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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2008	)))	Docket No. ACR2008

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2008 ANNUAL COMPLIANCE REPORT
(January 30, 2009)

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INTRODUCTION

On December 29, 2008, the Postal Service filed its "United States Postal Service FY 2008 Annual Compliance Report." On December 31, 2008, the Commission issued Order No. 161, Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment, seeking initial comments by January 30, 2009, and reply comments by February 13, 2009. Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint initial comments in response to the Commission's Notice.

PRELIMINARY MATTERS

A. Scope of Review

Section 204 of the Postal Accountability and Enhancement Act ("PAEA"), Public Law 109-435, requires the Postal Service to submit to the Commission an "**annual report**" within 90 days after the end of each (fiscal) year:

> (1) which shall analyze **costs, revenues, rates, and quality of service**, using such methodologies as the Commission may by regulation prescribe, and in sufficient detail to demonstrate that **all products** during such year complied with **all applicable requirements** of this title; and
> (2) which shall, for each **market-dominant product** provided in such year, provide —
> (A) **product information**, including **mail volumes**; and
> (B) measures of the **quality of service** afforded by the Postal Service in connection with such product including —
> (i) the **level of service** (described in terms of **speed of delivery** and **reliability**) provided; and
> (ii) the degree of **customer satisfaction** with the service provided. [39 U.S.C. § 3652(a) (emphasis added).]

After the Postal Service has filed its annual report, the Commission has 90 days in which to make a "determination of compliance" with Chapter 36 ("Postal Rates, Classes, and Services") of Title 39 of the U.S. Code, as well as to determine "whether any service standards in effect during such year were not met." 39 U.S.C. § 3653(a)-(b). If, at the end of the Commission's annual compliance review, the Commission makes a finding of "noncompliance," the Commission is required to "take appropriate action," as follows:

> (c) Noncompliance With Regard to Rates or Services.—If, for a year, a timely **written determination of noncompliance** is made under subsection (b), the Postal Regulatory Commission **shall take appropriate action** in accordance with subsections (c) and

> (e) of section 3662 (as if a complaint averring such noncompliance had been duly filed and found under such section to be justified). [39 U.S.C. § 3653(c).]

B. Course of Proceedings

The Postal Service timely filed its FY 2008 Annual Compliance Report ("ACR") on December 29, 2008, which was its second annual report filed subsequent to enactment of PAEA. Along with the FY 2008 ACR, the Postal Service filed 38 public attachments, USPS-FY08-1 – 38, and 23 nonpublic attachments, USPS-FY08-NP1 – 14, USPS-FY08-NP18 – 19, and USPS-FY08-NP21 – 27. Also, the Postal Service notified the Commission of the availability of its FY 2008 Comprehensive Statement, as required by section 3652(g)(1) of Title 39, on the Postal Service website, www.usps.com.

The Postal Service notes that the ACR is in a state of transition as it strives to achieve "a report which more closely resembles the format and content contemplated by the new statutory provisions." FY 2008 ACR, p. 2. As the Postal Service also observed, "this year's ACR is a first-time effort at trying to apply the standards of the PAEA [and] this effort is being made in the absence of final rules concerning the form and content of this Report." *Id.*

On December 31, 2008, the Commission issued Order No. 161, commencing proceedings in this docket. In the course of its review, the Commission identified a number of issues relating to costing which appeared to reflect unannounced changes in costing methodology. On January 12, 2009, the Commission issued Order No. 169 scheduling a technical conference on certain apparent methodological changes, which Valpak (and other intervenors and the Public Representative) attended on January 26, 2009.

Although Order No. 161 provided mailers no right to propound discovery requests to the Postal Service (and final regulations governing the annual compliance report and review are still pending in Docket No. RM2008-4), Valpak identified several costing and data problems with the FY 2008 ACR. On January 13, 2009, Valpak filed a Motion for Issuance of Commission Information Request concerning Core Costing Data on Detached Address Labels in this docket to obtain additional clarifying data and explanation from the Postal Service with respect to two issues relating to detached address labels ("DALs"). In response, the Commission issued Order No. 174 on January 23, 2009, granting Valpak's motion, and directed the Postal Service to provide the requested information at the January 26, 2009 technical conference.

Additionally, Valpak filed on January 21, 2009 suggested questions regarding the costing of saturation products and DALs for discussion at the technical conference which was held on January 26, 2009 in this docket, or, in the alternative, a motion for a Commission Information Request regarding such information if the Postal Service did not explain these matters to the Commission's satisfaction.

C. Difficulties Created by Timing of Annual Compliance Review and Pricing Changes

PAEA requires the Postal Service's annual compliance report to be filed 90 days after the end of the fiscal year, or at the end of December of each year, and limits the period of the Commission's review to 90 days, or by the end of March of the following year. *See* 39 U.S.C. §§ 3652 and 3653. As an exercise of its pricing prerogatives, the Postal Service has announced plans to change prices for competitive products each January, and change prices for market dominant products each May. The conflux of PAEA deadlines and the Postal Service pricing schedule creates two significant challenges for the Commission.

First, during each fiscal year every product will have two different rates, but the period when the different rates are in effect will vary as between competitive and market dominant products. Each annual compliance report must contain costs for the prior fiscal year, but those costs need to be matched against revenues from different sets of rates. As a result, when drawing inferences about the most recent rate increases, one may not be able to conclude with conviction that "current rates are [or are not] providing revenues sufficient to cover all operating costs." Evaluating compliance with this objective using data from two or more rate regimes during the prior fiscal years presents a recurring problem.

Second, by the time the Commission completes its Annual Compliance Determination, the Postal Service has already announced its price changes for the year. Therefore, any modifications the Commission may find necessary to order into effect under 39 U.S.C. section 3653(c) could be viewed by affected mailers as disruptive of price changes already announced by the Postal Service.

D. Nonpublic Annex

The Postal Service addresses a nonpublic annex on pages 67-71 of the FY 2008 ACR.

PAEA authorizes the Commission to create a nonpublic annex, with the principal references[1] in 39 U.S.C. section 3652:

> (a) [T]he Postal Service shall, no later than 90 days after the end of each year, prepare and submit to the Postal Regulatory

[1] The nonpublic annex is also referenced in 39 U.S.C. section 3654(f)(1).

> Commission a report (together with such **nonpublic annex** to the report as the **Commission** may require under subsection (e))
>
> * * *
>
> (e)(1) In general. — The Postal Regulatory **Commission** shall, by regulation, prescribe the content and form of the public reports (and any **nonpublic annex** and supporting matter relating to the report) to be provided by the Postal Service under this section.
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> * * *
>
> (f)(1) In general. — If the Postal Service determines that any document or portion of a document, or other matter, which it provides to the Postal Regulatory Commission in a **nonpublic annex** under this section or under subsection (d) contains information which is described in section 410(c) of this title, or exempt from public disclosure under section 552(b) of title 5, the Postal Service shall, at the time of providing such matter to the Commission, notify the Commission of its determination, in writing, and describe with particularity the documents (or portions of documents) or other matter for which confidentiality is sought and the reasons therefor.
>
> (2) Treatment.—Any information or other matter described in paragraph (1) to which the Commission gains access under this section shall be subject to paragraphs (2) and (3) of section 504(g) in the same way as if the Commission had received notification with respect to such matter under section 504(g)(1). [Emphasis added.]

Without the benefit of final Commission Rules on either (i) the nonpublic annex as part of the ACR, or (ii) rules according appropriate confidentiality (which rulemakings are pending in Dockets No. RM2008-1 and RM2008-4), the Postal Service filed a Motion Requesting Establishment of Protective Conditions to Govern Access to Certain Core Costing Documentation on December 12, 2008. On December 19, 2008, Valpak and the National Association of Presort Mailers filed a joint answer to the Postal Service's motion. On December 23, 2008, the Commission denied the Postal Service's motion in part. *See* Commission Order No. 155.

Concurrent with the filing of the FY 2008 ACR, the Postal Service filed a response to Commission Order No. 155, explaining that it was dividing the Cost and Revenue Analysis ("CRA") and other materials, filing some of the materials publicly in part, and filing them in their entirety in the nonpublic annex only. *See* Response of the United States Postal Service to Commission Order No. 155 (Dec. 29, 2008). The Postal Service addresses the nonpublic annex on pages 67-71 of the FY 2008 ACR.

On January 21, 2009, Valpak, along with the National Association of Presort Mailers, Inc. and the Association of Priority Mail Users, Inc., filed a joint reply to the response of the Postal Service to Commission Order No. 155, explaining the problems created by the position being taken by the Postal Service.

The Public Representative appointed by the Commission in this docket filed a Motion to Make Core Cost, Volume, and Revenue Materials Public (relating to the nonpublic annex) on January 27, 2009. Responses to the motion are due subsequent to the filing deadline of initial comments. *See* Commission Rule 3001.21(b). It is anticipated that this issue will be addressed by the Commission in this docket within the context of the Public Representative's important motion.

On November 13, 2008, the Postal Service submitted a notice to the Commission regarding the Governors' decision to increase competitive products rates of general applicability. Those rates went into effect on January 18, 2009. *See* Docket No. CP2009-8.

I. THE POSTAL SERVICE'S NET OPERATING PROFITS HAVE NOT BEEN SUFFICIENT TO ENDOW THE RETIREE HEALTH BENEFITS FUND AS ENVISIONED BY PAEA.

The Postal Accountability and Enhancement Act, section 201(a), establishes nine "objectives" in 39 U.S.C. section 3622(b) for the modern system of ratemaking required to be developed by the Act. Most of these objectives pertain to pricing and the pricing process, but one objective expressly pertains to the Postal Service's fiscal condition:

> To assure **adequate revenues**, including retained earnings, to maintain financial stability. [39 U.S.C. § 3622(b)(5) (emphasis added.)]

The timing and amount of rate changes directly affect the adequacy of revenues. Compliance with this objective can be evaluated using data contained in:

(i) the Postal Service's Securities and Exchange Commission ("SEC") Form 10-K (filed November 26, 2008); and

(ii) the CRA for FY 2008 (attachment USPS-FY08-1 to the Postal Service's FY 2008 Annual Compliance Report).

FY 2008 revenues reflect rates from Docket No. R2006-1 that were in effect from October 1, 2007 until May 12, 2008, at which time the first rate increase under PAEA, Docket No. R2008-1, went into effect.

For fiscal years ending September 30, the SEC Form 10-K shows the following summary results (in millions):[2]

	FY 2007	FY 2008
Operating revenue (incl. investment income)	$ 74,972.8	$ 74,932.0
Less: Operating expenses	-77,156.8	-72,138.0
Profit (deficit)	(2,184.0)	2,794.0
Funding of PSRHBF	-2,958.4	-5,600.0
Total profit (deficit)	($ 5,142.4)	($ 2,806.0)

Thus, according to the SEC Form 10-K, FY 2008 operating revenues were $74,932.0 million, operating costs were $72,138.0 million, and the Postal Service earned an **operating profit of $2,794.0 million, before** funding of the Postal Service Retiree Health Benefit Fund ("PSRHBF"). The fact that the Postal Service was able to achieve an operating profit of $2,794 million despite a significant decline in mail volume is a highly commendable outcome. In general, it bodes well for the future.

It is instructive to look at the two years combined. Over this period, the net operating profit amounted to $610 million, while the required contribution to the PSRHBF was almost $8.6 billion. In other words, the net operating profit over the last two years was less than 10 percent of the amount required for funding the PSRHBF.

Funding of the PSRHBF currently is scheduled to be completed in 10 years. The FY 2008 deficit reflects full funding, in the amount of $5.6 billion, of the PSRHBF for a second

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[2] The revenue and expense figures in the SEC Form 10-K differ slightly from the corresponding figures in the FY 2008 CRA.

consecutive year. However, the Postal Service has now asked Congress to allow it to use the PSRHBF to pay for health benefits for existing retirees, rather than fund those benefits as part of the current operating budget.[3] That would extend the 10-year limit to achieve full funding of the PSRHBF. Bills to accomplish this objective were introduced both at the end of the 110th Congress, as well as the beginning of the 111th Congress.[4] However, a recent report indicates that this legislation did not meet the criteria required for inclusion in the currently-pending "stimulus" bill.[5] More recently, the Postmaster General requested that Congress consider removing the appropriations' restriction that requires residential delivery six days a week.[6]

The FY 2008 PSRHBF payment of $5.6 billion, on top of that incurred in FY 2007, forced the Postal Service to borrow an additional $3.0 billion in FY 2008, so that at the end of FY 2008, the Postal Service's total debt grew to $7.2 billion. A one-year increase in debt of $3.0 billion, particularly when viewed in the context of a $15 billion debt limit, indicates that the Postal Service is not in a long-run sustainable financial "equilibrium." If its debt continues to increase at that rate, the debt limit would be reached long before future retiree health benefits are fully funded. Although sources of Congressional intent in enacting PAEA are

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[3] *See Business Mailers Review*, Dec. 1, 2008, p. 7.

[4] *See* H.R. 7313 introduced in the 110th Congress, and H.R. 22 introduced in the 111th Congress.

[5] *See Business Mailers Review*, Jan. 23, 2009, p. 1

[6] On January 28, 2008, the Senate Homeland Security and Government Affairs Committee's Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security held a hearing on "The Impact of the Economic Crisis on the U.S. Postal Service." http://hsgac.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=ce8899e6-d08e-4d07-a6df-6aecebc9c12e

sparse, it seems reasonable to infer that such a result was not among the ends that Congress (or the Government Accountability Office, or the U.S. Department of the Treasury, or those mailers and mailer associations which enthusiastically supported PAEA) intended PAEA to accomplish.

In the absence of any legislation such as that just mentioned, the Postal Service will need to focus on and emphasize increasing its profitability even more than it did in FY 2008. The Commission itself has noted that "the Postal Service's declining revenues, coupled with the Consumer Price Index ("CPI") price cap on products that generate approximately 90 percent of its revenues, may put the Postal Service's financial viability in peril."[7] The worsening financial condition of both the economy and the Postal Service requires that the Postal Service and the Commission not wait for additional legislation. At a minimum, the Postal Service needs to act in a more businesslike manner by focusing this year's rate changes on unprofitable volume in a way that will quickly remedy the $1.0 billion loss which the Postal Service incurred in FY 2008 on certain "underwater" products (discussed, Section II, *infra*).

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[7] *Report on Universal Postal Service and the Postal Monopoly*, Postal Regulatory Commission, Dec. 19, 2008, p. 166.

II. THE FY 2008 ACR DEMONSTRATES THAT DESPITE THE PAEA REQUIREMENT THAT EACH CLASS COVER ITS ATTRIBUTABLE COSTS, SEVERAL PRODUCTS AND THE PERIODICALS CLASS FALL SHORT.

A. The Number of Underwater Products Has Increased

The FY 2008 ACR reveals that the Postal Service had seven products with coverage of less than 100 percent, *i.e.*, products that did not cover their attributable costs (see Table 1).[8] The total negative contribution (*i.e.*, deficit) from these seven products was **$1.029 billion**.

Table 1

Products with Coverage Less Than 100 Percent if FY 2008

	Cover-age	Contri-bution ($, mill)	Dist (%)	Page Ref
Inbound Single-piece First-Class International	79.6	(53)	5.2%	18
Within county periodicals	94.5	(5)	0.5	33
Outside county periodicals	82.9	(450)	43.7	33
Standard flats	94.1	(228)	22.2	22
Standard parcels and NFMs	79.6	(167)	16.2	22
Single-piece parcel post	91.6	(66)	6.4	36
Media mail/library mail	87.4	(60)	5.8	36
TOTAL		(1,029)	100.0%	

Other than Periodicals, five of the money-losing products shown in Table 1 are in classes that more than covered their attributable costs in FY 2008. For those five products,

[8] The Postal Service also had three special services, Registered Mail, Stamped Cards, and Address List Services, that did not cover their attributable costs in FY 2008. Combined, they reduced the contribution to institutional costs by $1.1 million.

even though above-the-cap price increases are not mandated by PAEA in these circumstances, it would be fairly straightforward for the Postal Service to impose product price increases that exceed the cap if it chose to do so, and thereby reduce or eliminate the deficit from those products.[9] A disproportionate reduction in volume may result from above-average rate increases, but for money-losing volume in a money-losing firm[10], the luxury of permitting "underwater" products may not be possible, as the Postal Service actually reduces its losses when such volume contracts. But the two Periodicals products present a special problem, because they constitute the entire class.[11]

B. The Continuing Statutory Requirement Permits No Subsidy of Entire Classes.

Under the PRA, former 39 U.S.C. section 3622(b)(3) required the Commission to issue a recommended decision on a Postal Service request for a rate change in accordance with several factors, including:

> the **requirement** that each class of mail or type of mail service bear the **direct and indirect postal costs attributable** to that class or type plus that portion of all other costs of the Postal

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[9] Mitigating rate increases on other, profitable products will help those products, which support the Postal Service, continue to maintain their viability.

[10] Postmaster General Potter testified on January 28, 2009, before a Senate Homeland Security and Governmental Affairs subcommittee, that "If current trends continue, [the Postal Service] could experience a net loss of $6 billion or more this fiscal year." As a result, the Postal Service has asked "lawmakers to lift the requirement that the agency deliver mail six days a week." http://www2.tbo.com/content/2009/jan/28/mail-delivery-may-need-be-cut-back-postmaster-gene/

[11] Profit-making businesses always endeavor to reduce and eliminate deficits from any discrete product. Under PAEA, the Postal Service now is free to try to earn a profit.

> Service reasonably assignable to such class or type. [Emphasis added.]

PAEA (current 39 U.S.C. section 3622(c)(2)) maintains the same requirement, with the addition that costs be attributed "through reliably identified causal relationships":

> the **requirement** that each class of mail or type of mail service bear the **direct and indirect postal costs attributable** to each class or type of mail service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type. [Emphasis added.]

A class of mail is impermissibly "subsidized" under PAEA when revenues from the class fail to cover its attributable costs.

C. During FY 2008, Periodicals Have Again Generated Revenues Insufficient to Cover Attributable Costs and Extensive Subsidies to Periodicals Persist.

The FY 2008 ACR shows that revenues from Periodicals again failed to cover attributable costs; cost coverage was only 83.99 percent. *See* USPS-FY08-1, Cost and Revenue Analysis. The FY 2008 cost coverage reflects revenues from two sets of rates. For Periodicals, higher rates from Docket No. R2006-1 took effect on July 15, 2007. Thus FY 2008 revenues fully reflect those rates. On May 12, 2008, a further 2.71 percent increase from Docket No. R2008-1 was implemented.

The test year for Docket No. R2006-1 was FY 2008. At the time of the Commission's ACD for FY 2007, the jury was still out on whether rate increases from Docket No. R2006-1 might result in a 100 percent coverage during FY 2008, as had been projected. Final results are now in and it is clear that revenues derived from Docket No. R2006-1 rates were far from adequate to eliminate the shortfall between revenues and attributable costs of Periodicals necessary to comply with the requirement of 39 U.S.C. section 3622(c)(2).

Periodicals' failure to cover its attributable costs is not a new phenomenon. Periodicals' coverage for the 12-year period of FY 1997-2008 is shown in Table 2, below. The FY 2008 coverage of 83.99 percent was up slightly from the FY 2007 coverage of 83.01 percent, which was its all-time low. As can be seen from column 3, beginning in FY 1997, Periodicals has had cost coverages **consistently below 100 percent** for 12 consecutive years. Over this period, the cumulative subsidy received by Periodicals has exceeded $3.0 billion.[12] Last year's deficit simply added another **$437.2 million** to the cumulative subsidy received by Periodicals.

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[12] *See* Docket No. RM2007-1, Valpak Comments on Regulations Establishing a System of Ratemaking in Response to Commission Order No. 26 (Sept. 24, 2007), p. 17. Whether revenues from Periodicals ever will exceed their attributable cost and make up for any portion of this cumulative shortfall is unknown, although it seems somewhat unlikely at this time.

Table 2
Revenue, Cost, Coverage, and Cross-Subsidies to Periodicals
FY 1997 – 2008

PRC CRA Year	(1) Revenue (millions)	(2) Cost (millions)	(3) Coverage	(4) Revenue-Costs (millions)
2008	2,294.9	2,732.1	83.99%	-437.2
2007	2,187.9	2,635.6	83.01%	-447.7
2006	2,124.8	2,487.6	85.42%	-362.8
2005	2,068.9	2,431.6	85.08%	-362.7
2004	2,100.0	2,323.3	90.39%	-223.3
2003	2,139.6	2,196.2	97.42%	-56.6
2002	2,066.9	2,280.4	90.64%	-213.5
2001	2,106.9	2,367.1	89.01%	-260.2
2000	2,076.3	2,354.8	88.17%	-278.5
1999	2,017.7	2,213.1	91.17%	-195.4
1998	1,972.8	2,129.0	92.66%	-156.2
1997	1,964.6	2,038.5	96.37%	-73.9
Totals	25,121.3	28,189.3	89.12%	-3,068.0

The failure of Periodicals to cover its attributable costs means that for **12 consecutive years** the Periodicals class also has failed to contribute so much as one dollar toward the required "portion of all other costs of the Postal Service reasonably assignable to such class." Significantly, shortfalls shown in the last column of Table 2 are based on cost analyses repeated annually for over a decade, and do not reflect some anomalous cost result in one or two studies.

D. The Periodicals Subsidy Is Substantial, and Should Not Be Minimized.

Several observations applicable to the continuing subsidy to Periodicals can be made.

First, focusing only on the bottom line, any business which loses $3.0 billion on a product over 12 years would be expected to conclude that its finances have been harmed by offering the product. Without the product, revenues certainly would decline, but costs would decline even more, hence profitability would improve. Likewise, volume would decline, but money-losing volume is not what a business needs to reduce a financial deficit.

Second, it is important to note that not all Periodicals volume loses money. A significant portion more than covers its attributable cost, contributes meaningfully to institutional costs, and deserves recognition. At the same time, a significant portion of Periodicals volume fails to cover its attributable cost, some of it by a rather wide margin.

Third, in an effort to deflect attention from the enormous subsidy received by Periodicals in FY 2007, Magazine Publishers of America, Inc., Alliance of Nonprofit Mailers, and American Business Media have argued[13]:

> Even the asserted FY 2007 revenue shortfall of $447.7 million, as inflated as that figure is, amounts to only about ½ of one percent of the Postal Services's total revenue in the same year.

Of course, comparing the **net deficit** from Periodicals with the **gross revenues** of the Postal Service is meaningless. Far more appropriate would be to compare the **net deficit** from Periodicals in one year with the Postal Service's **net deficit** for the same year.

- For FY 2007, the $477.7 million **net deficit** from Periodicals could be compared to the Postal Service's $2,184.0 million **net operating deficit**

[13] Docket No. RM2008-4, Reply Comments of Magazine Publishers of America, Inc., Alliance of Nonprofit Mailers and American Business Media (Nov. 14, 2008), p. A-15 (notes omitted).

for that same year,[14] or **21.9 percent** of the Postal Service's total deficit— *i.e.*, over **one-fifth** of the entire deficit, a not insignificant amount.

- For FY 2008, the $437.2 million **net deficit** from Periodicals could be compared to the Postal Service's $2,806 million **net deficit** for that same year, or **15.6 percent**, still a significant figure.

Fourth, the average per-piece shortfall, shown in Table 3, provides further insight regarding the subsidy to Periodicals. In FY 2008, the **average** subsidy was $0.051 per copy for all periodicals mailed.[15] Since revenues from many periodicals covered their attributable costs, on money-losing copies within Periodicals the per-piece loss was considerably greater than the average. It is this volume that is deleterious to the financial health of the Postal Service.

Fifth, another consideration, mentioned *supra*, is the fact that Periodicals did not contribute to anything toward institutional costs ($32.219 billion in FY 2008). Being excused from making any contribution is not a "subsidy" in the literal sense of the term. Still, there is no denying that being relieved of any obligation to pay even a small portion of the considerable burden that other classes of mail are required to carry constitutes a huge benefit to the Periodicals class.

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[14] *See* Docket No. ACR2007, Valpak Initial Comments (Jan. 30, 2008), p. 16.

[15] Docket No. ACR2008, USPS-FY08-1. This figure represents all Periodicals; the per-piece subsidy for outside county periodicals was $0.058.

Table 3
Average Subsidy per Periodical
FY 1997 – 2008

PRC CRA Year	Subsidy (millions)	Total Periodicals Volume (millions)	Subsidy/ Piece
1997	73.9	10,411	$0.007
1998	156.2	10,317	0.015
1999	195.4	10,274	0.019
2000	278.5	10,365	0.027
2001	260.2	10,078	0.026
2002	213.5	9,690	0.022
2003	56.6	9,320	0.006
2004	223.3	9,137	0.024
2005	362.7	9,072	0.040
2006	362.8	9,025	0.040
2007	447.7	8,796	0.051
2008	437.2	8,605	0.051

E. Revenues from Periodicals Prices in Effect during FY 2009 Cannot be Expected to Cover Attributable Costs.

Periodicals' coverage of 83.99 percent in **FY 2008** means that a 19.1 percent average unit increase in revenues would have been needed just to cover last year's attributable costs.

Turning to **FY 2009**, unless the unit attributable cost of Periodicals somehow were to manage a substantial decline of **totally unprecedented** dimension, an average increase in unit revenues of approximately 19.1 percent would be needed again this year. Aside from wishful thinking and pure speculation, no basis exists for anticipating any meaningful reduction in unit cost during FY 2009. In the rate increase of last May, the Postal Service reported that it purposely avoided rate incentives designed to induce meaningful reductions in costs. It stated:

> [t]he Postal Service has … sought to limit the degree to which the increase for any one price element varies from the average increase for this product, so as to reduce the possibility of substantially greater-than-average price increases for any one publication (Factor 3). **Periodicals efficiency incentives have generally been maintained at their current levels.**
> In any event, for Periodicals the overriding objective was to avoid large price increases for all publications. The only way to achieve this objective was to change each price element roughly by the amount of the cap, which **overrides any individual decisions about passthroughs or cost recognition.** [USPS Notice of Market-Dominant Price Adjustment (Feb. 11, 2008), pp. 17-18 and 34 (emphasis added).]

With no reasonable basis to expect any substantial decline in unit attributable cost during FY 2009, revenues from prices in effect this year if allowed to be constrained by a 3.8 percent price cap almost surely will not cover attributable costs, and therefore would violate 39 U.S.C. section 3622(c)(2).

- First, Periodicals rates implemented last May did not change efficiency incentives, and were inadequate vis-a-vis FY 2008 unit attributable costs.

- Second, the inadequate rates in effect on October 1, 2008 are scheduled to remain in effect until the middle of May 2009.

- Third, the "banked" increase for Periodicals from Docket No. R2008-1, which was only 0.19 percent, provides scant upside potential.

- Fourth, regarding the May 2009 price increases, the 3.8 percent price cap, if adhered to, would limit the amount by which Periodicals revenues increase for the remainder of this fiscal year.

For the above reasons, it is unrealistic to hope that Periodicals rates in effect during **FY 2009** will result in revenues sufficient to cover attributable costs — and thereby comply with

39 U.S.C. section 3622(c)(2) — unless: (1) incentive effects are incorporated in the forthcoming rate changes; and (2) subsequent cost reductions resulting from those incentive effects are achieved; and/or (3) prices are increased above the 3.8 percent price cap. Consequently, in addition to finding that Periodicals did not comply with all factors of PAEA in FY 2008, without acting now the Commission can expect to be faced with a similar finding in next year's Annual Compliance Determination ("ACD") covering FY 2009.[16] [17]

F. Periodicals Price Changes Must Send Sound and Efficient Signals to Publishers.

In order to increase Periodicals coverage to at least 100 percent there needs to be:

- a substantial increase in **unit revenues**, or
- a substantial decrease in the Postal Service's **unit cost**, or
- a **combination** of the two.

The consequence of insistence by certain Periodicals mailers on the inviolability of the price cap is that it leaves only cost reductions, including use of rate incentives to achieve that end, on the table. In that regard, MPA and ANM recently have given strong endorsement to more reliance on designing rates to induce desired responses by Periodicals mailers.

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[16] To the extent that compliance determination under PAEA is solely intended to be an after-the-fact exercise, it is clear on its face that Periodicals rates were not adequate to, and did not, comply with all requirements of PAEA. However, although PAEA ostensibly has eliminated the cost roll-forward exercise, as well as the speculation previously embodied in future cost projections, when non-compliance is found to have occurred, a more in-depth discussion is warranted. *See generally* Docket No. RM2008-4, Valpak Initial Comments (Oct. 16, 2008), pp. 15-20, and Valpak Reply Comments (Nov. 14, 2008), pp. 11-12.

[17] Under PAEA, the Postal Service is supposed to have a profit incentive and act more like a profit-making institution. Towards this end, the Postal Service's 2007 Comprehensive Statement says (p. 52), "[i]n 2008 the Postal Service will use Net Income as a major measure of financial performance." In view of the Postal Service's deficit in FY 2008, the $3 billion increase in its outstanding debt, and the continuing decline in mail volume, Periodicals cannot continue to be the recipient of annual multi-million dollar subsidies.

> Ignoring [allied labor piece-related cost avoidance] when designing rates is **inappropriate** and sends **unsound** and **inefficient price signals** to mailers. First, the Efficient Component Pricing Rule ("ECPR") indicates that all cost avoidances should be recognized in designing rate differentials.
>
> Second, as ANM and MPA explained in Docket No. ACR 2007, including allied operations in cost avoidance estimates is consistent with the methods used to estimate cost avoidances in other classes of mail. [Docket No. RM2009-1, Comments of Magazine Publishers of America, Inc., and Alliance of Nonprofit Mailers (Dec. 1, 2008), p. 4 (emphasis added).]

These recommendations by ANM and MPA (i) are fully consistent with section 3622(b)(8) of PAEA, which supports pricing flexibility and explicitly provides for differential rate changes within a class of mail, and (ii) will result in larger rate increases for those publications that cause the Postal Service to lose money on each copy mailed.

Under circumstances where rates and unit costs move in tandem with the CPI, reducing costs by an amount sufficient to increase Periodicals coverage by at least 19.1 percent presents a serious challenge. Unfortunately, reducing the unit cost of handling Periodicals has proven elusive, although the Postal Service continues working on the problem. For example, to help automate carrier route sequencing of flats, including Periodicals, the Postal Service has announced plans to begin deployment of Flats Sequencing System ("FSS") machines in January 2009. The extent to which FSS machines ultimately will reduce carrier sorting costs for flats is unknown.[18]

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[18] When setting rates for Periodicals under PAEA, it is counterproductive for the Postal Service to make heroic assumptions concerning future cost reductions. Should large reductions in unit cost miraculously materialize, it would be perfectly appropriate for Periodicals to make a positive, albeit small, contribution to overhead costs for a change.

As MPA/ANM noted, appropriate pricing incentives send mailers the right signals and provide them with strong incentives, while inappropriate pricing incentives send the wrong signals. Within the Periodicals pricing structure, meaningful incentive effects are overdue. Periodicals rates also should reflect fully the effect of all important cost drivers, in accord with the principle of efficient component pricing, as MPA/ANM recommend.

Under PAEA, the cumulative $3.504 billion shortfall has become a cross-subsidy shared by other classes of mail, most notably those with high coverages, such as High Density/Saturation Letter mail used by Valpak. It has been argued that the price cap protects other classes of mail, while shifting to the Postal Service the burden of subsidizing any uncompensated costs, but that view is illusory. Continued massive subsidies to Periodicals will force the Postal Service every year to increase rates **up to the cap** for all other classes, when otherwise the Postal Service might have "saved" and "banked" some of the allowable rate increase.[19] Moreover, if the Postal Service is forced to file an **exigent rate case** because of cumulative losses, including the cumulative subsidy to Periodicals, then classes of mail **other than Periodicals** likely will be forced to share the pain disproportionately. The Postal Service simply cannot afford loss-leaders, especially loss-leaders that cost hundreds of millions of dollars each year. For the financial health of the Postal Service, the subsidy to the

[19] Increasing rates on profitable classes of mail will cause their volume to be lower than it otherwise would be. And needlessly increasing rates on profitable volume just to be able to continue subsidize money-losing volume is not common in business, makes no economic sense, and is contrary to PAEA's thrust of having the Postal Service operate in a more business-like manner.

Periodicals class needs be eliminated, as required by section 3622(b)(2) of PAEA, as quickly as possible.

Section 3622(b)(4) of PAEA supports pricing flexibility, but the FY 2008 Periodicals price changes avoided using that pricing flexibility. Using this flexibility to have the rate structure reflect costs more fully, as recommended by MPA/ANM, who have it exactly right, would result in rate increases that fall more heavily on copies of publications whose attributable cost far exceeds whatever they now pay in postage.[20] If the Commission were to determine that CPI price cap is not to be violated, despite arguments to the contrary,[21] in order to comply with 39 U.S.C. section 3622(c)(2), disproportionate rate increases focused especially on copies of publications that do not come close to paying the costs which they impose on the Postal Service present the most efficacious way to increase coverage.[22] The Postal Service simply cannot continue to jeopardize the company by shouldering the burden of perpetually subsidizing certain publications. Perpetuating any money-losing burden is not consistent with section 3622(b)(5), which calls for the Postal Service to have financial stability.

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[20] This is not to say that every publication must cover 100 percent of its attributable cost, or that each rate component must rigidly reflect 100 percent of attributable cost. The requirement of section 3622(c)(2) merely states that Periodicals, **as a class,** must cover its attributable costs. So long as that requirement is satisfied, rates for some periodicals can continue to cross-subsidize other periodicals.

[21] *See*, *e.g.*, Docket No. ACR2007, Valpak Initial Comments, pp. 44-51.

[22] *See* Docket No. ACR2007, Valpak Reply Comments on the United States Postal Service FY 2007 Annual Compliance Report (Feb. 13, 2008), pages 12 -13 , for a discussion of how a targeted rate increase on money-losing periodicals can reduce Postal Service losses.

III. STANDARD MAIL COSTING RESULTS WARRANT FURTHER EXPLANATION.

In its overview of this year's ACR, the Postal Service notes that "all … major sets of material … are presented in formats similar (if not identical) to what both the Commission and other parties participating in postal rate proceedings have seen and worked with in the past. In that sense, the Postal Service has sought to maximize the ease with which these materials may be reviewed." FY 2008 ACR, p. 4. Valpak has endeavored to use the time available to review cost data presented for all Standard Mail products and, with the exception of certain data for DALs (discussed *infra*), agrees with the Postal Service that cost data, by product, are available in this year's ACR. As explained below, however, simply making cost data available does not make them useful — particularly without discovery rights to seek clarification from the Postal Service, and operating within a narrow 30-day comment period.

An operational context is necessary to understand cost changes. For the past few decades, postal operations have been in a state of continual flux. Automation of letter mail, for instance, started several decades ago with the single position letter sorting machine, and over the ensuing years has evolved to the far more sophisticated DPS machines now in widespread use. Similarly, flat sorters with ever better capabilities have evolved, and deployment of the Flats Sequencing System gets underway this year. Assuming these FSS machines work as anticipated, carriers will spend less time in the office, more time on the street, and will deliver to more addresses. As FSSing replaces carrier casing of flats, mail processing costs for flats predictably will increase, while being (hopefully) more than offset by reduced in-office carrier costs.

In addition to deployment of newer generations of equipment, the facility network also evolves, albeit gradually. The number of dedicated FSS facilities can be expected to grow, and the aging BMC network is expected to evolve, with some BMCs perhaps becoming FSS facilities. Even when no new facilities are built, and no existing facilities are closed, various operations from time to time are consolidated with other, nearby facilities, so that over time the network capability evolves and adapts.

Although the effects of such changes on costs in any one year are likely to be moderate, they aggregate over time. Missing from this year's ACR is a comprehensive narrative description of how deployment of new equipment and changes in facilities have changed the operating environment, especially with respect to the implications such changes have for costs.[23] In addition to detailed cost spreadsheets, it would bring clarity if each ACR presents narrative updates on network changes, and how they affect costs.

To an extent that is admittedly limited, Valpak has examined certain of the Postal Service's costing results and has compared them with corresponding results from past cases. The mail processing and carrier costs for several categories of Standard Mail have been the focal point, as these make up a large portion of the total.[24] Although one cannot know the absolute level of a cost with certainty, making comparisons is often a powerful way to help

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[23] In rate cases under the Postal Reorganization Act of 1970 ("PRA"), the Postal Service provided a witness whose sole job was to provide an authoritative update on equipment and technology.

[24] Docket No. R2006-1, USPS-LR-L-135, shows that in Standard ECR, as a percentage of total costs, costs that are **not** mail processing costs and not carrier costs constitute only: 3.18 percent of the costs of letters; 10.22 percent of the costs of flats; and 0.06 percent of the costs of parcels.

assess reliability of the results. At the least, the type of comparisons made below can guide decisions relating to further inquiry.[25]

The comparisons below focus on costs of two vintages. The **first** is actual results for FY 2007, which were part of last year's ACR. The **second** is actual results for FY 2008, which have been provided by the Postal Service as part of this year's ACR.

A. Large and Anomalous Cost Changes for Selected Standard Mail Products

When costs change in large or anomalous ways, Valpak has urged that the Commission's proposed rules for each ACR require a narrative setting forth a full and detailed explanation to help understand such behavior.[26] The rather substantial year-to-year changes in unit costs discussed below represent examples of large changes that appear in this year's spreadsheets, without any explanation or discussion.

Saturation Letters

At an FY 2008 level of 1.844 cents, saturation letters saw an increase in **mail processing** costs of 28.50 percent, relative to FY 2007. The City Carrier Cost System ("CCCS") and the Rural Carrier Cost System ("RCCS") systems indicated that the proportion of these letters DPS'd in FY 2008 was about the same as the proportion DPS'd in FY 2007 for city routes and about 10 percentage points higher for rural routes. DPSing is not costless, but

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[25] The costs discussed below are drawn from: (1) FY 2008 Annual Compliance Report: USPS-FY08-10, 11, 18, and 19; and (2) FY 2007 Annual Compliance Determination: PRC-ACR2007-LR5 and PRC-ACR2007-LR7.

[26] *See, e.g.,* Docket No. RM2008-4, Valpak Direct Marketing Systems, Inc., and Valpak Dealers Association, Inc., Initial Comments Regarding Proposed Rules Prescribing Form and Content of Periodic Reports (Oct. 16, 2008), pp. 18-20.

in view of the small increase in the proportion DPS'd, the percentage increase in unit mail processing cost for saturation letters is far larger than one would expect.

Carrier Route Letters

Carrier route letters now have an automation-compatibility requirement. Nevertheless, their **mail processing** cost increased from 5.694 cents in FY 2007 to 12.139 cents in FY 2008, an astounding one-year increase of 6.445 cents, or 113.19 percent. The CCCS shows relative stability in the proportion of these pieces DPS'd — 52.02 percent this year, and 54.04 percent last year. The corresponding proportions for **rural** routes, excluding boxholder mail, are 48.44 percent and 47.92 percent, respectively.[27] Assuming these figures are approximately correct, the insignificant change in DPSing does **not explain** an increased **mail processing** cost of 113.19 percent.

The **carrier** cost for carrier route letters, at 9.525 cents, is up 64.42 percent from FY 2007. This rather large cost increase also needs an explanation.

Additionally, in some instances, relationships among categories raise questions worthy of discussion. Considering the sum of mail processing costs and carrier costs in FY 2008, the cost of 5-digit automation letters is 7.651 cents and the same cost for carrier route letters is 21.664 cents. Both categories must be automation compatible. In cases where both are DPS'd, it would seem that the costs of these two categories should be close. If they are not DPS'd, the 5-digit automation letters would receive one additional sort. Alternatively, one could be DPS'd and the other could be cased. In any event, for two categories of letters with

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[27] *See* proportions in the "RCSDALs" tab of the UDCInputs files in USPS-FY08-19 and USPS-FY07-19.

characteristics that appear rather similar, this 14.031-cent cost difference merits an explanation.

Saturation Flats

In FY 2008, at 1.89 cents, saturation flats saw an increase in **mail processing** cost of 23.74 percent, relative to FY 2007. Here, since 1.89 cents is only 0.42 percent above the figure projected for FY 2008 in Docket No. R2006-1[28], it may be that the FY 2007 figure for mail processing cost was out of line. The corresponding increase for **carrier** cost is 19.53 percent. The CCCS shows that 22.7 percent of these pieces were cased in FY 2008 versus 25.7 percent in FY 2007,[29] which would support a cost reduction, rather than an increase. For rural carriers, the proportion cased does not affect costs.

B. City Carrier Street Costs Lack Transparency

At present, as more and more letters are DPS'd, and in the future, as flats become FSS'd, carrier activities are being affected. Given this, and the fact that city carriers represent a large proportion of the Postal Service's costs, it is important that the carrier costing system not only provide reliable costs, but also that it be capable of accurately tracking the costs of a system that is changing.

General perceptions of carrier activities cannot provide costs, although a serious analysis of such activities should be able to provide a narrative explanation of what is occurring to generate the costing results. For example, one could hypothesize the following:

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[28] Docket No. R2006-1, PRC-LR-15, file PRCECRNECRRates.xls, tab "COST".

[29] *See* proportions in the "CCSDALs" tab of the UDCInputs files in USPS-FY08-19 and USPS-FY07-19.

First, **trays of DPS'd letters** should be a key element, perhaps **the** key element, in carrier activities, and the marginal street cost of an additional letter in a batch of letters for a stop should be very low.

Second, an additional key element should be **trays of flats**, perhaps with interspersed letters that have been cased, and in the future FSS'd flats, with a marginal cost that is higher than that for letters.

Third, **"sequenced"**[30] **letters and flats** should be in trays that are reasonably near other trays on carrier vehicles, but should be viewed as requiring an extra reach, usually for one piece, which then needs to be combined with other pieces.

Fourth, handling costs of **parcels** should be higher, partly because they are in a different location and partly because they sometimes are taken to the recipient's door.

As a greater proportion of letters are DPS'd, marginal street costs of DPS'd letters should decline, and the marginal street cost of a DPS'd letter should be lower than the marginal street cost of a sequenced letter.

In Docket No. R2006-1, a number of interrogatories were propounded about these various relationships, and the Postal Service responded with cost estimates for some of the activities involved,[31] and those cost estimates raised important questions about relative sizes of costs and cost changes. Although mailers currently do not have discovery rights in

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[30] "Sequenced" refers to pieces of saturation mail that carriers take, without casing or DPSing, directly to the street as an extra bundle.

[31] *See* Docket No. R2006-1, Response of Postal Service witness Kelley to VP/USPS-T30-22 (June 29, 2006 and errata filed Aug. 10, 2006).

Commission Annual Compliance Reviews, in order to facilitate analysis and to permit tracking of cost elements over time, Valpak believes that the Postal Service should submit (for the fiscal year under review and the immediately prior fiscal year) both in-office and street time unit cost estimates for: (i) letters that are DPS'd; (ii) letters that are cased; (iii) letters that are sequenced; (iv) flats that are FSS'd; (v) flats that are cased; (vi) flats that are sequenced; (vii) parcels; and (viii) DALs. Such cost presentations would enable the Commission and mailers to gauge the reliability of the cost data, and whether changes in costs correlate with changes in operations.

IV. DETACHED ADDRESS LABEL DATA SHOULD BE MORE TRANSPARENT, AND ANY NECESSARY CORRECTIONS TO THE UNIT COSTS OF SATURATION LETTERS AND FLATS SHOULD BE MADE.

A. Volume and Revenue Data

In May 2007, the RPW system began recording volumes and revenues of DALs as separate items. According to the Billing Determinants filed with the FY 2008 Annual Compliance Report, 901,549,000 DALs were entered during FY 2008. USPS-FY08-04. The vast majority (99.9 percent) of DALs accompanied saturation commercial flats, as shown here in Table 4.

Table 4

Volume of DALs, FY 2008
(thousands)

Host piece	DAL volume
Saturation commercial flats	900,696
Nonprofit saturation flats	837
Saturation commercial parcels	11
Nonprofit saturation parcels	5
TOTAL	901,549

Interestingly, the 900,696,000-figure constitutes just 8.1 percent of 11.052 billion total saturation commercial flats.

The Billing Determinants also report total DAL revenues of $14.1 million. The average per-piece revenue was 1.56 cents, a weighted average of the two surcharges in effect during the year — 1.5 cents until May 12, and 1.7 cents thereafter. These revenues are consistent with the DAL volume shown *supra*.

However, the volume implied by items in the DAL adjustment spreadsheet differs significantly from the volume of DALs shown in the Billing Determinants;[32] *see* Table 5, below.[33]

[32] USPS-FY08-10, UDCmodel08.xls, tab 1a.DAdjustment, cells K13 and K14 (also cells K19 and K20).

[33] These discrepancies were raised in Valpak's Motion for Issuance of Commission Information Request Concerning Core Costing Data on Detached Address Labels (Jan. 13, 2009), p. 4, and Valpak's Suggested Questions for Discussion at the Technical Conference of January 26, 2009, or in the Alternative, Motion for Commission Information Request (Jan. 21, 2009), p. 2.

Table 5

Actual and Implied DAL Volume, FY 2008
(thousands)

1. Total Volume, per Billing Determinants		901,549
2. Implied Volume:		
a. Total ECR saturation flats	11,517,282	
b. ECR attached label saturation flats	10,876,458	
c. Difference, saturation flats w/DALs		640,824

All volumes on the DAL adjustment spreadsheet referenced above match volumes shown in the Billing Determinants, **except** the figure shown in Table 5, row 2-b, "ECR attached label saturation flats" (10,876,458).[34] This figure implies a DAL volume of 640,824,000 for saturation commercial flats, as shown in row 2-c. The source of the implied volume of DALs, 640,824,000, appears to be certain proportions applied to CCCS and RCCS volumes, shown on tab "DALs" of the file UDCInputs08.xls, in USPS-FY08-19. Of this total, it is estimated, based on information developed by ADVO in Docket No. R2005-1, that 39,342,000 DALs are delivered on highway routes and to post office boxes.[35]

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[34] The term "ECR attached label saturation flats" refers to flats with on-piece addresses, for which DALs are not required. Valpak has been unable to ascertain the source of the datum for attached label saturation flats. It may be just a residual, *i.e.*, the difference between total saturation flats and the estimated number of DALs.

[35] The proportion delivered to highway routes and post office boxes comes from ADVO-LR-1, Docket No. R2005-1. Two other proportions are shown on tabs "CCSDALs" (city) and "RCSDALs" (rural) of the same file. The latter two tabs have hard-wired inputs that come, apparently, from the city and rural data collection systems.

In an effort to "clarify" what the Commission perceived as a change in methodology, the Postal Service submitted a further explanation concerning the adjustment for DAL costs.[36] This response of the Postal Service identifies specific spreadsheets, and points to certain cells within those spreadsheets where pertinent data can be found.[37] The data discussed in the Postal Service response are summarized below in Table 6. These data, which pertain only to the volume of DALs delivered by city and rural carriers, account for 601.5 million DALs.[38] However, in conjunction with the 39.342 million DALs delivered to rural routes and post office boxes, the result is consistent with the implied volume of DALs in Table 5.

Regrettably, the DAL volume data of 640.8 million shown in Table 5 do not correlate with the Billing Determinants volume of 901.5 million (Table 4). As between the 901.5 million DALs in the Billing Determinants and the 640.8 million DALs collectively delivered by the various carrier cost systems, a rather substantial gap exists.[39] The question that needs to

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[36] Responses of the United States Postal Service to Commission Order No. 169 (Jan. 21, 2009), item 4, pp. 9-12.

[37] The Postal Service response illustrates the type of Postal Service narrative necessary to understand complex, hard-to-decipher workbooks. *See* Docket No. RM2008-4, Valpak Direct Marketing Systems, Inc., and Valpak Dealers Association, Inc., Initial Comments Regarding Proposed Rules Prescribing Form and Content of Periodic Reports (Oct. 16, 2008), pp. 18-20.

[38] The 601.5 million volume provided by the Postal Service in response to Order No. 169 supports an asserted shift of $15 million from saturation letters to saturation flats.

[39] Such apparent inconsistency in data pertaining to DALs is confusing and not conducive to transparency. Requiring future ACRs to explain and reconcile such obvious differences would be a decided improvement, and would facilitate review in the short time available. Nevertheless, we are mindful of the Postal Service's statement that "this year's ACR is a first-time effort at trying to apply the standards of the PAEA ... It seems likely that this effort will provide further opportunities for all participants to learn more about the most appropriate ways for this process to be conducted." FY 2008 ACR at 2.

be addressed concerns why the city and rural systems, along with the ADVO-estimated proportion for highway routes and post office boxes, yield an estimate (640,824 thousand) that is so far below the Billing Determinants number (901,549 thousand).

Table 6

**Volume and Cost of DALs,
Per Response to Order No. 169, Item 4**

	Volume (mill.)	Total Cost Shifted (mill.)	Unit Cost (cents)
City Carriers			
Regular Delivery (incl. DPS)	349.2	6.85	1.96
Sequenced	109.8	1.64	1.49
Subtotal, City Carriers	459.0	8.49	1.85
Rural Carriers			
DPS	10.8	0.19	1.80
Other Letter	70.5	3.81	5.40
Box Holder	61.2	2.51	4.10
Subtotal, Rural Carriers	142.5	6.51	4.57
TOTAL	601.5	15.00	2.49

With respect to DAL City Street Costs, the Postal Service Response states that

> The city DAL volume is located in **USPS-FY08-NP14** workbook **CS06&7** worksheet **7.010** [sic]…. The city DAL letter volume is 349.2 M (cell F10+cell G10) and the DAL sequenced volume is 109.8 M (cell H12). As is consistent with the established methodology, this is an estimate of the volume of ECR Saturation Letters that are DALs. [Responses of the United States Postal Service to Commission Order No. 169 (Jan. 21, 2009), item 4, p. 10 (emphasis original).]

The estimated total volume of DALs delivered by city carriers is thus 459.0 million. The same spreadsheet shows the total volume of saturation flats delivered by city carriers to be 8,457,525, which is 73.4 percent of the total flats per the Billing Determinants shown in Tables 4 and 5, above. However, the 459.0 million DALs delivered by city carriers is only 50.9 percent of the total DALs per the Billing Determinants shown in Table 4 above. The discrepancy is obvious.

If city carriers delivered 73.4 percent of all DALs — *i.e.*, in the same proportion as flats — they would have delivered 662.0 million DALs. Because the Postal Service makes no attempt to reconcile its volume data for DALs found in detailed spreadsheets with the Billing Determinants, it would appear that the "established methodology" in the above-referenced spreadsheet(s) results in **underestimating:**

(i) the total volume of DALs;

(ii) the dollar amount that should be shifted from saturation letters to saturation flats; and

(iii) the coverage of saturation letters.

B. Handling of DALs

Of the DALs that remain in the network, the Postal Service is now DPSing a substantial proportion.[40] Moreover, further increases in this proportion appear likely, given the Postal

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[40] Data in this year's ACR show that 45.1 percent of all DALs on city routes are DPS'd, 30.9 percent are cased, and only 23.9 percent are taken directly to the street. On rural routes, only 13.5 percent of DALs are DPS'd. If the total DALs handled by city carriers is 662 million (see above), 45.1 percent implies a total of almost 300 million DALs DPS'd just for city carriers.

Service's interest in automation and the fact that all DALs (except those with a simplified address) will be required to be automation compatible.[41] DPSing of DALs involves certain cost implications, as discussed *infra*, that did not arise when all DALs were handled only by carriers.[42]

DPSing is mail processing which occurs only at central processing plants. Since many DALs are known to be entered at DDUs, DPSing also implies a need to transport DALs to the plants from the DDUs. Costs associated with DPSing obviously include direct labor and piggyback costs, as well as transportation from the plant to the DDU, and, for DALs entered at the DDU, should include backhaul transportation as well.

What Valpak has been unable to verify from the publicly-available data is how Postal Service's estimate of the DAL costs for **mail processing** and **local transportation** costs are attributed. Because the source files feeding into the final costs are both detailed and complex (and partly reside in the nonpublic annex[43]), and because the Postal Service nowhere presents a summary table or analysis of the segments and components showing the full cost of handling DALs (*see* next section), it cannot be ascertained (at least not within the time available)

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[41] *See* Comments submitted by Valpak to the Postal Service in response to Postal Service Notice of Proposed Rule, New Automation Requirements for Detached Address Labels, 73 *Fed. Reg.* 50,584 (Aug, 27, 2008); and Postal Service Notice of Final Rule, New Automation Requirements for Detached Addressed Labels, 74 *Fed. Reg.* 2,866 (Jan. 16, 2009).

[42] All known errors of the past were in the area of carrier costs, and the adjustment in this years's ACR is focused solely on carrier costs. *See* Responses of the United States Postal Service to Commission Order No. 169 (Jan. 21, 2009), item 4, pp. 9-12.

[43] *See* discussion of the nonpublic annex in Preliminary Matters Section, *supra*.

whether these DPS and local transportation costs are being properly charged to saturation flats, or erroneously charged to saturation letters.[44]

C. DAL Cost Adjustment, Passthrough, and Cost

Spreadsheets containing the distribution of carrier costs accomplish removal of those DAL costs from saturation letters in a separate step, or adjustment. This carrier cost adjustment causes:

- the cost of **saturation letters** to **decline** from 4.394 cents to 3.943 cents, and
- the cost of addressed **saturation flats** to **increase** from 4.324 cents to 4.481 cents.[45]

Whether further adjustments are called for, as discussed in the preceding section, is not known.[46]

So far as Valpak has been able to determine, the FY 2008 ACR contains neither an explicit presentation showing either the **full total cost** of handling DALs, nor an explicit **per-piece cost** for DALs. A summary table,[47] however, does show a carrier cost (in-office and street combined) for **all saturation flats** (with and without DALs) of 4.623 cents and, separately, a carrier cost for **addressed saturation flats** of 4.481 cents. Using the volumes of

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[44] *See* Valpak Motion for Issuance of Commission Information Request Concerning Core Costing Data on Detached Address Labels (Jan. 13, 2009), pp. 2-3.

[45] *See* spreadsheet UDCmodel08.xls in USPS-FY08-10, tab 1a.DAdjustment, column P.

[46] The cost coverage of saturation letters and flats shown on page 22 of FY 2008 ACR is incorrect; *see* attachment to Request of the United States Postal Service for Modification of Commission Order No. 169 (Jan. 16, 2009).

[47] *See* USPS-FY08-10, UDCmodel08.xls, tab 1.Table 1, cells G79 and G80.

flats with and without DALs in the accompanying spreadsheet, these two figures imply a **carrier cost** for DALs of 2.56 cents.[48] The average unit cost estimate, 2.49 cents, shown *supra* at the bottom of the last column in Table 6, is close to this estimate. Depending on which cost estimate is used, the current surcharge of 1.7 cents would represent between 66.4 and 68.3 percent of the **carrier** cost that **is shifted** from saturation letters to saturation flats.

The **shifted carrier cost** does **not** by any means represent the **full cost** of DALs, hence it is not an estimate of the passthrough of DAL costs into rates. In addition to shifted carrier costs, handling of DALs also involves **other costs that are not shifted**, because from the outset they are correctly charged to saturation flats (but not necessarily to DALs). These other costs include:

- **in-office casing** costs by carriers (Segment 6), as well as
- applicable **mail processing** costs for **DPSing**, and
- costs for **local transportation** between DDUs and SCFs — assuming that these latter costs are in the first instance correctly being charged to flats and do not need to be shifted (*see* discussion *supra*, in Section B).

The passthrough of DAL costs into rates is not a matter of worksharing. Nevertheless, the passthrough is a pertinent consideration when establishing or evaluating rates, and the passthrough of costs represented by the DAL rate should be just as available as are passthroughs for the various rate elements in Periodicals, which also are not matters of worksharing.

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[48] The volumes in the spreadsheet are not consistent with the Billing Determinants, as discussed *supra*, and the implied cost of 2.56 cents, as well as the 66.4 percent passthrough, must be considered speculative. Enhanced transparency in the Postal Service's ACR could avoid the need for speculation by mailers in the narrow 30-day window for comments.

V. THE FY 2008 ACR IMPROVES REPORTING ON NEGOTIATED SERVICE AGREEMENTS, BUT IS STILL LACKING.

The FY 2008 Annual Compliance Report mentions negotiated service agreements ("NSAs") for market dominant products briefly on page 10, and again, in more detail, on pages 48-49. It also provides data and information on those NSAs in USPS-FY08-30. Reporting of NSAs in the current ACR is a decided improvement over the FY 2007 ACR, which contained virtually no data, but only a short paragraph referring to periodic reporting of NSAs and an ambiguous reference in one attachment (later clarified in response to a Commission Information Request).

A. Status of Six Active Market Dominant NSAs

The FY 2008 ACR summarizes the results of six market dominant NSAs operational during all or part of FY 2008.

- Two or these NSAs (Chase/Bank One and HSBC) were not active in FY 2008.
- The NSA with Discover expired one quarter into FY 2008, with no rebates paid over that period.
- Of the remaining three NSAs, Bookspan and HSBC met threshold volumes to qualify for discounts, but Lifeline Screening did not.
- A seventh NSA with Bank of America Corporation ("BAC") was in effect during the second half of FY 2008 and is discussed *infra*.

The FY 2008 ACR states that when gains from NSAs are measured using the "Panzar/Wolak approach favored by the Commission," the cumulative net benefit from all active NSAs in FY 2008 was a negligible **$73,000**.[49] The information, broken down by the

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[49] FY 2008 ACR, p. 49. The FY 2008 ACR also states that "[u]sing the valuation method traditionally employed by the Postal Service, the calculations in USPS-FY08-30 show a cumulative net benefit (after rebates are deducted) of **$1.776 million**." *Id.* (emphasis added).

four agreements on which the Postal Service bases its net benefit, is shown in the following table.

Table 7

NSA (Contract period)	Net value to USPS	Discounts paid
Discover (Jan. – Dec.)	$ 67,856	$ 0
Bookspan (June – May)	$ (78,848)	$ 357,156
Bradford (June – May)	$ 84,221	$ 80,626
Lifeline Screening (Aug. – July)	$ 0	$ 0
Totals	**$ 73,229**	**$ 437,782**

B. Bank of America Corporation NSA

The FY 2008 ACR finesses issues that have arisen from the BAC NSA, simply stating:

> Because Bank of America was only in effect for part of FY 2008, however, and had not reached its first anniversary by the end of the fiscal year, its **preliminary data are not included** in this ACR. [FY 2008 ACR, p. 48, emphasis added.]

The BAC NSA specifies that payments are to be calculated quarterly and paid within 45 days after the end of each quarter, which means payments either were made or at least accrued in FY 2008.[50] The Postal Service acknowledges that it has "preliminary data," but chose not to report it. Public release of financial information is not scheduled to occur until after the close of the first contract year.

[50] Docket No. MC2007-1, Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement a Baseline Negotiated Service Agreement with Bank of America Corporation, Attachment F, p. 13.

The Commission's preliminary ACR rules proposed that NSA reporting be on a **contract year** basis. In response, the Postal Service has suggested that it be allowed to report on NSAs on a **fiscal year** basis. *See* Docket No. RM2008-4, Postal Service Initial Comments, p. 36. If the Commission adopts the Postal Service suggestion and the Postal Service is permitted to subsequently report data for the BAC NSA for FY 2009 on a **fiscal year** basis, Valpak would ask the Commission to require that data for FY 2008, which are omitted in the FY 2008 ACR, be included as a separate item.

C. General Compliance with 39 U.S.C. Section 3622(c)(10)

In an effort to demonstrate that NSAs for market dominant products are compliant with PAEA, the Postal Service asserts:

> The NSAs **for which FY08 data are included** in this ACR also did not cause unreasonable harm to the marketplace, because **similar functionally-equivalent NSAs were, or could have been, made available** to similarly-situated mailers. [FY 2008 ACR, p. 49 (emphasis added).]

In a brief footnote, the Postal Service concedes that Capital One Services, Inc. ("Cap One") could not get a functionally-equivalent NSA, and a complaint docket is pending. *See* Docket No. C2008-3. The essence of the Cap One complaint, of course, is that Cap One claims to be similarly situated to BAC, and seeks an NSA with terms identical (ergo, functionally-equivalent), to the one with BAC.

The Postal Service obviously does not want to extend to other mailers the NSA with BAC— at least not on terms identical to, or as favorable as, those given to BAC. Valpak suggests that the Postal Service's carefully-worded statement regarding compliance is only partially true because it does not address whether **all** NSAs in effect during FY 2008 "were, or could have been, made available to similarly-situated mailers."

D. Preferability of Changes to the General Tariff Schedule and Niche Classifications

The information provided on NSAs in the FY 2008 ACR, as well the Cap One complaint proceedings with respect to the BAC NSA, reinforces Valpak's long-standing belief that for market dominant products either changes in the general tariff schedule or niche classifications are usually preferable to NSAs because they are available simultaneously to all eligible mailers, and either of these two options preserves a level playing field among mailers at all times.[51] A good example of a mutually-beneficial niche classification was the Commission's approval regarding averaging for weight-averaged nonletter-size business reply mail in Docket No. MC99-2.

VI. COVERAGES FOR SATURATION PRODUCTS ARE TOO HIGH.

This docket has precedential aspects, as it is the first annual compliance review of prices established by the Postal Service under PAEA.[52] Standard Mail contains six products,

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[51] *See generally* Docket No. MC2002-2, Valpak Initial Brief (Apr. 3, 2003), pp. 31-32; *see also* Matthew H. Robinson, Margaret Cigno, and J.P. Klingenberg, Negotiated Volume Discounts in a Regulated Post, presented at the Center for Research in Regulated Industries' 26th Annual Eastern Conference, Skytop, Pennsylvania, May 16-18, 2007 (mimeo) http://www.prc.gov/prc-docs/library/refdesk/techpapers/prcstaff/NSA paper 2007.pdf.; John Haldi and William J. Olson, Evaluating Negotiated Service Agreements for Market Dominant Products Under PAEA, presented at the Center for Research in Regulated Industries' 27th Annual Eastern Conference, Skytop, Pennsylvania, May 15, 2008) (mimeo) http://lawandfreedom.com/site/postal/NSAs_PAEA.pdf.

[52] Furthermore, the Commission's determination creates a "rebuttable presumption" of compliance with PAEA with respect to any complaint case that may be filed

and these products are interdependent since the price cap is applied at the class level. The coverage relationships among these six Standard Mail products need to be consistent with guidance provided in PAEA.

A. Rate Background

Price changes were recommended for all subclasses of mail and special services by the Commission in Docket No. R2006-1 on February 26, 2007. The Commission recommended larger rate increases for certain flats than the Postal Service had initially proposed.[53] The Board of Governors asked for reconsideration of Standard Mail flats rates. *See* Initial Statement of the United States Postal Service on Reconsideration, Mar. 28, 2007. On reconsideration, the Commission found it in order to recommend what it called "transitional rate relief" (Second Opinion and Recommended Decision on Reconsideration, May 25, 2007, p. 30) for the flats focused on by the Governors. However, on June 19, 2007, the Governors rejected this recommendation, after which rates originally recommended by the Commission went into effect.

The rates being reviewed in the instant docket were proposed by the Postal Service on February 11, 2008, found consistent with PAEA (including the CPI cap of 2.9 percent) by the

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regarding the prices and services in FY 2008. *See* 39 U.S.C. § 3653(e).

[53] "[T]those catalogs which pay the piece rates for automation flats entered at Section Center Facilities (SCF) closest to the delivery destination (DSCF) face a 41.1 percent increase under the Commission's proposal, but would have experienced an 18.5 percent increase under the Postal Service's proposal." [Docket No. R2006-1, Decision of the Governors (Mar. 19, 2007), p. 9.]

Commission on March 17, 2008 (and April 9, 2008), and implemented by the Postal Service on May 12, 2008.

For the Standard Mail class, the increase was 2.838 percent, and the increases for the individual Standard products were as follows:

- Letters — 3.39 percent;
- Flats — 0.86 percent;
- Parcels and NFMs — 9.66 percent;
- High Density/Saturation Letters — 1.66 percent;
- High Density/Saturation Flats and Parcels — 2.09 percent; and
- Carrier Route Letters, Flats and Parcels — 2.99 percent. [Commission Order No. 66 (Mar. 17, 2008), at 31.]

The Postal Service justified **letter** and **flat** price changes as follows:

> The price changes for the Letters and Flats products reflect the Postal Service's decision to moderate the increases for catalogs and other flats mailers due to the large price increases they experienced last year (Factor 3). To moderate the price increases for Flats, the Postal Service has increased the prices for Letters slightly more than the cap. [Notice of Market-Dominant Price Adjustment (Feb. 11, 2008), p. 15].

The decision of the Postal Service to propose a relatively low percentage increase for flats was unusual, justified only by the fact flats received a relatively large increase in Docket No. R2006-1. Neither elasticity, nor costs, nor coverage was discussed. The estimated cost coverage for flats was 103.02 percent, and for letters was 216.48 percent.[54] These coverages

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[54] Costs for mail processing (dropship corrected) and delivery are from PRC-ACR2007-LR5 plus other costs from Docket No. R2006-1, USPS-LR-L-135. In the FY 2008 ACR, at 23, the Postal Service states that "[s]ince this is the first time the Postal Service has had CRA-level detail for these products, there is no prior data for comparison." A similar statement is made at the top of page 31 (*id.*). Actually, at a suitably useful level of precision, most or all of the costs needed for the products in Standard Mail could have been developed last year, just as estimates were prepared in Docket No. R2006-1. *See* Docket No. R2006-1, Direct Testimony of Robert W. Mitchell, VP-T-1, pp. 160-161.

show that (a) rates for **flats** were unduly low and perilously close to being below cost, and (b) rates for **letters** were extremely high.

The Postal Service described increases proposed for **Saturation and High Density Mail** as "modest, below-cap increases." (*Id.*, p. 16.) The Postal Service "widen[ed] the gap between saturation letters and flats brought to the Destination Section Center Facility," stating that "[t]his change will reduce the incentive for some mailers to convert letter-size mail pieces to flats, which are not as efficient to process and deliver" (*id.*, p. 17).

B. PAEA Standards for Compliance

Selected PAEA objectives and factors are identified or discussed briefly below:

(b)(1)"To maximize incentives to reduce costs and increase efficiency."

(b)(5) "assur[ing] adequate revenues, including retained earnings, to maintain financial stability." One implication of this objective is that if profitability of one set of rates instead of another is not considered, the Postal Service could jeopardize its ability to achieve financial breakeven under the cap, and require recognition of elasticities.

(b)(8) "To establish and maintain a just and reasonable schedule for rates and classifications, however the objective under this paragraph shall not be construed to prohibit the Postal Service from making changes of unequal magnitude within, between, or among classes of mail." The only way to make unequal changes among classes of mail would be to "bank" some of the allowed cap for a class.

(c)(1) "the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery." The requirement that value be taken into account is normally taken to refer to elasticity. The theory of value has been established and agreed upon for over one hundred years. Within a class such as Standard Mail, however, the collection, mode of transportation, and priority of delivery normally would be the same for each product within the class.

(c)(3) "the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters." In general, considering the effect of rate increases is a temporary matter. That is, if a higher rate were appropriate, one might get there in four steps instead of two, but this would not be a reason to provide permanent favor to a particular category.

(c)(4) "the available alternative means of sending and receiving letters and other mail matter at reasonable costs."

(c)(7) "the importance of pricing flexibility to encourage increased mail volume and operational efficiency" should be considered. Along with (b)(1), noted above, this factor points to the economic efficiency of the postal sector, and this interpretation is supported by the fact that one set of rates instead of another cannot affect the technical efficiency of production. That is, the cost of sorting a letter or parcel is the cost of sorting a letter or parcel, and it is not affected by the rate for it.

(c)(8) "the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail."

Taken together, these PAEA considerations point to giving considerable weight to the **profitability** and **economic efficiency** of proposed rates. Fortunately, issues of profitability and economic efficiency suggest rates that are nearly the same. That is, if a profit maximizing set of rates is selected in case after case, the rates that result are "Ramsey optimal" for a certain profit level under a cap, and thus have strong efficiency properties. These matters were recognized in Docket No. RM2008-4, where the Commission stated:

> Under the PRA, rule 102 did not require the Postal Service to provide information about the price elasticity of demand for postal products. The PAEA, however, requires that "information" on mail volumes be provided for market dominant products. *See* 39 U.S.C. 3652(2)(A). Further, many of the objectives and factors that the PAEA directs the Commission to consider in establishing a regulatory system for market dominant products involve value of service considerations, either explicitly (*see* sections 3622(c)(1) and 3622(c)(8)), or implicitly (*see*

> sections 3622(c)(3) and 3622(c)(4)). The most objective evidence of a product's value of service is its **price elasticity of demand**. Accordingly, demand elasticities provide useful guides for evaluating how well these factors have been recognized in rates. Knowledge of price elasticities of demand is also essential for evaluating the impact of rates on **allocative efficiency**. Allocative efficiency is a goal embodied in sections 3622(b)(1) and 3622(b)(5).
>
> The PAEA requires the Commission to ensure that the institutional costs of the Postal Service are allocated appropriately between market dominant and competitive products. *See* sections 3622(b)(9) and 3633(a)(3). Doing so in a way that takes allocative efficiency into account requires the Commission to have knowledge of the relative price elasticities of both market dominant and competitive products. [Notice of Proposed Rulemaking Prescribing Form and Content of Periodic Reports, Order No. 104 (Aug. 22, 2008), p. 10, footnote omitted (emphasis added).]

As the Commission explains, notions of **economic efficiency** (equivalently, allocative efficiency) depend on **elasticities** in the markets, by way of which markets provide information on the value placed on each product. If there is no value to draw on through a price increase, the market will abandon the product when the price is increased, and elasticity will be high.[55] On the other hand, if there is value to draw on through a price increase, the market will continue buying the product and elasticity will be low.

If profitability of one set of rates instead of another is being considered, or if economic efficiency is being considered, the key measure of relevance is either the markup or the

[55] Elasticities are generally negative in value, but are often discussed in terms of their absolute value. Thus, an elasticity of -0.9 is said to be a higher elasticity (more elastic) than an elasticity of -0.3.

traditional cost coverage.[56] A product with a relatively high elasticity should have a relatively low cost coverage — the converse also being the case. It is not true that a product with a high elasticity should always receive a lower percentage rate increase; it should just receive a relatively low percentage rate increase until its coverage gets to a relatively low level.

One could argue that a default position would be for each product to have the same cost coverage. This would be equivalent to a naive department store that purchased goods and marked them all up 50 percent. Movements from this default position would be based on profitability to the Postal Service (this being helpful to its interest in achieving financial breakeven),[57] market considerations, value of service, elasticity, and matters of national policy. Under the category of national policy, one would ask whether some interests of the nation lean toward favoring one product within a class at the expense of another. The issue of "expense of another" is important because, under a cap, assuming the cap is fully used, a lower rate increase can be given to one product only if a higher rate increase is given to at least one other product.

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[56] These measures have been commonplace in Commission proceedings. A cost of 10 and a rate of 16 implies a markup of 60 percent and a cost coverage of 160 percent. Some of the Ramsey formulas are simpler if the markup fraction is used, this being the markup amount over the revenue, or 60 over 160, yielding 37.5 percent. The measure used does not affect the outcome.

[57] Mailers should be viewed as having a legitimate interest in the Postal Service watching out for its profitability. Not only does this seem consistent with the structure of PAEA, it would be expected to be the case that perpetual deficits would lead to higher rates for the mailing community.

C. Review of Reported Coverages

The Postal Service FY 2008 ACR discussed Standard Mail on pages 21-32 in a summary manner. As originally appearing in the CRA, and as clarified in the Postal Service's response on January 21, 2009 to Commission Information Request No. 1 to be accurate despite the text in the ACR[58], the Standard Mail product coverages for FY 2008 are currently reported to be:

Product	Coverage
HD/Sat. Letters	229.1
HD/Sat. Flats & Parcels	255.6
Carrier Route	150.5
Letters	192.7
Flats	94.2
Parcels & NFMs	79.6

The Postal Service discussion does not mention any policy reason for favoring one Standard Mail product at the expense of others, except for the statutory preference for nonprofit mail. It points out several times that Standard Mail receives a lower level of service than, for example, First-Class Mail, but it does not differentiate the service received by the various Standard Mail products.[59] Little or no discussion is provided on how high specific coverages should be relative to others, although there is some discussion of certain rates that should be above or below others. In an overview of the Standard Mail products, it states: "Furthermore, the Postal Service does not want to diminish the importance of each product making a positive

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[58] The following coverages were originally reported in the FY 2008 ACR, p. 22: HD/Sat. Letters — 208.9; HD/Sat. Flats & Parcels — 265.4; Carrier Route — 150.2; Letters — 192.7; Flats — 94.1; and Parcels & NFMs — 79.6.

[59] In reference to cost coverages and the attendant contributions, the Postal Service uses the term "reasonable" eight times, and the word "fair" eight times.

contribution, and will work to achieve that result."[60] FY 2008 ACR, p. 23. Nothing specific is said about how far above 100 percent any particular coverage should be.

On January 16, 2009, the Postal Service presented its demand analysis.[61] It shows elasticities for the two former subclasses (product aggregates), with their nonprofit components separated:

Standard Regular -0.31	Standard Nonprofit -0.18
ECR -0.91	ECR Nonprofit -0.53

The FY2008 ACR provided limited discussion of the six Standard Mail products (pp. 23-32). It emphasizes alternatives and market considerations for High Density/Saturation Letters and High Density/Saturation Flats and Parcels. It points out that although Carrier Route has been a part of ECR, its market characteristics would be more akin to those products in Standard Mail that are less presorted than the High Density and Saturation products. Little is said specifically about letters or parcels. For flats, it notes that the small percentage price increase last year was due to the large percentage rate increase in Docket No. R2006-1, that alternatives exist, and that a large increase could cause erosion of volume. All this falls short

[60] Although PAEA does not require each individual product (as distinguished from class) to cover its attributable cost, the Commission's Report on Universal Postal Service and the Postal Monopoly (Dec. 19, 2008), p. 134, notes that "A profit-maximizing Postal Service would raise prices on loss-making market dominant products to at least break even."

[61] Letter from R. Andrew German, Managing Counsel, Pricing & Product Development, United States Postal Service to Steven W. Williams, Secretary, Postal Regulatory Commission of January 16, 2009.

of arguing or presenting evidence that the elasticity of flats is high.[62] Accordingly, several conclusions seem obvious:

1. In view of their high cost coverage and high elasticity, rates for **both High Density/Saturation Letters** and **High Density/Saturation Flats and Parcels** are too high. Both products should receive relatively low percentage increases in future rate adjustments.

2. **Letters** have a cost coverage that is unduly high, which raises compliance questions. Letters are candidates for rate increases that are below average.

3. **Flats**, being below cost, without evidence of high elasticity, are substantially out of compliance with PAEA. Flats should receive substantial rate increases in future rate adjustments.

D. The Estimated Coverage of Saturation Letters Appears Understated

The analysis above is based on Postal Service coverage estimates. However, for at least three reasons, the coverage on High Density/Saturation Letters in fact may be significantly higher than that calculated by the Postal Service.

1. The "Admittedly Simple" Cost Adjustment for Letter-Shaped Pieces That Pay Flat Rates Could Not Be More Conservative

Initially, the cost of all letter-shaped pieces are attributed to letters, because the Postal Service's costing systems cannot distinguish between letter-shaped pieces that pay letter rates and those that pay flat rates. The result of allocating all costs to letters while some volumes and revenues are allocated to flats is a mismatch. Valpak concurs with the Postal Service that

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[62] Some observers have pointed to reductions in flats volumes after the rates of Docket No. R2006-1 were implemented as evidence that the product is elastic. However, when the analysis is corrected for the increase in paper prices, the increase in fuel prices, the decline in the state of the economy, the lightweight flats that changed their format into letters, and the fact that several catalogers went out of business, it is not clear that a case can be made for a high elasticity.

an adjustment for this mismatch is entirely appropriate, because it helps keep together the revenues, volumes, and costs for each product.[63]

The Postal Service adjusts the cost of saturation letters by (i) deducting an estimate of the cost of letter-size pieces whose revenues and volumes are recorded as flats when entered, and (ii) shifting the cost of those pieces to flats. Since this adjustment reduces the cost of saturation letters while leaving revenues unchanged, the cost reduction increases coverage. The **209.03 percent** coverage of **saturation letters, before** the adjustment, increased to **229.08 percent after** the adjustment.[64]

The approach for adjusting costs was described in the Postal Service's Responses to Order No. 169, as "admittedly simple." Since letter-shaped pieces entered as flats constitute 8.8 percent of total letter volume, 8.8 percent of letter costs are shifted to flats. The implicit assumption underlying this approach is that heavy-weight, non-machinable letter-shaped pieces have the same average unit cost as lighter-weight, machinable letters. However, this "simplistic adjustment" constitutes perhaps the most conservative adjustment conceivable. A higher proportion of costs would be shifted under virtually any other, possibly more realistic adjustment, for reasons explained below.

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[63] *See* Request of the United State Postal Service for Modification of Commission Order No. 169 (Jan. 16, 2009), pp. 2-7; Responses of the United States Postal Service to Commission Order No. 169 (Jan. 21, 2009), item 1.

[64] The FY 2008 ACR, page 22, indicates a coverage for saturation letters of 208.9 percent. This was corrected by the attachment to the Request of the United State Postal Service for Modification of Commission Order No. 169 (Jan. 16, 2009). At the technical conference held January 26, 2009, attendees were advised to rely on coverages shown in the CRA.

Succinctly, any letter-shaped pieces whose weight exceeds 3.5 ounces are considered "non-letters," and must pay the flat rate. A weight over 3.5 ounces exceeds the capability of existing letter-sorting equipment and makes them non-machinable. Further, since they are rated as flats, they are not required to be barcoded. Failure to print a barcode on the envelope also would make them non-machinable.

Saturation letter-shaped pieces that are trayed and presorted to carriers' walk sequence do not necessarily require any sortation, *i.e.*, in theory, carriers could take them directly to the street as an extra bundle. However, circumstances sometimes arise where sortation is required, and the only option for pieces that are non-machinable is expensive manual sortation. Thus, on average, one would expect the **unit cost** for a letter-shaped **non-machinable piece** to exceed the unit cost for letters that are required to be **automation compatible**, *i.e.*, barcoded and machinable. Any allowance for this higher average cost would result in more costs being shifted from saturation letters to saturation flats, and that, in turn, would increase coverage.

2. The Cost Adjustment for DALs Appears To Be Understated

The CRA coverage of 229.08 percent for High-Density and Saturation Letters, mentioned above, reflects a shift of carrier costs (Segment 7 and Segment 10) for some 600 million-plus DALs from saturation letters to saturation flats. As discussed in Section V, however, the Billing Determinants report that some 900 million DALs were entered. Since the "established methodology" fails to reconcile with the Billing Determinants, it fails to account for the cost of delivering the balance of DALs that were entered. It appears, therefore, that a more accurate adjustment for DAL costs likely would shift an additional several million dollars from saturation letters to saturation flats. Such an adjustment also would increase the coverage for letters further, above the 229 percent in the CRA. *See* discussion *supra*, section V.

3. The Manner by which the Postal Service Calculates Standard Mail Preferred Rates Reduces Coverage on High-Density/Saturation Products

Although PAEA made certain changes to 39 U.S.C. section 3626, it left untouched the subsection which establishes the manner in which Nonprofit Standard Mail rates are calculated. The point of reference in pricing between commercial and nonprofit rates is explicitly identified as the **subclass**.

> (A) The estimated average revenue per piece to be received by the Postal Service from each **subclass** of mail under former sections 4452(b) and (c) of this title shall be equal, as nearly as practicable, to **60 percent of the estimated average revenue per piece** to be received from the **most closely corresponding regular-rate subclass** of mail.
> (B) For purposes of subparagraph (A), the estimated average revenue per piece of each regular-rate subclass shall be calculated on the basis of **expected volumes and mix of mail for such subclass** at current rates in the test year of the proceeding.
> (C) Rate differentials within each subclass of mail matter under former sections 4452(b) and (c) shall reflect the policies of this title, including the factors set forth in section 3622(b) of this title. [39 U.S.C. § 3626(a)(6) (emphasis added).]

In its pricing change notice for last year, however, the Postal Service determined not to use the **subclass** level as its reference point, but the **class** level, stating:

> section 3626(a)(6) requires that Nonprofit Standard Mail prices be set to achieve an average revenue per piece that is 60 percent of the commercial average revenue per piece. **Previously**, this ratio was calculated at the **subclass level**. Since subclasses no longer exist in the new pricing system, the Postal Service has **now** calculated this ratio at the **class level**. [Postal Service Notice of Market-Dominant Price Adjustment, Docket No. R2008-1 (Feb. 11, 2008), pp. 24-25 (emphasis added).]

In the FY 2008 ACR, the Postal Service continued applying the formula at the **class** level:

> By law, when the Postal Service adjusts Standard Mail prices, the average revenue per piece for **Standard Mail** sent by **nonprofit** mailers must be 60 percent of the average revenue per piece for **Standard Mail** sent by **commercial** customers. [FY 2008 ACR, p. 22 (emphasis added).]

Of course, the nonprofit ratio could be calculated at: (i) the **class** level, as the Postal Service has done; (ii) the **subclass** level, as implied by the statute; or (iii) the **product** level. Valpak has not researched or analyzed this legal issue, and at this time takes no position on whether the Postal Service's focus on the **class** level is consistent with 39 U.S.C. section 3626(a)(6)'s focus on the **subclass** level. Although the Postal Service does not provide calculations at any alternate level for FY 2008, Table 8 shows, for the class, former subclasses, and products, the ratios of average revenue per piece from nonprofit mail and the corresponding commercial counterpart.[65]

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[65] Source: USPS-FY08-04, Billing Determinants, spreadsheet 08 Standard BD.xls.

Table 8

Average Nonprofit Revenue as Percent of Average Revenue from Corresponding Commercial Counterpart

By Class:	
Standard Mail (class)	60.7%
By Former Subclass:[66]	
Standard Mail Regular	58.3%
Standard Mail ECR	57.2%
By Product:	
Standard Mail Regular	
Letters	60.0%
Flats	64.0%
Parcels and NFMs	82.8%
Standard Mail ECR	
Carrier Route Letters, Flats, and Parcels	64.3%
High Density/Saturation Letters	50.8%
High Density/Saturation Flats, Parcels	53.2%

Analyzing the ratio at the **product** level illustrates that both **Nonprofit High Density/Saturation Letters** and **Nonprofit High Density/Saturation Flats and Parcels** have an average revenue that is substantially under 60 percent of their corresponding commercial counterpart. For each product, calculation of CRA coverage includes both commercial and nonprofit components. Consequently, if prices were adjusted so that average revenue per piece from nonprofit mail within both High Density/Saturation Letters and High Density/Saturation Flats and Parcels were raised to 60 percent, revenue of each product would be increased, and

[66] In the time available, we have been unable to trace why the ratio for the entire class is over 60 percent, while the ratio for both subclasses is under 60 percent.

the coverage for each product likewise would be somewhat higher. Without such an increase in nonprofit rates, the coverage burden on commercial saturation mail should be seen to be somewhat greater than estimated.

VII. THE POSTAL SERVICE FAILS TO ADDRESS ALL PAEA-REQUIRED ASPECTS OF SERVICE PERFORMANCE.

A. Introduction

For market dominant products, 39 U.S.C. section 3652(a)(1) requires the Postal Service to provide data on "quality of service." This requirement is more specifically described as:

> measures of the quality of service afforded by the Postal Service in connection with such product, including— (i) the **level of service** (described in terms of **speed of delivery** and **reliability**) provided; and (ii) the degree of **customer satisfaction**[[67]] with the service provided. [39 U.S.C. § 3652(a)(2)(B) (emphasis added).][68]

This requirement reflects the objective for the ratemaking system: "To maintain high quality service standards established under section 3691." 39 U.S.C. § 3622(b)(3).

Accordingly, the Postal Service's FY 2008 ACR contains a section titled "Service Performance." FY 2008 ACR, pp. 11-15. The Postal Service states that its internal information systems "are in the process of being enhanced and augmented to meet the new statutory requirements…." FY 2008 ACR, p. 11. Until the Postal Service's new and

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[67] The Commission's Information Request No. 1 of January 14, 2009 correctly points out that PAEA-required consumer satisfaction information was not provided by the Postal Service in its FY 2008 ACR.

[68] *See* FY 2008 ACR, p. 11.

improved data gathering systems are in place, it is understandable that the FY 2008 ACR can address service performance only for those few products for which data are now available.

Prior to PAEA, the Postal Service had in place only limited performance measurement systems for just a few categories of mail. The Postal Service's existing information systems track the following single-piece items:

(1) overnight, two-day and three-day First-Class Mail;
(2) First-Class international letters; and
(3) retail package services.

Drawing on the above data sources, the Postal Service presents a table (FY 2008 ACR, p. 13) assembling a few sparse data that are pertinent to service performance for those few mail categories. The accompanying discussion in this year's ACR appropriately extolls improved on-time delivery of single-piece First-Class Mail, an impressive achievement. Otherwise, however, presentation of service performance in this year's ACR reflects scant improvement over the FY 2007 ACR. Valpak hopes that the comments here will help improve future accountability and transparency by encouraging improved reporting of service performance information, as required by PAEA.

B. Performance Targets Are Noticeable by Their Absence

The first step in assessing performance is understanding the **service performance targets** against which service is to be assessed. However, the Postal Service's discussion of "Service Performance" fails even to mention, much less provide, any specific service performance targets for market dominant products, even for those First-Class or Package Services for which on-time delivery data were provided. This omission makes meaningful analysis impossible. Service performance targets inform mailers realistically what to expect, they constitute a vital dimension of service quality, and they are integral to achieving accountability within the performance measurement scheme incorporated in PAEA.[69]

The problem posed by lack of performance targets can be illustrated using those data reported in the ACR. For example, although on-time delivery of single-piece three-day First-Class Mail reached 91.7 percent (an impressive 2.1 percentage point improvement over FY 2007, we are told), one cannot tell how this 91.7 percent on-time delivery compares with the specific target for three-day mail — whether it is below, at, or above the target.

Although the Postal Service was unable to provide performance targets last year in its FY 2007 ACR, since then the PAEA requirement to establish specific performance goals by June 19, 2008 has passed and the Board of Governors have at least considered if not approved specific performance targets. Publication of performance targets will increase transparency and accountability, as required by PAEA, and enable the Commission to evaluate service performance as it is required to do by PAEA.

[69] In Docket No. PI2009-1, *Report on Universal Postal Service and the Postal Monopoly* (Dec. 19, 2008), the Commission notes that:

> A number of statutory sections of title 39 direct the Postal Service to provide **quality postal services**.... Section 3661 mandates that the Postal Service request an advisory opinion from the Commission when it seeks to change the nature of postal services which will generally affect **service** on a **nationwide** or substantially nationwide basis. [Commission Report, pp. 197-198 (emphasis added).]

Since any reduction in, or degradation of, **service performance targets** would correlate with a nationwide decline in service quality, any such changes need to be subject to Commission review.

C. Reliability, Consistency, and the Tail of the Mail Have Not Been Addressed

In its Initial Comments on the FY 2007 ACR, with respect to reliability and consistency, Valpak stated:

> The Postal Service needs to provide additional information and focus more attention on the "**tail of the mail**" that did not receive timely delivery in order to assess compliance more fully. Without such information, it will be difficult, or perhaps impossible, to assess whether the Postal Service is improving its compliance vis-a-vis [the] objective [in 39 U.S.C § 3622(b)(3), "To maintain high quality service standards established under section 3691"]. [Docket No. ACR2007, Valpak Initial Comments (Jan. 30, 2008), p. 13 (emphasis added).]

Addressing this same issue, the Commission's FY 2007 Annual Compliance Determination stated that:

> The Postal Service should provide days-to-delivery data on tail of the mail in its filings. Data reflecting days-to-delivery until 99 percent delivery is achieved would be extremely useful. **Tail of the mail is a substantial concern** of the Commission **due to its disproportionate effect on perceived service quality.** It is also an important measure of **service consistency. In future annual compliance reports**, the Postal Service also should provide **year-to-year performance comparisons,** and include narrative information regarding any **new initiatives to improve service performance**. [Docket No. ACR2007, Postal Regulatory Commission Annual Compliance Determination, Mar. 27, 2008, p. 55 (emphasis added).]

The Commission's FY 2007 ACD was quite clear about what was to be provided "[i]n future annual compliance reports…." Nevertheless, the FY 2008 ACR contains neither data nor discussion about performance received by mail not delivered timely — *i.e.*, the "tail of the mail" — for either single-piece First-Class Mail or for Package Services (the latter is discussed further in section E, *infra*).

Meaningful data on tail of the mail, as required by 39 U.S.C. section 3652(a)(2)(B)(i), are integral to measuring reliability. No matter how impressive was this year's improvement in on-time performance for all categories of single-piece First-Class Mail, as mentioned *supra*, with no supporting data the reported improvement cannot be extrapolated to the tail of that mail. Delivery of pieces that failed to meet the established standard may be highly erratic and inconsistent. Data on this score are vital, and should be provided, regardless of any possible misgivings by the Postal Service. Accountability requires data and discussion of performance that fails to achieve established targets, as well as performance that was exemplary. In the absence of any data on service received by pieces not delivered timely, the Commission has no way to assess the "reliability" of postal service delivery, as required by PAEA.

D. Performance of Delivery Confirmation Service Should Be Reported

The FY 2008 ACR notes that data from delivery confirmation (an optional service offered in conjunction with package delivery service) are, and will be, the sole basis for assessing performance of the Postal Service's package delivery service. It would seem that data for that assessment would be readily available from the existing delivery confirmation system data base. It is not known why they were not provided as part of the current ACR, and they should be reported on a regular basis in future ACRs.

Although the FY 2008 ACR does not say so explicitly, the datum provided for on-time performance of single-piece retail packages (FY 2008 ACR, p. 13) presumably reflects delivery confirmation only for those packages that were scanned successfully, either upon delivery or attempted delivery (either event "stops-the-clock"). However, the FY 2008 ACR does not discuss or provide data on the number of packages that were scanned initially but which subsequently have no scan showing either actual or attempted delivery. In order to assess reliability of the delivery confirmation service itself (as opposed to on-time delivery of packages), basic data are needed on the number and percentage of retail packages with delivery confirmation that have no stop-the-clock scan.

E. Service Performance Information for Retail Package Services Is Lacking

FY 2008 on-time delivery performance for retail package services appears as a single datum on page 13 of the FY 2008 ACR. Otherwise, the FY 2008 ACR contains no discussion of what appears to be the rather poor on-time performance received by package services. Neither the table on page 13 nor the accompanying discussion compares this year's on-time delivery (63.9 percent) with last year's on-time delivery (57.7 percent)[70], despite the admonition in the Commission's FY 2007 ACD that the Postal Service "should provide year-to-year performance comparisons…." (*Id.*, p. 55.) In addition, as discussed above, the FY 2008 ACR does not permit the comparison of this year's on-time delivery of 63.9 percent with whatever performance target the Postal Service has established for retail package services, because performance targets have not been made available.

For retail single-piece packages, the Postal Service indicates that delivery confirmation data are the only data on which it intends to rely for parcels. The delivery confirmation data base is well established. Therefore, those data should be as available for FY 2008 as they will be in future years. Despite the existence of extensive data pertaining to delivery confirmation, for those packages that failed to be delivered on time the ACR contains no data reflecting

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[70] *See* Docket No. ACR 2007, FY 2007 ACR (Dec. 28, 2007), p. 17.

consistency and reliability. Failure to use the existing database and present information on tail-of-the-mail for retail package services sets a poor precedent. Importantly, it misses a good opportunity to begin establishing the most appropriate format for reporting tail-of-the-mail information.

Finally, the Postal Service's FY 2008 ACR does not include required "narrative information regarding any new initiatives to improve service performance" of retail package services.

F. Future Accountability and Transparency: Progress in Presenting Service Performance Information

Valpak raises these issues regarding delivery confirmation service and package services, not because it uses these services, but because it is concerned that a precedent not be established in this docket that available performance data need not be reported as part of each ACR.

In its Initial Comments on the FY 2007 ACR, Valpak stated that: "[a]lthough the law does not explicitly state that the Postal Service 'has to make adequate progress,' it does lay on the Commission the responsibility of overseeing implementation of the law." Docket No. ACR2007, Valpak Initial Comments (Jan. 30, 2008), p. 14. Development of the requisite data gathering systems is fundamental, of course, but progress on those systems is not at issue here. When those systems are up and running in the future, they predictably will be capable of generating a huge volume of data. Even those few products for which performance data are now available likely have an extensive database. Standing alone, large databases are the antithesis of transparency. And if one becomes drowned in details and masses of data, at the end of the day both accountability and transparency easily can become lost.

Now, therefore, would appear to be the ideal time for the Commission to implement appropriate reporting formats to be used when all performance data systems are in place. The Commission and mailers need summary information presented in a readily-accessible format, designed to address important basic questions, such as:

- Did service performance of the product meet the established target?
- How did this year's service performance for the product compare with prior years?
- How reliable and consistent was service performance for the product? That is, for mail that failed to meet the target, when was it delivered?

CONCLUSION

Although the Commission's review of the Postal Service's FY 2008 ACR has a few transitional aspects, discussed *supra*, it could establish important precedents both for disclosure by the Postal Service in future Annual Compliance Reports, and for Commission remedial action, if any is found to be required. Resolution of this docket also will be instructive for all parties as the Commission issues final regulations which will govern the FY 2009 Annual Compliance Report, as well as the Commission's review of that report. It is urged that the Commission use this docket to advance the type of increased transparency and accountability required by PAEA.

Respectfully submitted,

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