in requesting comments on the Pitney Bowes proposal, the Commission described it as seeking “to change the analytical principle that establishes the set of worksharing relationships that are presumed to exist between the various presort rate categories of presorted First-Class letter mail.” Order No. 1510, at 1. To ensure that all interested persons, including the Postal Service, have a reasonable opportunity to address the merits of extending this change to other

categories impacted by the elimination of 3-digit discounts, the Commission will allow interested persons to submit additional comments on that issue.

## VII. ORDERING PARAGRAPHS

*It is ordered:*

1. The benchmark for 5-digit automation First-Class Letter Mail is the current volume-weighted average of AADC and 3-digit letters as described in the body of this Order.
2. All other cost avoidance calculations are unchanged by this Order.
3. Interested persons may file comments on or before July 8, 2013, addressing the desirability of making similar revisions to the benchmarks currently used to calculate the costs avoided by sorting automation First-Class postcards, and Standard Regular letters, to the 5-digit level.

By the Commission.

Shoshana M. Grove  
Secretary