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WASHINGTON, D.C. 20268-0001

RATE ADJUSTMENT DUE TO EXTRAORDINARY OR EXCEPTIONAL CIRCUMSTANCES

Docket No. R2013-11

RESPONSES OF THE UNITED STATES POSTAL SERVICE TO QUESTIONS 1-13 OF PRESIDING OFFICER'S INFORMATION REQUEST NO. 11
(November 29, 2013)

The United States Postal Service hereby provides its responses to Questions 1-13 of Presiding Officer's Information Request No.11, dated November 21, 2013. Each question is stated verbatim and is followed by the response. The responses to Questions 1-12 are sponsored by Altaf Taufique; the response to Question 13 is sponsored by Stephen Nickerson.

Respectfully submitted,

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RESPONSE OF ALTAF TAUFIQUE TO
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1. The following questions concern workshare discounts that are below 100 percent of avoided costs.

   a. If a workshared function can be performed at a lower cost by mailers or mail service providers, please explain how the workshare discount should be structured to maximize efficiency.

   b. Please explain how efficiency is impacted when passthroughs are set below 100 percent of avoided costs.

   c. Please explain what benefits, if any, the Postal Service derives from setting passthroughs below 100 percent of avoided costs.

   d. Please explain whether it was possible to design a set of rates that generates the approximately 4.3 percent average rate increase for each product and class and also aligns these workshare discounts with avoided costs.

   e. Please explain whether the Postal Service considered using its pricing flexibility to adjust discounts equal to avoided costs for workshare discounts that were set below 100 percent prior to adopting the across the board approach applied in this proceeding?

   f. Please explain what consideration, if any, was given to workshare discounts not set at 100 percent of avoided costs in the Postal Service's determination that the rates proposed in this docket are reasonable and equitable.

RESPONSE

a. "Productive efficiency" is maximized by setting the workshare discount equal to the Postal Service's cost avoidance. This is an extremely useful pricing construct, but deviations can be appropriate, for two reasons. First, the Postal Service has imperfect knowledge[1] of its cost avoidances. [2] For example, there is no way to have perfect knowledge of the cost avoidances which will be applicable during the same time that the prices are in effect; by necessity, the prices are set with reference to the most recent year's measures. The costs avoided during the time period in which the discounts

[1] The estimated cost avoidances change for a variety of valid reasons such as the introduction of an improved methodology, new data, etc.
[2] Moreover, mailers might not have perfect knowledge of their costs for worksharing, and might not base their worksharing decisions entirely on cost factors.

are in place will not be known until after that period has passed. Second, productive efficiency is only a supply-side consideration. The optimal price would also consider the demand side, and therefore "allocative efficiency."

b. If the workshare passthrough is below 100 percent – i.e., if the offered workshare discount falls short of the Postal Service's actual cost avoidance – then productive efficiency in the postal sector potentially is impaired.

c. Setting a workshare passthrough below 100 percent can be a wise precautionary (risk-reducing) move by the Postal Service. For one thing, cost avoidance reductions[3] can easily propel a 100 percent passthrough to above 100 percent, requiring a §3622(e)(2) demonstration by the Postal Service. For another thing, there is always the potential for overestimating the Postal Service's cost avoidance – in which case a 100 percent passthrough would lead to an inflated discount, and work would unnecessarily be transferred to a workshare partner (which is particularly problematic in an age of declining Postal Service volume and excess capacity). There is the possibility that the estimated cost avoidances are biased upward. First, during most of postal history, cost variability due to worksharing was observed while mail volume was growing. It is possible that cost variability is asymmetric and specifically "stickier" when mail volume is declining instead of increasing. Second, postal technology is constantly improving, normally resulting in unit cost reductions.

[3] As the Postal Service takes additional steps to reduce overall costs, the expectation is that cost avoidances will likewise shrink.

Third, the Postal Service is very good at identifying the processes associated with a particular activity, and estimating what those processes cost. Then, when an activity is bypassed as a result of worksharing, a cost avoidance can be ascribed. However, it can be more difficult to foresee what kinds of costs may newly arise as a result of the bypass and production-process change.

In addition, please consider that historically, when a new discount was introduced, passthroughs were sometimes set below 100 percent because of revenue leakage from mailers who already met the workshare preparation requirements (for reasons presumably unrelated to obtaining a discount). Since there would be no additional cost savings from these mailers after the discount was implemented, but revenue would decrease when their pre-existing mailing practices were now rewarded with a lower rate, a passthrough of less than 100 percent was implemented to protect non-workshare mailers from having to pay higher rates to contribute to the recovery of such a deficiency.

d. It may be possible, but the Postal Service has not developed a set of prices meeting the described condition. The Governors decided on an "across-the-board" approach. This was implemented by ensuring that passthroughs above 100 percent were not increased, and that passthroughs below 100 percent were not decreased. Some of the passthroughs below 100 percent were actually allowed to move up. For example, the passthrough for First-

Class Mail 5-Digit Automation Letters was moved from 82 percent to 89 percent.

e. No. Any desired passthrough adjustments were reserved for Docket No. R2013-10.

f. The Postal Service considers that the outstanding characteristic of Docket No. R2013-11 is (temporary) removal of the §3622(d)(1)(A) price cap. This has the effect of somewhat undermining one of the primary purposes of the cap, rate "predictability and stability." §3622(b)(2). An across-the-board pricing approach, with no mailer experiencing a significant deviation from the mean, can help mitigate this effect. While this may sacrifice some "productive efficiency," the attempt to redress the impact on the §3622(b)(2) pricing "objective" renders the proposed rates reasonable and equitable. Also, see Mr. Taufique's statement, at pages 10-13.

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2. The following questions concern workshare discounts that are above 100 percent of avoided costs.
   a. Please explain whether it is possible to design a set of rates that generates the approximately 4.3 percent average rate increase for each product and class and also aligns these workshare discounts with avoided costs.
   b. Please explain whether the Postal Service considered using its pricing flexibility to adjust discounts to equal avoided costs for workshare discounts that were set above 100 percent prior to adopting the across the board approach applied in this proceeding.

RESPONSE

a. The Postal Service has not done the exercise but it appears possible that a set of rates could be designed to generate an approximately 4.3 percent average rate increase for each product and class, and also align the above 100 percent discounts with avoided costs.

b. As suggested in the response to subpart f of question 1 of this POIR, the rate design in this docket was not meant to fix all of the real and perceived problems in rate relationships, cost coverages or passthroughs. The principal purpose of the filing was to recover some of the contribution lost because of the unprecedented volume declines caused by the Great Recession. The goal was to keep the Postal Service in operation, while meeting the statutory standards applicable to exigent increases and balancing other relevant statutory policies.

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3. In Docket No. R2013-10, the Postal Service used the "rate shock exception" to explain why it was maintaining passthroughs greater than 100 percent for First-Class Automation 5-digit Flats and Standard Mail Nonautomation 5-digit Nonmachinable Letters. In light of the above CPI prices increases proposed in this proceeding, please explain why the Postal Service did not use this opportunity to align these discounts with their avoided costs.

RESPONSE

Even though it was not categorically stated in the notice filed by the Postal Service, the concern was that a significantly above CPI increase (10.3 percent) followed by an additional 4.3 percent increase would be disruptive for mailers preparing First-Class Mail 5-Digit Automation Flats. It would be similarly disruptive for Standard Mail 5-Digit Nonautomation Nonmachinable Letters to receive a 9 percent increase followed by a 4.3 percent increase. A 100 percent passthrough would lead to 10.3 and 9.0 percent increases for First-Class Mail 5-Digit Automation Flats and 5-Digit Nonautomation Nonmachineable Letters, respectively.

In the Exigent filing, the proposed increase for First-Class Mail Automation Flats is 7.6 percent in order to maintain the passthrough established in the CPI docket. If the discounts are adjusted to bring the passthrough down to 100 percent, this increase would be approximately 15 percent.

For Standard Mail 5-Digit Nonautomation Nonmachinable Letters, the proposed Exigent increase is as high as 6.8 percent. Had the passthrough been brought to 100 percent, the increase would be as high as 11 percent.

Also, as stated in the response to subpart f of question 1 of this POIR, the Exigent increase was not intended to enhance productive efficiency.

4. In Periodicals and Standard Mail, the Postal Service has added FSS prices and is now requiring FSS preparation for mail that destinates in FSS zones.

   a. Does providing discounts for Carrier Route mail sorted to the FSS send efficient price signals to mailers?
   b. Please explain the rationale for providing Carrier Route discounts for mail sorted to the FSS.

RESPONSE:

a. No. The Postal Service agrees that providing discounts for Carrier Route mail sorted to the FSS does not necessarily provide efficient price signals to mailers.

b. Requiring FSS preparation will allow the Postal Service to gather volume data about how much mail is entered in FSS zones. To offset mailer costs for FSS preparation, the Postal Service also is introducing discounts for dropshipping scheme pallets at the destination facility. The Carrier Route prices are still available based on the preparation that the pieces would have received if the mail was not destinating in the FSS zone. This pricing protects the Carrier Route mailers from large increases during the transitional period.

5. In this docket, the proposed barcoding discount for Qualified Business Reply Mail Letters and Qualified Business Reply Mail Cards is set at different levels even though the avoided costs are the same for the two categories.
    a. Please confirm that this is a consequence of the across-the –board approach. If not confirmed, please explain.
    b. Please explain if the Postal Service plans to realign these discounts in the future.
    c. Please explain, what consideration, if any, the Postal Service gave to changes in rate relationships other than workshare discounts and preferred rates when applying the across-the-board approach.

RESPONSE

a. Confirmed.

b. These discounts will be aligned in future CPI filings.

c. Workshare discounts constitute the major type of rate relationship and in this docket a concerted effort was made to keep them from changing, if they already exceeded cost avoidances. See Taufique Statement at 3-5. Given the nature of the Exigent increase, changes in other rate relationships were not considered.

6. The following table details the Total Contribution from Market Dominant Products that did not cover cost from FY 2008 to FY 2012.

Market Dominant Products with Negative Contribution				
	Periodicals	**Standard Mail Flats**	**Other**	**Total**
FY 2008	437	218	327	982
FY 2009	642	616	467	1725
FY 2010	611	577	481	1669
FY 2011	609	643	344	1596
FY 2012	670	527	276	1473
	2969	**2581**	**1895**	**7445**

From FY 2008 to FY 2012, the Postal Service lost $7.5 billion on products that did not cover cost, including $ 5.5 billion from Periodicals and Standard Mail. How did this figure factor into the development of the R2013-11 prices?

RESPONSE:

The Postal Service is aware that Periodicals and Standard Mail Flats have not covered their costs since 2008. However, this cost coverage concern was addressed in Docket No. R2013-10, rather than in Docket No. R2013-11. The purpose of R2013-11 was to increase revenue for the Postal Service. The prices were determined in a way that distributed the burden of the 4.3 percent as evenly as possible among all products, given various constraints, in order to be reasonable and equitable.

7. In Docket No. R2013-10, the Postal Service proposed a new category for First-Class Single-Piece Metered Letters. In that docket, the Postal Service proposed a price for First-Class Single-Piece Stamped letters that is 1 cent higher than the price for First-Class Single-Piece Metered Letters. The Postal Service proposes to maintain the 1-cent differential between Single-Piece Stamped and Metered letters in its exigency filing. Pages 14-15 of Witness Taufique's testimony state that the 1-cent lower price for Metered letters "will mitigate the impact of the increases for small businesses."

a. What percent of small businesses are expected to pay the Metered versus the Stamped letter rates?

b. How will the 1-cent differential in prices for Stamped and Metered letters mitigate the impact of the rate increases for small businesses specifically?

c. What was the rationale for maintaining a 1-cent differential between the prices for Stamped and Metered letters in this proceeding?

RESPONSE

a. The Postal Service does not have specific research on the percentage of small businesses that we expect to pay the metered rate. We have used research cited by Neopost in Docket No. RM2010-13 which shows the increase in usage in foreign posts who have implemented similar pricing. We also used research cited by Stamps.com in Docket No. RM2010-13 which shows the growth in competitive products when discounts are applied. Stamps.com also filed comments on Docket No. R2013-10 in which they said "another reason the Postal Service should recognize PC Postage in prices is that Stamps.com customers spend 41 percent of total postage on Postal Service Expedited services such as Priority Mail and Express Mail, while the average USPS customer spends just 20 percent on these services. Our research shows that the increased spending is due in large part to customers switching from FedEx and UPS, since printing Postal Service shipping labels from our software is easy and convenient. So, as we attract more customers to our software based on the lower rate, we expect these same customers to ship more packages through the Postal Service."

b. The 1-cent differential will mitigate the impact of the rate increase for small business by providing them with a lower rate than they would have had, which will encourage them to stay in the mail.

c. The Postal Service stayed with the $0.01 differential in this filing because we want to gain experience with the price differential to find out if the currently proposed $0.01 difference may be sufficient to encourage continued use of mail by small businesses.

8. On June 19, 2013, Valpak provided the Postal Service with its revised Standard Mail Contribution Maximization model (Valpak model).

a. Did the Postal Service use the Valpak model in developing the rates noticed in Docket Nos. R2013-10 and R2013-11? If yes, please explain how it was used.

b. If the Valpak model was not used, please explain why not.

c. Please identify flaws, weaknesses, or shortcomings, if any, of the Valpak model.

RESPONSE:

a. No.

b. The chosen across-the-board approach in Docket No. R2013-11 does not allow the highly differentiated price changes suggested by the Valpak model, or any other models of similar type. Differentiated price changes were in play for Docket No. R2013-10, but the Valpak model is not dynamic/multiyear; it addresses contribution only in the test year. Contribution should be evaluated, and enhanced, in a long-run context. Single-year profitability is not necessarily consonant with long-run profitability. Additionally, Standard Mail own-price elasticities are not known with enough certainty to justify mechanistic application in a model whose legitimacy (e.g., vis-à-vis "maximizing" contribution) relies to a great extent on those elasticities. This particularly applies for Standard Mail Flats and Standard Mail Letters whose elasticities are not even estimated separately by the Postal Service. In its Initial Comments filed on November 26, 2013, Valpak offers that its revised model allows users to "change" the elasticity inputs. Valpak Initial Comments at 104. But this is not so helpful for purposes of "maximizing" or "optimizing" contribution – if the values of those inputs are not known.

c. Please see the response to subpart "b" above. The Postal Service views a long-run rather than a short-run approach as important. Standard Mail Flats and Standard Mail Letters volumes appear to be on different autonomous (independent of price) tracks. Long-run profitability requires considering both the short-run (or more immediate) effect of price changes on volume and how much volume will actually be around in the long run to produce a revenue yield. The Valpak model fails to account for the permanent impairment of overall average revenue per piece that can come from devoting limited price cap space to volume that is in comparative autonomous decline.

9. Mr. Taufique's statement (p. 6) lists eight classes and products that did not cover their attributable costs, according to the FY 2012 ACD. It also contains the following statement: "As urgent as the Postal Service's financial needs are, increases that are too high could threaten the financial health and, possibly, even the survival of **key customer segments and industries**." (emphasis added).

a. Does the Postal Service consider catalog mailers a "key segment" in the context of the statement above?
b. Please explain in more detail the link between the catalog industry and the products they use, *e.g.* Standard Mail Flats and Carrier Route?
c. What is the percentage of Standard Mail Flats and Carrier Route Flats pieces that are mailed by the catalog industry?
d. In Mr. Taufique's testimony, he notes that significant price increases could endanger the health of some customer segments and industries. Is he referring to the catalog industry with that statement? If not, or if his statement encompasses other customer segments, please list which customer segments is he referring to.
e. What research has the Postal Service conducted to identify what level of price increase would constitute a threat to the financial health of the catalog industry? Please discuss the specifics of the research conducted.

RESPONSE

a. Yes.

b. Catalog mailers and other merchants typically use both the Carrier Route and Flats products to send their flat-shaped advertising messages. The factor that determines whether a catalog or any mail piece is sent using the Carrier Route product or the Flats product is address density, rather than content. In many cases, a catalog is sent using Carrier Route, with residual pieces sent as Flats.

c. The Postal Service does not collect specific data that captures the volume of catalogs, so we are unable to provide a specific percentage. It is estimated, however, that catalogs represent a majority of the pieces in both products (Carrier Route and Flats).

d. Yes, Mr. Taufique is referring to the catalog industry with the statement that significant price increases could endanger the health of some customer segments and industries. Mr. Taufique's statement also encompasses retailers.

e. There has been no specific recent formal pricing research conducted, but based on continual dialogue with our customers and those in the mailing industry, the Postal Service clearly understands that the catalog industry is under significant pressures due to changing customer behaviors, technological enhancements, and the relatively stagnant economy. As postage continues to be a large part of the entire cost of mailing for these customers, it fundamentally can impact their financial health.

10. In Mr. Taufique's statement, he opined that an across-the-board-price increase balances many considerations and is reasonable and equitable.
    a. Please explain how the cross-subsidy of underwater classes and products by other classes and products factored into the Postal Service's pricing decisions proposed in this docket.
    b. What research did the Postal Service conduct into economic considerations that private sector firms factor into their pricing decisions (*e.g.* coverage, elasticity)?
    c. Is comparing the approach to pricing decisions made by private sector firms to those of the Postal Service appropriate? Please explain.

RESPONSE:

a. The 4.3 percent across-the-board price increase will improve cost coverage on (and reduce the "cross-subsidization" of) all underwater products and classes. In addition, the underwater products and classes ultimately burden the Postal Service's aggregate net operating income, cash flow and liquidity position. This burden therefore was reflected in the 4.3 percent proposal.

b. The Postal Service conducted no such research particular to this docket. However, Postal Service staff is aware of, and continuously follow trends in, private sector pricing. This includes, for example, several memberships in the Professional Pricing Society. In addition, several Postal Service staff members have pricing experience in the private sector.

c. There is always something to be learned from cross-comparisons. Private sector examples can be both appropriate and not so appropriate. Postal Service pricing may be more complex in that various statutory criteria other than profitability must be considered (not to mention the Postal

Service faces greater public scrutiny). In addition, the Postal Service's Market Dominant products face competition from non-mail products, specifically alternative media.

11. The following table is adapted from Witness Nickerson's workpapers:

	Periodicals	Standard Mail Flats	Other	Total
FY 2013	499	318	44	**861**
FY2014 AR	383	186	19	**588**

a. Did Mr. Taufique work in conjunction with witness Nickerson or his staff to design prices that would minimize the amount of contribution lost by products that do not cover costs?

b. In FY 2014, Periodicals and Standard Mail Flats are projected to lose over $550 million in contribution.

   i. Did the Postal Service analyze what price increases would be required for Periodicals to be projected to cover cost in FY 2014? If so, what increase would be required?

   ii. Did the Postal Service analyze what price increases would be required for Standard Mail Flats to be projected to cover cost in FY 2014? If so, what increase would be required?

c. When does the Postal Service project that it will be able to recover sufficient revenue to cover costs of Periodicals and Standard Mail Flats?

RESPONSE:

a. No. The chosen across-the-board pricing approach was not intended to "minimize" losses on underwater products and classes.

b. (i - ii) No. The increases were presumed to be so large that it was not considered a reasonable candidate for the exigent filing.

c. The Postal Service is unable to make such a projection in the face of a multitude of revenue and cost uncertainties. However, the Postal Service will continue to give Standard Mail Flats an above average increase as ordered by the Commission in the FY2012 ACD. The Postal Service continues to rely on price signals encouraging efficient preparation (such as FSS pallets dropshipped at destination FSS facilities) and cost reductions to improve the cost coverage for Periodicals.

12. In FY 2012, the average revenue per piece for Periodicals was 25.7 cents per piece, the lowest since FY 2009. The cost per piece has increased over the same period to 35.6 cents per piece.

The following table contains the Periodicals unit cost and revenue projections from witness Nickerson's Statement.

Periodicals Unit Cost and Revenue (cents)		
	Cost	**Revenue**
FY 2012	35.6	25.7
FY 2013	33.9	26.1
FY 2014 BR	33.8	26.4
FY 2014 AR	33.9	27.4

a. When developing the R2013-11 prices for Periodicals, did Mr. Taufique review the cost and revenue projections of witness Nickerson?

b. Witness Nickerson projects that Periodicals unit revenue will increase and unit cost will decrease in FY 2013, departing from the trend since FY 2009. Did Mr. Taufique design prices with this change of course in mind?

RESPONSE

a-b. No. The across-the-board approach was decided before the exigent prices were developed.

RESPONSE OF STEPHEN NICKERSON TO PRESIDING OFFICER'S INFORMATION REQUEST NO. 11

13. In witness Nickerson's Attachment 17, the test year after rate figures (January 26, 2014 implementation) show expected operating revenues of $67.2 billion (total revenues less interest and investment income) and expected controllable operating expenses of $66.7 billion (total expenses less the $5.7 billion RHB payment), resulting in an expected operating net income of $500 million. Assume that (1) the Postal Service attains the expected test year after rates volume, (2) volumes do not decline in future years, (3) wage rates do not change in future years, (4) other variable unit expenses do not change in future years, (4) no CPI-U price increases in future years, and (5) competitive products continue to produce sufficient revenue to cover at least 5.5 percent of institutional operating expenses (operating expenses here mean expenses which pertain to operations and over which the Postal Service has control. Operating expenses exclude workers' compensation non-cash adjustments and the annual payment to the postal service retiree health benefits fund).

a. Under these assumptions, would the rates requested in this case, be sufficient to cover institutional operating expenses in future years? If not, please explain.

b. Assume that volumes continue to decline, but that the other assumptions above hold. Please explain how the Postal Service will continue to cover institutional operating expenses? If not, please explain.

c. Assume that (1) volumes continue to decline, (2) the Postal Service adjusts market dominant prices annually using its price cap authority, but (3) the other assumptions above hold. Would the annually adjusted rates continue to allow the Postal Service to cover institutional operating expenses as long as the contribution lost from the volume decline was offset by the allowable price cap rate increase? If not, please explain.

d. With reference to subpart c, if the allowable price cap increase did not offset the lost contribution from the volume decline and if Congress did not permit the Postal Service to reduce delivery frequency, would the Postal Service aggressively seek to reduce institutional operating expenses in other cost segments (i.e., other than cost segments 7 and 10)? How would the Postal Service reduce these other institutional operating expenses in a way that would offset the lost contribution from declining volumes? Please describe any pragmatic limitations involved in making your decisions.

RESPONSE

a. Setting aside for a moment, the unrealistic assumptions described in the question, at some point total costs would likely overtake total revenue. One critical cost-driving variable that is entirely outside of the Postal Service's control is the number of delivery points, which increases continuously over time. Over half of the Postal Service's delivery costs (Cost Segments 6, 7 and 10) are institutional rather than attributable. And while these institutional costs may not be "volume-variable," they are to a great extent variable with the number of delivery points. In addition, two new costs will begin in 2017, per current law. These are the amortization payment for the CSRS unfunded liability and the normal costs and amortization of the unfunded retiree health benefits liability.

b. The Postal Service's Five-Year Business Plan outlines the strategies it has put into place to align the costs under management's control with current and projected mail volumes. As has been noted frequently, there are limitations to what the Postal Service will be able to accomplish within the confines of its current, broken, business model. That is why management has requested that Congress pass comprehensive legislation to enable the organization to be self-sustaining. The uncertainty surrounding the nature and timing of any future legislation is one of the factors that have required the Postal Service to seek to generate additional liquidity though an exigent price increase in response to contribution losses caused by the Great Recession.

c. Not necessarily. See the response to subpart a above. Additionally, it will depend on the amount by which "competitive products continue to produce sufficient revenue to cover at least 5.5 percent of institutional operating expenses."

d. If allowable price increases within the confines of the CPI price cap were not sufficient to allow the Postal Service to maintain liquidity (setting aside defaults on the legally-required retiree health benefits prepayments) management would consider additional cost reductions in all areas. Pragmatic considerations include, but are not limited to, legality, compliance with contractual agreements, political constraints, acceptance by our customers and competitive considerations.