

Before the
POSTAL REGULATORY COMMISSION
Washington, DC 20268-0001

Section 701 Report

:

Docket No. PI2016-3

COMMENTS OF THE GREETING CARD ASSOCIATION

I. INTRODUCTION

The Greeting Card Association (GCA) files these comments pursuant to Commission Order No. 3238 (April 14, 2016). In them, we discuss several significant issues, including some raised in the Commission's previous (2011) section 701 Report. We have concentrated on questions regarding the market-dominant rate and classification provisions of the Postal Accountability and Enhancement Act of 2006 (PAEA).

At the outset, we would note that one amendment to existing legislation might well do more to improve the effectiveness of PAEA than any other single change: removal of the impracticable schedule for prefunding of retiree health benefits. As discussed below, this annual burden is responsible for a great part of the Postal Service's financial distress. This is not a provision which affects only the market-dominant rate-payer, but replacing it with one more in line with normal practice – and financial reality – would benefit everyone affected by chapter 36 of PAEA.

II. THE COMMISSION NEED NOT RECOMMEND CHANGES IN THE PRICE CAP

A. Background

At the outset, GCA wishes to make clear that in our view the price cap – designated in sec. 3622(d) as a "requirement" – cannot be significantly changed except by Congressional legislation. Since a sec. 701 proceeding can appropriately result in recommendations to Congress as well as ideas which can be implemented administratively, this legal situation need not foreclose discussion of the price cap in this Docket.

In fact, though, GCA believes that changes in the price cap need not be considered. In the 2011 proceeding, the Commission concluded that no changes to the basic structure of the price cap need be recommended. The same conclusion would be appropriate today.

In this connection, the historical context of the 2011 review is important. When the Commission issued its first sec. 701 report (September 22, 2011), the severe recession of 2008-09 had ended. The scope and meaning of the exigency provision (sec. 3622(d)(1)(E)), however, were still unsettled. The Commission had rejected the Postal Service's first request for an exigency increase for lack of a showing of causal relation between the recession and the request – grounds which were later essentially upheld by the Court of Appeals for the District of Columbia Circuit. The ultimate decision in favor of a time- and amount-limited exigency increase was still in the future.¹

Consequently, neither the Commission nor any stakeholder could have been sure, in 2011, that it would be feasible to remedy the effects of an “extraordinary or exceptional” economic downturn by invoking sec. 3622(d)(1)(E). This fact is relevant because doubts about the effectiveness (in terms of revenue adequacy²) of the present price cap are likely to center on the prospect that a serious economic downturn will both (i) reduce general inflation, thus shrinking the price cap, and (ii) depress mail volume, thereby reducing Postal Service revenue. Since the Postal Service is now able to count on the exigency mechanism in such cases, these doubts lose most of their persuasiveness.

B. The existing price cap is efficient and effective

The productive efficiency rationale. The central argument for price cap regulation is that it motivates the firm to improve productive efficiency. That the sec. 3622(d) price cap has largely succeeded in doing this is clear from experience. Accurate appreciation

¹ Order No. 1926 (December 24, 2013).

² As distinguished from the incentive to productive efficiency which is the primary reason for choosing a price cap structure.

of this experience requires a distinction – obscured when one speaks simply, for example, of “labor costs” – between controllable and non-controllable labor cost components.

The Postal Service’s Inspector General recently issued a report drawing just that distinction.³ The IG found that when the retiree health benefit prefunding requirement imposed in 2006 is excluded (as non-controllable) the Postal Service has reduced its inflation-adjusted labor cost by \$10.2 billion since FY2006, and its total adjusted costs by \$13.7 billion. Its total factor productivity has improved in spite of substantial volume declines since FY2009. Figure 4 in *Peeling the Onion* shows that *controllable* labor expenses declined from FY2006 to FY2015. Only the *non-controllable* cost categories, RHB obligations and workers’ compensation, increased. When RHB prefunding obligations are taken out of the calculation, inflation-adjusted labor costs declined, on average, 2.6 percent a year.

A non-controllable expense, by definition, cannot be reduced by management efforts, whether those efforts are motivated by a price cap or by something else. It therefore should have no influence on the decision whether a particular price cap has been effective in promoting productive efficiency. How far the Service’s successful efforts have resulted from the price cap and how far from its recognition that volume declines are not about to go away is perhaps unknowable, but it seems clear that the cap has been a major part of an effective pro-efficiency combination.

Predictable and stable rates: (1) Transparency. A main objective of PAEA is the assurance of predictable and stable rates (sec. 3622(b)(2)). The existing price cap is especially well adapted to achieve it. Both the current rate of inflation and the Commission’s formula for translating it into an allowable revenue increase are easily available to the mailing community, making it feasible to predict near-term increases at the class level with fair assurance.

Predictable and stable rates: (2) Importance of class-level application. Stability and predictability are also promoted by the requirement (sec. 3622(d)(2)) that the price

³ *Peeling the Onion: The Real Cost of Mail*, RARC-WP-16-009, April 18, 2016 (“Peeling the Onion”)

cap be applied at the class level. This is significant in part because in the 2011 proceeding the Postal Service advocated a system-wide price cap.⁴ Such a change would make rates less predictable and potentially much less stable.

A system-wide price cap would substantially increase the range of variation possible for each class. Consider a highly simplified example: Assume (i) a system with only two classes, First Class and Standard Mail, (ii) a two-percent price cap in the test year, fully utilized and with no banked authority available, and (iii) no volume effects. On the basis of FY 2015 revenues and volumes, the existing class-level cap would allow, for the whole system, a revenue increase of \$942.6 million. The existing rules would of course allow a two-percent increase for each class. With a system-wide cap, however, the limit cases are a 3.20 percent increase for First Class and a 5.32 percent increase for Standard.⁵

Clearly, a rule which allowed a class to be visited, in a given year, with an increase anywhere between zero and 5.32 percent would undercut the objective of stable and predictable prices. To avoid that possibility, the Commission should reject the idea of a system-wide price cap.

C. Some other proposals from the 2011 proceeding

Another proposal for change was advanced by the Postal Service in the 2011 proceeding: an index designed to reflect more closely the Service's mix of costs, which, it argued, do not necessarily track those of urban wage earners.⁶

Such a change, if made at all, would have to be made by Congress, since sec. 3622(d) explicitly requires use of the CPI-U. It would not, however, be consistent with one of the basic goals of PAEA.

⁴ Postal Service Comments, attached to *Section 701 Report* (September 22, 2011), pp. 18-19.

⁵ We call these "limit cases" because each assumes no increase for the unaffected class. Strictly speaking, perhaps, we could consider a case involving an increase for one class and a decrease for the other, as long as the end result was a two-percent overall increase. But such a case seems to be unquantifiable, except arbitrarily, for purposes of a numerical example.

⁶ See particularly the Service's comments on the draft 2011 report, at fn. 22 on pp. 20-21.

The limit case of an index reflecting the cost profile of the regulated firm would be a cost-of-service ratemaking system – the approach PAEA was designed to supersede. The difference is not merely theoretical. The shift from ex ante to ex post oversight of rates depends to a large degree on the fact that the limit on price increases does *not* depend on the Postal Service’s costs and how it measures and manages them, but on an extrinsic factor known in advance of the rate filing. The CPI-U meets this specification; an index keyed strictly to Postal Service costs would not.⁷

It is true that the Service’s 2011 proposal was not simply a mirror image of its costs but, apparently, an attempt to approximate them by weighting the index heavily (80 percent) toward labor costs as reflected in the Employment Cost Index (ECI), with the remainder based on the Gross Domestic Product Chain-Type Price Index (GDPPI) – the latter change proposed because the GDPPI reflects more goods and services than the CPI-U (and, apparently, a basket of goods which exhibited less negative price change in the recession). It remains true that as the chosen index more closely approaches the regulated firm’s cost profile, ex post rate oversight becomes less effective. The Commission should not recommend to Congress that the present index be changed.

One further idea, put forward by the Commission in preliminary fashion in the 2011 Report, deserves mention here. This was the concept of additional (above the cap) revenue increments for improvements in service quality.

GCA believes that, whatever the theoretical merits or disadvantages of this concept, it would be inappropriate to try it under present conditions. First, the additional revenue would necessarily be contributed by market-dominant products. While the improvements in question would be those observed in the market-dominant classes, there is enough operational overlap between the market-dominant and competitive sectors

⁷ It is also significant that when cost-of-service ratemaking was the rule, under the 1970 Postal Reorganization Act, substantial procedural protections were afforded to interested parties. This was necessary and appropriate, because the outcome depended on facts about and interpretations of Postal Service costs and revenues – information, in the first instance, in the Service’s possession. PAEA did away with the procedural safeguards but also created a ratemaking system *not* dependent (except under sec. 3622(d)(1)(E)) on Postal-Service-specific facts. The closer a changed system approached the old cost-of-service model, the more these procedural protections would be missed.

that competitive product users would benefit, while market-dominant users would provide 100 percent of the financial reward to the Postal Service. This result seems clearly inconsistent with the mandate of sec. 3622(b)(8) that there be a just and reasonable schedule of rates and classifications.

In addition, service quality is now a serious problem, particularly for Single-Piece First-Class Mail. The Commission has had to direct the Service to provide information and plans for improving it, with a 90-day deadline from the most recent Annual Compliance Determination.⁸ When service has declined, in some cases, to 78 percent success in meeting the target (Single-Piece First-Class Letters and Cards, 3-to-5-day service standard) the appropriate course is to require improvement, as the Commission has the power to do under PAEA, and not to try to motivate it by breaching the price cap.⁹

III. THE EXISTING WORKSHARE DISCOUNT PROVISIONS SHOULD BE RETAINED

Section 3622(e) essentially continues past practice regarding worksharing discounts. The Commission need not, and should not, recommend changes to it.

Status of the workshare discount standards. In a thoroughgoing inquiry into the nature and proper role of worksharing and worksharing rates, the Commission emphasized the primacy, in administering PAEA, of what it called the “quantitative” provisions. Preliminarily summarizing its findings in Order No. 536 (Docket RM2009-3, September 14, 2010), the Commission said:

⁸ *Annual Compliance Determination, Fiscal Year 2015*, pp. 137-138.

⁹ Conversely, the notion of reducing revenue as a sanction for service deficiencies seems at least equally inappropriate. This technique has been used, especially by State utility regulators, where service problems are serious enough. The theory behind it, however, is inapplicable to the Postal Service. A deduction from revenue diminishes the funds available for dividends, motivating shareholders to replace the management responsible. Since the Service has no shareholders, using this technique would merely aggravate its financial problems and could make correction of service shortfalls still more difficult.

. . . [T]he PAEA establishes three objective, quantitative, and mandatory pricing constraints that constitute clear “out of bounds” lines that the Commission must enforce. One is the limit on workshare discounts.^[10]

At p. 16 of the same Order, the Commission noted that “Congress framed each of these requirements as objective, quantitative pricing standards, made their application mandatory, and placed each in a self-contained section of the PAEA.” And see *id.*, p. 18 and fn. 10. The relationship between the quantitative standards and the objectives and factors of sec. 3622(b) and (c) is explained in detail at pp. 33 et seq. of the same Order.

All this suggests that, as the Commission recognized, Congress did not intend the workshare discount standards it set in sec. 3622(e) to be tinkered with by administrative action. (In fact, at p. 34 of Order 536, the Commission treated them, along with the price cap and the preferred rate rules, as legislated “requirements” on the same footing.) Any changes would thus have to be thought of as potential Congressional amendments. There are, however, good reasons why they should not be thought of at all.

Efficient pricing of workshared products. It is probably unnecessary, at this point in history, to reiterate at length the theory of Efficient Component Pricing (ECP). The Commission has fully explained its value as ensuring provision of those mail products adaptable to worksharing at the least combined cost: if both costs avoided and the reference grouping (benchmark) are properly identified, the Postal Service will perform all and only those functions which it can perform at less cost than the mailer, and vice versa. Sec. 3622(e)(2) embodies this principle.¹¹

There also is no “practical” reason to change this approach. First, sec. 3622(e)(2) provides a number of quite capacious exceptions to the ECP principle. See

¹⁰ Order No. 536, p. 3. The other two are the price cap and the rules for preferred rates. See *id.*, p. 16.

¹¹ Or, more precisely, part of it: ECP theory calls for a floor as well as a ceiling for discounts, since non-monopoly subservices are to be priced at the monopolist’s average incremental cost. Sec. 3622(e)(2) sets a ceiling but no floor. The Commission’s rules recognize that deviations in both directions may be troublesome (see 39 CFR sec. 3010.12(b)(6)), but in practice most emphasis has fallen on discounts apparently exceeding the ceiling.

sec. 3622(e)(2)(A) to (D) and (e)(3). Practical difficulties in applying it can generally be alleviated by resort to one of these exceptions.¹² The Postal Service commonly cites one or more of them when a discount exceeding avoided cost has been questioned, and the Commission has frequently accepted the explanation as establishing compliance with the statute.¹³ To any argument that the ECP principle *by itself* unduly restricts pricing flexibility, the first answer is that the statute does not enact ECP *by itself* but provides ample maneuvering room for the Postal Service and worksharing mailers to avoid any practical difficulties in applying it.

Moreover, as the Commission has pointed out¹⁴, sec. 3622(b)(1) requires the ratemaking system to “maximize incentives to reduce costs and increase efficiency.” Efficiency is not increased when products are priced in a way which encourages mailer performance of functions which the Service could perform more cheaply. Indirectly related to this consideration – but also, ultimately, an efficiency concern – is the fact that discounts greater than avoided cost deprive the Postal Service of revenue which it needs, among other things, to restore its own capital stock.¹⁵ In *Peeling the Onion*, the Inspector General notes that the Service’s capital investment is not even keeping pace with its own depreciation and amortization.¹⁶ The productive efficiency of the Service depends, inter alia, on an adequate stock of well-functioning facilities, vehicles, and other necessary capital items.

IV. THE QUESTION OF NEW CLASSES OF MAIL

In the 2011 Report, the Commission recommended that PAEA be amended to allow the Service to create new classes of mail.¹⁷ The report acknowledges that sec.

¹² For an extended discussion of the pricing flexibility these exceptions provide, see Docket RM2009-3, *Comments of the Greeting Card Association*, pp. 14 et seq.

¹³ For example: *Annual Compliance Determination, Fiscal Year 2015*, pp. 25-26 (Standard Mail Automation Mixed AADC Letters), pp. 26-27 (Standard Mail Non-Automation 5-Digit Non-machinable Letters).

¹⁴ Order No. 536, p. 36.

¹⁵ The sacrifice of revenue is also, of course, a concern under sec. 3622(b)(5) – adequate revenue.

¹⁶ *Peeling the Onion*, pp. 2, 15-16.

¹⁷ See 2011 Report, pp. 43 et seq.

3622(d)(2) “could be read as barring the Postal Service from creating new classes of products.” That provision directs that the price cap be applied to “a class of mail, as defined in the Domestic Mail Classification Schedule as in effect on the date of enactment [of PAEA].” In GCA’s view, sec. 3622(d)(2) *should* be read as blocking the administrative creation of new classes. The DMCS contained no *general* definition of what constitutes a “class,” so the provision must mean that the cap is to be applied to just those particular classes which the then-effective DMCS listed. Since sec. 3622(d) as a whole is denominated as a “Requirement,” it appears that only Congressional legislation could enable the Service to create a new class.

Whether such legislation should be advocated is a separate question. The Commission recommended it because “[t]he apparent inability of the Postal Service to create new classes significantly limits the Postal Service’s flexibility to adapt to changed circumstances in our postal system.”¹⁸

GCA believes that such legislation, while it would indeed be necessary to allow administrative creation of new classes, is itself not necessary. First, the most prominent “changed circumstances in our postal system” over the five years since the 2011 Report seem to have taken place in the competitive sector, which is unaffected by sec. 3622(d). Moreover, it is not clear that an innovative market-dominant product could not be created within the existing class structure. The key function of market-dominant classes seems to be to provide a basis for application of the price cap. The Commission’s example in the 2011 Report – a hybrid of First Class and Standard Mail, offering First-Class speed without free forwarding and other First-Class attributes – could probably be created within First Class. There seems to be no compelling reason why such a product would need to inhabit a class of its own, with its own price cap, particularly since the unwanted First-Class features could be costed and priced in the usual fashion, and excluded from a new product within First Class, with a price determined accordingly.

Another question is how far administrative “flexibility” to create new classes should be limited in order to avoid excessive fragmentation in the application of the

¹⁸ Id., p. 43.

price cap. The Commission's 2011 recommendation did not contemplate changing the substance of sec. 3622(d)(2), so it appears that each class, existing or new, would have its own cap. If, for, example, Single-Piece First-Class Letters and Cards were carved out as a new class, reconciling the resulting constricted price cap with the traditional whole-cent postage convention could prove troublesome if not impossible. Amending PAEA to allow administrative creation of new mail classes seems unnecessary, and could create difficulties in the practical construction of rates.

V. CONCLUSION

Because we believe that PAEA is effectively achieving what its drafters meant to achieve as *regulatory* goals, our conclusions as to possible changes are largely negative. One *non-regulatory* feature of PAEA – the retiree health benefit prefunding mechanism – is not working; and as to this we hope the Commission will recommend changes to the statute. For the reasons discussed above, accordingly, GCA suggests that the Commission's sec. 701 report should –

- Emphasize the importance of replacing the present unsustainable retiree health benefit prefunding schedule with one which will allow the Postal Service to achieve financial stability;
- Neither recommend to Congress nor undertake to carry out changes to the existing price cap, the index it uses, or the scope of its application;
- Not call for or propose to make changes to the current workshare discount provisions of PAEA;
- Omit further consideration of the 2011 proposals for above-the-cap revenue increases for service improvements and latitude for the Postal Service to create new mail classes without Congressional authorization.

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Respectfully submitted,

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