

**BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON DC 20268-0001**

RATE ADJUSTMENT DUE TO )  
EXTRAORDINARY OR EXCEPTIONAL ) Docket No. R2010-4  
CIRCUMSTANCES )

**COMMENTS OF  
USERS OF FLAT-SHAPED MAIL  
(August 17, 2010)**

Pursuant to Order No. 485 at 6, the undersigned parties respectfully submit these comments on the rate increases proposed by the Postal Service for Periodicals Mail and Standard Mail Flats. The undersigned parties are also co-sponsors of the separate comments of the Affordable Mail Alliance, which explain why all of the rate increases proposed by the Postal Service in this docket should be denied in their entirety. The present comments provide further and independent reasons why the proposed increases for Periodicals Mail and Standard Mail Flats are unjustified.

**INTRODUCTION AND SUMMARY**

In this docket, the Postal Service is proposing an eight percent rate increase for Periodicals Mail—significantly above the 5.6 percentage average increase proposed for all mail classes and services as a whole. While the Postal Service is not proposing an above-average price increase for Standard Mail Flats in this case, it apparently plans to do so in the future when the catalog industry is in a less “delicate financial condition.” Kiefer Statement at 29-30.

The Postal Service defends its approach on the theory that the current rates for these products do not cover their attributable costs. Kiefer Statement at 6 & 41. This theory is incorrect.

First, the failure of Periodicals and Standard Mail Flats to cover the costs attributed to them by the Postal Service is primarily a function of the Postal Service's inability to gain control of its operating costs, which have outpaced the rate of inflation for years. Rather than try to price its way out of negative contribution, the Postal Service should focus on reducing its costs.

Second, the Postal Service has grossly overstated the costs properly attributable to these products by ignoring the effect of excess capacity on cost causation during the period until the proposed rates are raised again. Contrary to the Postal Service's assumption, Periodicals and Standard Mail Flats are not the cause of the large amounts of excess capacity in the operations where they are processed, and in fact cover the attributable costs they actually cause.

Third, and perhaps most importantly, the Postal Service's request ignores the broader contributions that Periodicals and Standard Mail Flats make to the Postal Service's overall revenues. For senders of Periodicals Mail, catalogs and other Standard Mail Flats, these mail products are complementary goods with other, higher-markup classes of market-dominant mail, such as presorted First-Class and Standard Mail letters, and competitive products, such as Express Mail. The Postal Service's proposed increases for Periodicals Mail and Standard Mail Flats would suppress not only the volume of these products (by shrinking these sectors and by encouraging the companies that survived to migrate to the

Internet and private delivery), but also the Postal Service's contribution from the collateral mail volume that they generate. Moreover, Periodicals Mail, by increasing the general attractiveness of mail to the public, also increases the attractiveness of mail as an advertising medium for companies that do not themselves publish periodicals or catalogs. The proposed rate increases for Periodicals and Standard Mail Flats, by suppressing the volume of these products, would suppress the volume of advertising mail from unrelated senders as well. In short, the proposed increases for Periodicals and Standard Mail Flats, rather than shoring up two "underwater" postal products, would in fact merely exacerbate the Postal Service's financial problems.<sup>1</sup>

## COMMENTS

### **I. REVENUE FROM PERIODICALS MAIL AND STANDARD MAIL FLATS HAS FAILED TO COVER REPORTED ATTRIBUTABLE COSTS ONLY BECAUSE THE POSTAL SERVICE HAS FAILED TO LIMIT THE COSTS OF HANDLING FLAT-SHAPED MAIL TO EFFICIENT AND ECONOMICAL LEVELS.**

Revenues from two of the largest flat-shaped products – Periodicals Mail and Standard Mail Flats – fail to cover their long-run attributable costs (as estimated by the PRC) only because the Postal Service has failed to limit its costs of handling flat-shaped mail to efficient and economical levels. This section demonstrates this point through an analysis of trends in costs, mail preparation, and postal rates. USPS unit costs for handling Periodicals have increased much

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<sup>1</sup> Time Warner Inc., in its separate comments today, offers a further ground for disallowing the above-average increases proposed for Periodicals Mail: the Postal Service has failed to show that those particular increases satisfy the "necessary" standard of 39 U.S.C. § 3622(d)(1)(E). We agree with Time Warner.

more rapidly than the rate of inflation. Despite well-above-inflation rate increases, revenues could not keep pace with out-of-control costs. And while the Postal Service began presenting CRA cost data for Standard Mail Flats only in FY 2008, these data (and available data from previous years) confirm the Postal Service's poor performance in handling flats; in fact, trends in Standard Mail Flat unit costs appear even worse than those for Periodicals.

The alleged shortfall is caused by the Postal Service desire to keep surplus workers busy, and not by the handling requirements of the existing volume of flat-shaped mail. This fact is critically important for evaluating the proposed increases. Attributing these costs to flat-shaped mail violates the basic rule that costs may not be attributed to a particular product, class or category unless it causes the costs to be incurred. Moreover, attributing these needless costs to flat-shaped mail also violates the policy against allowing the Postal Service to recover inefficiently-incurred costs, and guts the incentives for efficiency and the protections against abuse of the Postal Service's monopoly power that are intended to be embodied in the price cap form of regulation. In the words of USPS witness Neri, the Commission should not "reward poor performance with lower expectations." Tr. 3/335.

**A. Increases In The Reported Attributable Costs Of Periodicals and Standard Mail Flats Have Outstripped Inflation Even Though The Postal Service Has Invested In Flats Automation, And Improvements In Mail Preparation And Worksharing By Mailers Have Greatly Decreased The Work Content Of Flat-Shaped Mail.**

As explained in the Affordable Mail Alliance’s Motion to Dismiss (“AMA Motion”), organizations operating under best practices of honest, efficient, and economical management should be able to hold cost increases below the rate of inflation. AMA Motion at 19. The Postal Service has not met this standard, and mailers of flats have borne the brunt of the Postal Service’s inefficiency. Since FY 1996, the Postal Service’s reported unit costs for Periodicals Mail, a class that is almost entirely flat-shaped, have increased much faster than inflation.<sup>2</sup> Moreover, the well-above-inflation increases in reported unit costs have occurred despite substantial improvements in mail preparation and the implementation of the flats automation program in intervening years.

According to Cost and Revenue Analysis (“CRA”) reports, the Postal Service’s unit cost for the Periodicals class increased by 82 percent during this period, from 18.5 cents in FY 1996 to 33.7 cents in FY 2009. This is more than double the rate of inflation – the CPI-U increased by 37 percent during the same period.<sup>3</sup> While CRA data for the Standard Mail Flat product are not available

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<sup>2</sup> FY 1996 is used as the starting period for this analysis because it is the last year in which Periodicals revenues were estimated by the PRC to cover attributable costs, not because it was a year in which the Postal Service efficiently processed flats. In fact, USPS cost trends were no better in the previous decade. From FY 1986 to FY 1996, Periodicals unit costs increased by 95 percent while the CPI only increased by only 42 percent.

<sup>3</sup> Calculated from Bureau of Labor Statistics Series ID CUUR0000SA0.

before FY 2008, unit mail processing and delivery costs by shape were calculated in previous rate cases. From FY 1999 to FY 2009, the reported unit costs of processing and delivering Standard Mail Flats increased by 106 percent, nearly four times the 29 percent increase in CPI-U.<sup>4</sup> Had the Postal Service simply held the increase in Periodicals and Standard Mail Flat unit costs to the rate of inflation during these periods, both would have covered their costs in FY 2009.<sup>5</sup>

**Table 1. Long-Term Unit Cost and CPI-U Increases**

|   | <b>Periodicals</b> | <b>Standard Mail Flats</b> |
|---|--------------------|----------------------------|
| Unit Cost   | 82.4%              | 105.8%                     |
| CPI-U   | 37.4%              | 29.2%                      |
| Periodicals trend is for FY 1996 – FY 2009; Standard Mail Flats trend is for FY 1999 – FY 2009. |                    |                            |

<sup>4</sup> In FY 2009, unit mail processing and delivery costs for the Standard Mail Flat product were 26.0 cents and 15.1 cents, respectively. Docket No. ACR2009, USPS-FY09-19 and USPS-FY09-26. In FY 1999, unit mail processing and delivery costs for Standard Mail Other (i.e., Commercial Non-ECR) Flats (which comprise most of what is now the Standard Mail Flat product) were 12.7 and 7.2 cents, respectively. Docket No. R2000-1, PRC-LR-9, MP SHAPBN-PRC99-99.xls, “ATTACHMENT 17” and PRC-LR-11, LR95del-PRC2.xls, “summary BY.” From the same sources, FY 2009 unit mail processing and delivery costs for Standard Mail Nonprofit Other (Non-ECR) flats were 13.2 cents and 6.0 cents, respectively. CPI-U figures are calculated from Bureau of Labor Statistics Series ID CUUR0000SA0.

As a further reference point, a Quad/Graphics analysis of trends in input costs for catalogs for a similar time period—1997 to 2008—found that paper costs increased by less than twenty percent while printing costs declined by about fifteen percent.

<sup>5</sup> Had USPS held its costs for handling Periodicals to inflation during this period, FY 2009 costs would have been 25 percent less (1-1.37/1.82). Had USPS held Standard Mail Flat costs to inflation, FY 2009 costs would have been 37 percent less (1-1.29/2.06)

As further evidence that the brunt of Postal Service inefficiency has been borne by mailers of flats, since FY 2001 (the first year in which the Cost and Revenue Analysis (PRC Version) separately reported cost data for Single-Piece and Presort First-Class Mail Letters), the increases in unit cost for Periodicals were nearly double the rate of inflation, while the increase in both Single-Piece and Presort First-Class Mail unit costs was slightly below inflation.<sup>6</sup>

Holding increases in flats cost to inflation should have been easy. During this period, both automation of the flats mailstream and the level of worksharing increased, and there were no offsetting trends that should have increased costs.

The equipment used to sort flats has improved substantially since FY 1996. As USPS witness Neri stated, “the AFSM introduced an improved level of productivity to the operations.” Tr. 3/321. In FY 1996, the equipment primarily used by the Postal Service to sort flats was the FSM 881, which had a productivity of approximately 750 pieces per workhour. Docket No. R97-1, USPS-LR-H-113, PRODUCT.XLS, “PRODUCTIVITIES”. Currently, the machine primarily used for sorting flat-shaped mail is the automated AFSM 100, which had productivity in excess of 3,000 pieces per workhour in FY 2009.<sup>7</sup> Docket No.

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<sup>6</sup> The increase in unit cost for Periodicals from FY 2001 – FY 2009 was 39%; the increases in unit cost for Single-Piece and Presort First-Class Mail Letters, Flats, and Sealed Parcels were 20% and 16% respectively. The CPI-U increased by 21%.

<sup>7</sup> Because flats preparation costs are not included in the AFSM 100 productivity, see, e.g., Docket No. ACR2007, MPA/ANM Initial Comments at 16-18, the comparison of the FY 1996 FSM 881 and FY 2009 AFSM 100 productivity is inexact. However, these figures and those contained in the Corporate Flats Strategy and provided by witness Neri (which both present a more exact comparison) make clear that the AFSM 100 is a much more productive machine.

ACR2009, USPS-FY09-23, YRscrub2009.xls, "Table." See also the Postal Service's Corporate Flats Strategy (USPS-LR-J-151) at 5 (showing productivity goals of 1,500 handlings per workhour on the AFSM 100 and only 574 handlings per workhour on the FSM 881); Tr. 3/321 (Neri).

The work content of Periodicals Mail has also decreased substantially during the same period:

(1) Primarily because of increased comailing, the percentage of Periodicals pieces sorted to the Carrier Route level increased from 44.1 percent in FY 1996 to 57.9 percent in FY 2009. Docket No. R97-1, USPS-LR-H-145; Docket No. ACR2009, MPA/ANM Reply Comment at 5.

(2) The percentage of Periodicals Outside County volume (in terms of advertising pounds) entered at the Destination Sectional Center Facility (DSCF) or Destination Delivery Unit (DDU) increased from 30.0 percent in FY 1996 to 65.4 percent in FY 2009. Docket No. R97-1, USPS-LR-H-145; Docket No. ACR2009, USPS-FY09-4, 09\_Periodicals.xls.<sup>8</sup>

(3) Between FY 1996 and FY 2009, the Postal Service changed mailing standards to eliminate the use of "skin sacks," a practice identified as significantly driving up Periodicals costs.

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<sup>8</sup> This comparison is focused on DDU and DSCF-entered Outside-County advertising pounds because data are unavailable to compare the percentage destination-entered for the entire class. The destination entry trend for Periodicals as a whole is substantially similar for two reasons: (1) Periodicals Outside-County volumes comprise the vast majority of all Periodicals; and (2) most destination-entered Periodicals are entered at the DSCF.

SKIN SACK REDUCTION PROGRAM — Mailing standards will be modified to no longer allow the preparation of certain sacks within Periodicals that contain fewer than the established minimum of 24 pieces...Operational savings will be achieved through a significant reduction in sacks which will result in a reduction in the allied labor associated with processing these sacks.

Docket No. R2005-1, USPS-LR-K-49 at 19-20. Primarily because of this change, but also because of an increase in co-mailing, which allows the substitution of pallets for sacks, the number of sacks used to mail Outside County Periodicals dropped by 65.9 percent from FY 2004 to FY 2009. Docket No. ACR2009, MPA/ANM Reply Comments at 6.<sup>9</sup>

(4) Also, flats mailers have had to comply with numerous additional mail preparation requirements to help the Postal Service improve its efficiency. See, e.g., Tr. 3/428-430 (discussing label placement requirements).

The work content of Standard Mail Flats has also decreased substantially during this period. The percentage of Standard Mail Flats that are destination entered increased from 55.6 percent to 69.1 percent from FY 1999 to FY 2009. Docket No. R2000-1, USPS-LR-I-259; Docket No. ACR2009, USPS-FY09-4, Standard Mail.xls, "Summary 2 P. G6-2."<sup>10</sup> Moreover, the percentage of Standard Mail Flats that are presorted to 5-Digit, the finest presort level within this product, appears to have increased modestly during the same timeframe.<sup>11</sup>

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<sup>9</sup> The USPS also implemented surcharges for sacks as well as flats tubs.

<sup>10</sup> These percentages are for all non-letters (of which flats comprise the vast majority) because entry point data for flats (separate from other non-letters) were not available in FY 1999.

<sup>11</sup> According to Docket No. R97-1, USPS-LR-H-105, Standard (A) Regular Rate Mail Characteristics Study (1997) and Docket No. R97-1, LR-H-195 Standard (A) Nonprofit Rate Mail Characteristics Study (1997), the percentage presorted to 5-

Finally, there have been no offsetting developments during the same period that would have tended to increase the costs of flat-shaped mail. When asked by Chairman Goldway if there were “any areas that have developed in the last 10 years that increased costs for periodicals”, USPS witness Neri stated that he was unaware of any. Tr. 3/330.

Despite these trends, the rates charged by the Postal Service for flat-shaped mail have shot up at a disproportionate rate. As shown in Table 2, the average increase in Periodicals rates from FY 1996 to FY 2009 was substantially higher than (1) the average price increase for all classes of mail; and (2) the rate of inflation.

**Table 2. Postal Rate Increases v CPI-U (1996-2009)**

| Fiscal Year | Rate Increases   |             |               |                  |             | CPI-U |
|-------------|------------------|-------------|---------------|------------------|-------------|-------|
|             | First-Class Mail | Periodicals | Standard Mail | Package Services | All Classes |       |
| 1997        |                  |             |               |                  |             | 2.7%  |
| 1998        |                  |             |               |                  |             | 1.6%  |
| 1999        | 2.5%             | 5.1%        | 3.0%          | 1.9%             | 2.8%        | 1.9%  |
| 2000        |                  |             |               |                  |             | 3.2%  |
| 2001        | 3.5%             | 12.7%       | 8.4%          | 8.1%             | 6.3%        | 3.2%  |
| 2002        | 7.9%             | 10.0%       | 7.1%          | 5.0%             | 7.7%        | 1.5%  |
| 2003        |                  |             |               |                  |             | 2.3%  |
| 2004        |                  |             |               |                  |             | 2.3%  |
| 2005        |                  |             |               |                  |             | 3.3%  |
| 2006        | 5.2%             | 5.1%        | 5.4%          | 5.1%             | 5.0%        | 3.7%  |
| 2007        | 7.0%             | 11.8%       | 9.3%          | 12.0%            | 7.6%        | 2.3%  |
| 2008        | 2.9%             | 2.7%        | 2.9%          | 2.9%             | 2.9%        | 4.4%  |
| 2009        | 3.8%             | 4.0%        | 3.8%          | 3.8%             | 3.8%        | -0.3% |
| 1996-2009   | 37.6%            | 63.5%       | 47.1%         | 45.4%            | 42.0%       | 37.4% |

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Digit was 61.4%. In Docket No. ACR 2009, USPS-FY09-4, 09 Standard Mail.xls, the percentage presorted to 5-Digit was 65.0%.

While data on the average price increase experienced by Standard Mail Flats during this same period are unavailable, the prices for two typical Standard Mail Flat pieces – 3.3-ounce, DSCF-entered, 3-Digit and 5-Digit Automation Flats –increased by 114 percent and 73 percent, respectively, suggesting that the average price increase during this period was huge. See USPS Domestic Rate History (filed at PRC on July 1, 2010).

There is only one plausible and coherent explanation for the paradox of the simultaneous increase in reported unit costs and decline in work content of flat-shaped Periodicals and Standard Mail since FY 1999: the extraordinary inefficiency and lack of economy of the Postal Service’s handling flat-shaped mail. As explained in the Affordable Mail Alliance Motion to Dismiss (July 26, 2010), major contributors to this problem are chronic excess capacity in mail processing facilities, AMA Motion at 21, above-inflation compensation increases, *id.* at 30, and the Postal Service’s failure to manage its workforce effectively and reduce its size sufficiently. *Id.* at 25. An important symptom of the latter was well described in recent Congressional testimony:

We believe that extensive manual processing survives because the Postal Service has not succeeded in reducing its workforce enough to match reduced processing needs.

Written Statement of James O’Brien Before the House Committee on Oversight and Government Reform Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia at 5 (May 12, 2010).<sup>12</sup>

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<sup>12</sup> While the Postal Service generally expects flats to be sorted on automated equipment, it apparently does not have a national policy requiring automated processing, leaving the decision to local discretion. See, e.g., Tr. 3/317. Witness

This excess capacity, and the resulting deployment of underused workers to perform manual processing, are not new, and the undersigned parties are not the only observers to report these problems. They have been detailed in numerous filings before the Commission. See Docket No. ACR2009, Time Warner Initial Comments at 13, fn. 21 for a partial list of recent relevant filings.<sup>13</sup> Furthermore, the PRC itself has questioned the efficiency with which the Postal Service handles Periodicals and other flat-shaped mail. See, e.g., PRC R97-1 Op. & Rec. Decis. at ¶ 3148 (May 11, 1998) (acknowledging that the automation refugee issue “warrants systematic investigation”); PRC R2000-1 Op. & Rec. Decis. at ¶¶ 3011-3015, 3076, and 5592-93 (Nov. 13, 2000) (stating that “[t]he only conclusion is not comfortable: there are many reasons for believing that

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Neri conceded “that decisions have been made at some locations to work mail manually” and later confirmed that “if the equipment is available, the expectation is there that mail is worked on the equipment. Are there instances where that might not be happening? Yes.” Tr. 3/316, 320. In response to a POIR requesting the Postal Service to “provide the percentage of [flat-shaped] pieces currently processed in a non-optimal fashion by manual sort,” USPS responded that “30 percent of volume was handled manually in FY 2009.” Tr. 3/299-300.

<sup>13</sup> Docket No. RM2010-6, Initial Comments of Time Warner Inc. in Response to Order No. 363 (filed January 11, 2010), Appendix: Comments On Costing Proposal No. 29; Docket No. RM2010-4, Initial Comments of Time Warner Inc. in Response to Order No. 327 (filed November 16, 2009); Docket No. RM2009-10, Initial Comments of Time Warner Inc. in Response to Order No.269 (filed August 20, 2009), Appendix: The High Costs of Manual Flats Sorting; Reply Comments of Time Warner Inc. on ACR2008 in Response to Order No. 161 (filed February 13, 2009); Docket No. ARC2008, Initial Comments of Time Warner Inc. in Response to Order No. 161 (filed January 30, 2009); Reply Comments of Time Warner Inc. in Response to Order No. 130 (filed December 10, 2008); Docket No. RM2009-1, Initial Comments of Time Warner Inc. in Response to Order No. 130 (filed December 1, 2008); Docket No. RM2008-2, Initial Comments of Time Warner Inc. in Response to Order No. 99 (filed September 8, 2008), Addendum: Recommendations for Improving the Periodicals Class.

costs should have decreased; only a few factors that could be associated with increases; and a persistent net upward trend”).

Because of the Postal Service’s inability to control its costs, the well-above-inflation price increases that flats mailers have faced have not been sufficient to keep up with cost increases.

**B. The Long-Festering Problem Of Excess Costs Has Exploded Since The Beginning Of The Recession.**

Consistent with the Postal Service’s extremely poor operational performance during the recent recession (see AMA Motion at 39), trends in unit costs for flat-shaped mail have degenerated further since FY 2007. This is due to the well-above-inflation increases in compensation costs (see AMA Motion at 30) and the increased presence (and thus attribution) of excess labor, particularly in operations where flats are processed. In the last several years, even the Postal Service has conceded the presence of excess labor.

In December, 2008, the Postal Service acknowledged that in Fiscal Year “2008, despite the reduction of 50 million workhours, TFP [total factor productivity] declined primarily due to volume declines so rapid and so large (4.5 percent) that it was impossible to adjust resources with sufficient speed to maintain positive TFP.” FY 2008 Comprehensive Statement on Postal Operations (Dec. 18, 2008) at 54 (available at [www.usps.com/financials](http://www.usps.com/financials)). Likewise, in May, 2009, the Postal Service acknowledged that “there will be some excess capacity in virtually all areas of operations” in the summer of 2009. In particular,

the Postal Service will have excess capacity in buildings, equipment, and vehicles... The delivery networks for both city and rural delivery have also material excess capacity...The postmaster network has material excess capacity ... there are other areas of possible excess capacity.

Docket No. R2009-3, Response of United States Postal Service to Chairman's Information Request No. 1, Question 4 (May 15, 2009).

These factors have combined to increase the Postal Service's unit cost for Periodicals by 12 percent from FY 2007 to FY 2009 (according to CRA reports), *triple* the rate of inflation during the same period. For Standard Mail Flats, the Postal Service's recent performance has been even worse. According to CRA reports, during the period from FY 2008 to FY 2009, when the CPI *decreased*, the Postal Service's unit cost for Standard Mail Flats increased by 15 percent, more than *twice* the itself-unacceptable overall rate of postal inflation during the same period (more than six percent). USPS Annual Tables, FY 2009 TFP, Table 51 (filed at PRC on March 2, 2010). The presence of excess capacity is perhaps best illustrated by the huge increases in unit delivery costs for flats from FY 2007 to FY 2009:

- Periodicals Mail Flats – 24% increase in unit delivery costs<sup>14</sup>
- Standard Regular Flats – 36% increase in unit delivery costs<sup>15</sup>

In short, handling flat-shaped Periodicals and Standard Mail has become the make-work of last resort for the Postal Service's large and growing reserve army of underused workers. This busywork, not the needs of flat-shaped mail, is

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<sup>14</sup> Docket No. ACR2007, USPS-FY07-19, UDCmodel071211.xls, "1.Table 1"

<sup>15</sup> Docket No. ACR2009, USPS-FY09-19, UDCmodel09.xls, "1.Table 1"

the reason that the attributable costs of flat-shaped mail reported by the Postal Service have risen so sharply.

**C. The Policies Expressed in the PAEA and in Previous Commission Statements Dictate That the Postal Service Focus on Reducing Costs Before Further Raising Prices**

These facts render the proposed rate increases for flat-shaped Periodicals and Standard Mail completely unjustified. While one of the ratemaking “factors” of PAEA, 39 U.S.C. § 3622(c)(2), states that each class of mail should cover its attributable costs, 39 U.S.C. § 3622(c)(2), the bedrock principle of cost attribution is causation. Costs that are unneeded to serve a specified increment of mail volume are not caused by that volume, and hence cannot properly be attributed to it. See 1 Alfred E. Kahn, *Economics of Regulation* 71 (1970) (“All the purchasers of any commodity should be made to bear such additional costs—*only* such, but also *all* such—as are imposed on the economy by the provision of one additional unit.”); *Nat’l Ass’n of Greeting Card Publr. v. USPS*, 462 U.S. 810, 820 (1983) (quoting PRC Op. R74-1 at 110) (“causation is both the statutory and the logical basis for attribution”).

Moreover, a factor as important as cost attribution is management efficiency. The PAEA requires that rate-setting for market dominant products take into account the “need for the Postal Service to increase its efficiency and reduce its costs, including infrastructure costs, to help maintain high quality, affordable postal services.” 39 U.S.C. § 3622(c)(12). Similarly, one of the “objectives” of ratemaking for market dominant products is to “maximize incentives to reduce costs and increase efficiency.” Furthermore, one of the

Postal Service's most basic duties is to "maintain an *efficient* system of collection, sorting, and delivery of the mail nationwide." 39 U.S.C. § 403(b)(1) (emphasis added). Finally, and most immediately, the Commission may not approve rate increases under the "exigency" provision, 39 U.S.C. § 3622(d)(1)(E)—the provision under which the Postal Service has requested approval of the increases proposed in this case—without a showing that the Postal Service needs the extra money to keep providing service "under best practices of honest, efficient, and economical management." As the members of the Affordable Mail Alliance have explained in their separate comments, these provisions codify the longstanding regulatory policy that users of market-dominant regulated services may not be compelled to pay for costs that are needlessly high. See AMA Motion to Dismiss at 6-9, 14 (citing precedent).

This issue also has an exhaustion-of-remedies dimension. Congress, aware of the Postal Service's chronic inability to control its costs of handling Periodicals mail, specifically directed the Postal Service and the Commission in 2006 to conduct a joint study of, *inter alia*, "the quality, accuracy and completeness of the information used by the Postal Service in determining the direct and indirect postal costs attributable to periodicals," and to make "recommendations for any administrative action or legislation that might be appropriate." PAEA § 708(a), 120 Stat. 3246. The Commission, in its FY 2009 Annual Compliance Determination Report, stated that "the Commission is persuaded that the best course, under the circumstances, is to await the issuance of the Joint Report before addressing Periodicals rates in specific detail." FY 2009 Annual Compliance Determination (March 29, 2009) at 75. In

addition, the Postal Service is expected to complete a Lean Six Sigma value stream map for Periodicals by the end of August. This Lean Six Sigma value stream map will identify “all of the steps of the process, and then [present the Postal Service] the opportunity to identify projects that [the Postal Service] could launch for leaving out activities or steps of that process.” Tr. 3/353. Instead of waiting for the issuance of the Joint Report and the completion of the Lean Six Sigma analysis, however, the Postal Service has jumped the gun with disproportionate rate increases for Periodicals mail.

For the foregoing reasons, any discussion of rate increases for Periodicals and Standard Mail Flats is premature until the Postal Service has brought its excess capacity under control. The Postal Service’s filing in this proceeding identifies a number of strategies to do just that. See USPS-LR-9. Without commenting on individual strategies, we believe that getting costs under control is the appropriate way to ensure that revenues for flat-shaped mail cover costs. The Commission concurred with this approach for the Periodicals class in its FY 2008 Annual Compliance Determination (ACD):

*These efforts [to improve Periodicals cost coverage] should be directed mainly at cost control and improved pricing signals so that meaningful progress toward compliance with section 3622(c)(2) can be made; FY 2008 Annual Compliance Determination Report at 54.<sup>16</sup>*

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<sup>16</sup> The Postal Service has failed to “improve pricing signals” in the rates it proposes in this case. Container charges would still be based upon very limited passthroughs. And the Carrier Route discount would remain well below cost avoided. The latter is particularly problematic, because the Carrier Route discount is the primary incentive to produce highly efficient mailings through co-mailing. The Postal Service justifies the low Carrier Route passthrough in Periodicals on the Flat Sequencing System (FSS) deployment. Kiefer Statement at 40. This is faulty reasoning – (1) for the foreseeable future, the FSS will

The Postal Service's apparent "plan" of disproportionately increasing prices now and, if the flat strategies fail to achieve significant savings, again in the future, cannot be condoned. July 27<sup>th</sup> Exigent Rate Adjustment Technical Conference (webcast), approximately at 21:00. Allowing the Postal Service to recover inefficiently-incurred costs through above-inflation rate increases eliminates any and all incentives for the Postal Service to control these costs. Why cut costs when you can recover unnecessary costs through rate increases? Honest, efficient, and economical management requires that cost-cutting occur first.

## **II. PERIODICALS MAIL AND STANDARD MAIL FLATS COVER THEIR SHORT-RUN ATTRIBUTABLE COSTS.**

In addition to resulting in costs bloated above those that would be incurred under "best practices of honest, efficient, and economical management," the presence of excess capacity has a substantial impact on how costs vary with changes in mail volume and thus the attributable costs that should be used to estimate cost coverage. When taking this principle into account, the financial position of Periodicals Mail and Standard Mail Flats appears much less dire. Because the Postal Service, despite recognizing this effect in other contexts, has made no provision for it in this case, it has substantially overstated the costs that should be attributed to Periodicals Mail and Standard Mail Flats. Correcting for

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process only a minority of eligible flat volume; and (2) while FSS may reduce the value of presorting flats to Carrier Route, large, highly workshared mailings created by co-mailing will continue to have significant value in the FSS environment. Docket No. R2006-1, MPA-T-2 (Glick) at 14-15, fn. 5.

this oversight proves that the price increases proposed by the Postal Service are unwarranted.

The Postal Service's excess capacity would require a deep reduction in the costs attributed to Periodicals Mail and Standard Mail Flats even if (contrary to fact) the capacity costs were fully consistent with "best practices of honest, efficient and economical management." The presence of excess capacity that cannot be sold or productively redeployed during until the proposed rates next can be increased has major implications on how costs vary with changes in mail volume, and thus what costs should be attributed to each class, subclass and product.

Standard principles of microeconomics recognize that the marginal or incremental costs of output in the presence of excess capacity can be well below long-run marginal or incremental costs in the short-run—i.e., the period until the excess capacity can be productively disposed of or redeployed. See 1 Alfred E. Kahn, *The Economics of Regulation* 70-75 (1970); see also *Cost Standards for Railroad Rates*, 362 I.C.C. 898 (1981), *aff'd*, *Water Transport Ass'n v. ICC*, 684 F.2d 81 (D.C. Cir. 1982) (adopting minimum rate floor equal to "directly variable cost").

The Postal Service recognized these principles last year in the Standard Mail summer sale case:

The general implication of excess capacity for the Postal Service is that temporary additions to volume can be worked through the network without generating very much or any additional attributable cost. Rather, unused or underused capacity can be employed to handle any temporary increases in volume. This means that the

resulting short-run marginal cost of temporary additional volume will be less than long-run marginal cost of sustained volume increases under normal capacity conditions. In the lexicon of postal costing, temporary excess capacity means that the short-run attributable cost per piece of any temporary increment to volume will be below the measured long-run attributable cost per piece for the same product.

The attributable costs used in the ACR are long-run attributable costs, in the sense that they are based upon sustained changes in volume and timely adjustment of all inputs. Because any volume increases that would take place as a result of the Standard Mail Volume Incentive Program would do so in a condition of excess capacity, the long-run attributable costs from the ACR are not appropriate for estimating cost coverage. To estimate cost coverage, the temporary short-run attributable costs per piece for this additional volume must be estimated.

Docket No. R2009-3, USPS Response to Chairman's Information Request No. 1, Question 4 (May 15, 2009).

In this proceeding, the Postal Service again highlighted that the Postal Service's excess capacity means that short-run attributable costs are currently less than long-run attributable costs.

- At the July 27<sup>th</sup> technical conference, Dr. Kiefer explained the "stickiness" of Postal Service costs: "The costs may have been a little bit sticky, or a little bit fixed, in response to volume changes, to the extent that they were sticky downward, they may also be a little sticky upward." Exigent Rate Adjustment Technical Conference (July 27, 2010) (webcast), approximately 1:11:00.
- Due to this cost stickiness, "[t]hese volume declines have helped to drive the Flats cost coverage down to only 82 percent." Kiefer

Statement at 28. His response to POIR No. 3, Question 5, clarifies that the cost coverage reduction was due to an inability to align workforce with volumes, “[d]espite substantial efforts to trim [attributable] costs in line with volume declines, it was not possible to reduce costs by the same percentage as the massive mail volume declines that occurred within a relatively short period of time.”

- At the August 10 hearing, the Postal Service’s Chief Financial Officer stated, “We have a fixed cost, primarily a fixed cost network when you really get down to it...any volume loss actually will cause, all other things equal, will cause a decrease in our profits...We have largely a fixed cost network...if you lose a million pieces of that particular product quickly you will not make more money, you’ll lose money, even if that product was underwater in most cases.” Tr. 1/77-78, 82 (Corbett).

As described above, in the summer sale case, the Postal Service predicted that, in the summer of 2009, there would be excess capacity in many postal operations, particularly in buildings, equipment, vehicles and the delivery/postmaster networks. The delivery network is, by far, the largest of these cost items with “material excess capacity.” As indicated by the huge increases in unit delivery costs, the delivery network clearly had excess capacity throughout FY 2009 and, until these costs are dramatically reduced, will continue to have excess capacity into the future.

The Postal Service then went on to develop upper-bound estimates of the short-run attributable costs for Standard Mail products based on the conservative assumption that there was no excess capacity in other areas, e.g., mail processing.<sup>17</sup> When this upper-bound method for estimating short-run attributable costs is applied to Standard Mail Flats and Periodicals, they are shown to cover attributable costs in the presence of excess capacity, as Table 3 shows:

**Table 3.  
Calculation of FY 2009 Periodicals and Standard Mail Flat Cost Coverage  
(Revenue as % of Short-Run Attributable Costs)**

| Mail Class/Product  |     | Revenue                                  | Short-Run<br>Attributable<br>Costs | Revenue                                   |
|---|-----|--|------------------------------------|---|
|   |     | (As % of Long-Run<br>Attributable Costs) |                                    | (As % of Short-Run<br>Attributable Costs) |
|   |     | [1]                                      | [2]                                | [3]=[1]/[2]                               |
| Periodicals   | [a] | 76.05%                                   | 67.4%                              | 112.8%                                    |
| Standard Mail<br>Flats  | [b] | 82.15%                                   | 66.3%                              | 123.9%                                    |
| [1] FY 2009 CRA   |     |  |                                    |   |
| [2][a] Appendix A (Calculating Periodicals Short-Run Attributable Costs Using R2009-3 Method) |     |  |                                    |   |
| [2][b] Calculated from Docket No. 2009-3 Data Collection Report at 3                          |     |  |                                    |   |

Thus, when costs are properly attributed to reflect the lower level of cost variability in the presence of excess capacity, Periodicals and Standard Mail

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<sup>17</sup> As the recent eyewitness testimony of Time Inc. witness Jim O'Brien illustrates, the Postal Service currently has considerable excess capacity for processing flat-shaped mail. See Written Statement of James O'Brien Before the House Committee on Oversight and Government Reform Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia (May 12, 2010).

Flats are not, in fact, “underwater,” and there is no need for the steep price increases proposed by the Postal Service.<sup>18</sup>

### **III. PERIODICALS MAIL AND STANDARD MAIL FLATS COVER THEIR LONG-RUN ATTRIBUTABLE COSTS.**

The notion that Periodicals Mail and Standard Mail Flats are being subsidized by other users of other products founders on a further and independent ground: both Periodicals Mail and Standard Mail Flats (including catalogs) are complements of other, higher-markup postal products. As explained by the Postal Service’s Chief Financial Officer, the contribution of these complementary products, as well as other values of periodicals and catalogs should be taken into account when evaluating profitability:

[Y]ou have to...determine what impact on your overall profitability a drop in volume of a particular type of mail will bring about. For example periodicals, why do people go to their mailbox? Because there are magazines there. Is that make it more attractive for advertisers to also advertise in the mail because they know people are picking up their mail et cetera. What is the indirect impact of a particular piece of mail on other pieces of mail, will it generate additional mail either through back end delivery of products that are sold in that piece of mail, of reply cards or other types of things? So you have to consider a whole lot of things when you're pricing an individual product. . . I personally believe that things like periodicals increase the value of the overall mail.

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<sup>18</sup> As the Commission is aware, both the Postal Service and the undersigned parties believe that treatment of periodical mail processing costs as virtually 100 percent variable over the long run is an overstatement. The Commission need not reconsider its previous position on this issue, however, to find that *short-run* variability in the presence of excess capacity is significantly below 100 percent.

Tr. 1/80-81 (Corbett). The contribution from higher-markup complements to periodicals and catalogs more than offsets any conceivable losses to the Postal Service from the periodicals and catalogs themselves.

#### **A. Periodicals Publishers**

Periodicals publishers make significant use of First-Class Mail and Standard Mail for subscription promotions, gift subscription solicitations, acknowledgments of subscriptions, invoices, business reply and courtesy reply mailings for subscribers to send payments back to publishers, renewal notices, reminder notices for continuous service subscriptions, and other correspondence with customers. The rental of subscriber lists also generates mail volume.

Publishers also generate significant First-Class Mail and Standard Mail volumes in the ordinary course of business. To better understand these other uses, CDS Global, the largest provider of fulfillment solutions in support of the magazine publishing industry, recently studied the postage expenditures of 460 business-to-consumer and business-to-business publications that spend a total of approximately \$1 billion in postage annually. As Table 4 shows, this study found that only 60 percent of what the publishers spent on postage was in the Periodicals Mail class.<sup>19</sup>

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<sup>19</sup> A Postal Service analysis of the Top 100 Periodicals mailers strongly suggests that the contribution of Periodicals publishers is even higher than estimated in Table 5 below. The analysis shows that an even smaller percentage -- less than half -- of the postage these mailers spend is in the Periodicals class with the remainder primarily in the high-contribution Standard Mail and First-Class Mail classes. Response of James Kiefer to POIR No. 3, Question 10.

**Table 4. Periodical Publisher Postage by Mail Class/Type**

| Mail Class/Type                             | % of Total Postage Paid |
|---|-------------------------|
| <b>Periodicals</b>                          | 60.1%                   |
| <b>Standard Mail (Primarily Letters)</b>    | 29.0%                   |
| <b>First-Class Mail (Primarily Letters)</b> |                         |
| Letters                                     | 6.6%                    |
| Business Reply Mail                         | 2.4%                    |
| Courtesy Reply Mail                         | 1.5%                    |
| <b>Other</b>                                |                         |
| Address Change Service (ACS)                | 0.2%                    |
| PO Box, PERMIT, Accounting Fees             | 0.2%                    |

Source: CDS Global Study

As Table 5 below shows, the First-Class Mail and Standard Mail contributions more than offsets the purported loss of the Periodicals sent by publishers. This is true using FY 2009, FY 2010, and FY 2011 (Before Rates) unit contribution by product figures.

**Table 5.  
Periodical Publisher Mail Volume and Contribution (in Millions)**

| Mail Class/Product                          | Volume        | Contribution |              |              |
|---|---------------|--------------|--------------|--------------|
|   |               | FY 2009      | FY 2010      | FY 2011 (BR) |
| First-Class Mail Single-Piece Letters/Cards | 357           | \$64         | \$71         | \$71         |
| First-Class Mail Presort Letters/Cards      | 761           | \$174        | \$180        | \$179        |
| Periodicals                                 | 7,954         | (\$642)      | (\$535)      | (\$500)      |
| Standard Mail Letters                       | 5,200         | \$414        | \$452        | \$458        |
| <b>Total</b>                                | <b>14,271</b> | <b>\$10</b>  | <b>\$168</b> | <b>\$207</b> |

Source: Volumes From CDS Study (Inflated to Reflect Total FY 2009 Periodicals Mail Volume; FY 2009, FY 2010, and FY 2011 (BR) unit contributions used to calculate total contribution from FY 2009 CRA and Masse Statement, Attachments 9 and 10.

For newspaper periodicals, the Standard Mail component is much heavier, reflecting significant use of the high-contribution High Density and Saturation products for shopper and Total Market Coverage publications.

The study confirms the results of a previous MPA study. A 2007 survey of a subset of MPA members that accounted for approximately 25 percent of the total postage received by the Postal Service from Periodicals Mail indicated that, for every dollar spent on Periodicals postage, the publishers spent approximately 18 cents in First-Class Mail postage and 42 cents in Standard Mail postage. Moreover, the study found that (1) the First-Class Mail and Standard Mail categories used by periodical publishers are high-markup categories that pay significant contributions per piece to institutional costs; and (2) the positive contribution from these complementary mail classes used by Periodicals publishers almost completely offset the negative contribution of \$643 million assertedly generated by Periodicals mail. See Docket No. ACR2009, MPA/ANM Reply Comments (filed on 2/23/2010) at 2.

## **B. Catalog Mailers**

Likewise, catalog mailers, in addition to using Postal Service shipping service products (*e.g.*, Express Mail, Priority Mail, and Parcel Select), also make significant use of the Standard Mail Carrier Route product to mail catalogs.

As shown in Table 6, most catalog mailings make use of both the Standard Mail Flat and Standard Mail Carrier Route products.

**Table 6.**  
**Catalog Mail Volume by Product (By Mailing Size)**

| <b>Mailing Size</b> | <b>Carrier Route</b> | <b>Flat</b> |
|---------------------|----------------------|-------------|
| 100,000             | 2%                   | 98%         |
| 200,000             | 10%                  | 90%         |
| 500,000             | 24%                  | 76%         |
| 1,000,000           | 39%                  | 61%         |
| 2,000,000           | 59%                  | 41%         |
| 4,000,000           | 74%                  | 26%         |
| 6,000,000           | 85%                  | 15%         |

Source: Quad/Graphics

Because catalogs generally (and, in fact, individual catalog mailings) include both the Standard Mail Flat and Standard Mail Carrier Route product, the contribution of catalogs is best measured by summing the contribution of the two products. Together, these two products made a significant contribution in FY 2009 and are projected to make even larger contributions in both FY 2010 and FY 2011 (Before Rates).

**Table 7.**  
**Contribution of Standard Mail Flats and Carrier Route Product**  
**(in Millions of Dollars)**

| <b>Fiscal Year</b> | <b>Flats</b> | <b>Carrier Route</b> | <b>Total</b> |
|--------------------|--------------|----------------------|--------------|
| FY 2009            | -\$622       | \$694                | \$73         |
| FY 2010            | -\$454       | \$748                | \$294        |
| FY 2011 (BR)       | -\$418       | \$806                | \$388        |

Source: FY 2009 CRA; Masse Statement, Attachments 9 and 10

A recent Postal Service study quantifying the contribution of the Top 600 catalogers confirms that catalog mailers make a substantial contribution to

institutional costs. In his response to POIR No. 3, Question 7, USPS witness Kiefer stated that the Postal Service

has produced an estimate of cost coverage of mail sent by catalog mailers ...Based on this analysis the catalog industry generates mail with a total cost coverage of approximately 132 percent.

Response of James Kiefer to POIR No. 3 at 11 (August 9, 2010). Dr. Kiefer emphasized this point at the August 12 hearing, stating that the Postal Service “believe[s] that as a whole, taken as a whole, that catalog mail, this catalog industry, is a profitable industry for [the Postal Service].... [W]e’re making money on this industry ... If you look at the top line there, these estimates suggest that we are more than covering our costs from these catalogers.” Tr. 3/453-455.

The Postal Service’s proposed price increases for Periodicals and Standard Mail Regular Flats would drive out of the system not only flats-shaped mail but also this derivative volume. If periodical and catalog mailers are not mailing their flats, they will not be mailing these other pieces. The Commission has recognized the value of the “multiplier effect” provided by certain types of mail.<sup>20</sup> In its shortsighted focus on the price of one category of products, the Postal Service is ignoring the broader impacts of its proposal. At a time when the Postal Service claims to be desperate for more money, driving away customers who make a positive contribution to the Postal Service’s institutional costs is folly.

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<sup>20</sup> See Rate and Service Changes to Implement Baseline Negotiated Service Agreement with Bookspan, Docket No. MC2005-3, Opinion and Recommended Decision at 45 (noting that the NSA regulations required the Commission to find that “the Agreement covers its indirect and direct attributable costs and provides a reasonable contribution to other Postal Service costs” and explaining that the existence of a multiplier effect supported the Commission’s conclusion that the Bookspan NSA met this standard).

## **CONCLUSION**

The supposed need for significant increases in the prices for Periodicals and Standard Mail Flats arises solely from the Postal Service's failure to constrain its costs. Raising prices on this mail, rather than addressing the causes of this failure, would only exacerbate the problem by driving this mail, and the significant collateral mail volume that catalogs and periodicals generate, from the postal system. Rather than accept the Postal Service's proposed increases, the Commission should make clear that it expects the Postal Service to focus on bringing its costs in line with inflation. Doing so will benefit both the Postal Service and mailers, will finally resolve an issue that has long been acknowledged, but which the Postal Service has failed to remedy, and will keep faith with the regulatory approach embodied in the PAEA.

Respectfully submitted,

David M. Levy  
Matthew D. Field  
Seung-Hyun Ryu  
VENABLE LLP  
575 Seventh Street, N.W.  
Washington DC 20004  
(202) 344-4800  
[dlevy@venable.com](mailto:dlevy@venable.com)

*Counsel for Alliance of Nonprofit  
Mailers and Magazine Publishers of  
America*

David R. Straus  
THOMPSON COBURN LLP  
1909 K Street, N.W., Suite 600  
Washington DC 20006  
(202) 585-6921  
[dstraus@thompsoncoburn.com](mailto:dstraus@thompsoncoburn.com)

*Counsel for American Business Media*

C. Hamilton Davison  
President & Executive Director  
AMERICAN CATALOG MAILERS  
ASSOCIATION, INC.  
PO Box 41211  
Providence RI 02940-1211  
(800) 509-9514  
[hdavison@catalogmailers.org](mailto:hdavison@catalogmailers.org)

*For American Catalog Mailers  
Association, Inc.*

Anthony W. Conway  
Executive Director  
ALLIANCE OF NONPROFIT MAILERS  
Suite 610  
1211 Connecticut Avenue, N.W.  
Washington DC 20036-2705  
(202) 462-5132  
[Tony@nonprofitmailers.org](mailto:Tony@nonprofitmailers.org)

*For Alliance of Nonprofit Mailers*

Tonda F. Rush  
KING & BALLOW  
PO Box 50301  
Arlington VA 22205  
(703) 237-9801  
[trush@americanpressworks.com](mailto:trush@americanpressworks.com)

*Counsel to National Newspaper  
Association*

Jerry Cerasale  
Senior Vice President for Government  
Affairs  
DIRECT MARKETING ASSOCIATION, INC.  
1615 L Street, N.W.  
Suite 1100  
Washington DC 20036  
[jcerasale@the-dma.org](mailto:jcerasale@the-dma.org)

*Counsel for Direct Marketing  
Association, Inc.*

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