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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Rate Adjustment due to Extraordinary or	)	
Exceptional Circumstances	)	Docket No. R2010-4

INITIAL COMMENTS

OF

**VALPAK DIRECT MARKETING SYSTEMS, INC., AND
VALPAK DEALERS' ASSOCIATION, INC.**
(August 17, 2010)

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COURSE OF PROCEEDINGS

On July 6, 2010, the Postal Service filed its "Exigent Request of the United States Postal Service," pursuant to 39 U.S.C. section 3622(d)(1)(E), supported by the statements of three witness: Joseph Corbett, Chief Financial Officer; Stephen J. Masse, Vice President, Finance and Planning; and James M. Kiefer, Pricing Economist. The Postal Service provided three nonpublic library references, and nine public library references consisting of five sets of worksheets for the five market dominant classes, a Product Cost & Contribution Model, a Cost Factor Development, revenue and volume forecasts, and its "Flats Strategy."

On July 8, 2010, the Commission issued Order No. 485, "Notice and Order Concerning Rate Adjustment for Extraordinary or Exceptional Circumstances."[1] Order No. 485 established a procedural schedule including three technical conferences and three days of public hearings on the three Postal Service witnesses as well as an additional witness for the Flats Strategy and establishing a deadline of August 17, 2010 for Initial Comments and September 2, 2010 for Reply Comments. The deadline for the Commission's determination of the Postal Service's request is October 4, 2010.

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[1] When the Postal Service's exigent request looked likely, the Commission decided to open a discussion of various procedural matters surrounding an exigent request, even though it was "confident that its Exigent Rate Case Rules will provide an effective procedural framework for consideration of the currently anticipated case." Docket No. PI2010-3, Order No. 456. The Commission held a Technical Conference on June 16, 2010 in order to discuss these procedural issues which apparently helped the Commission in preparing for the present docket. *See* Order No. 485, pp. 5-6.

Following the Postal Service's Request and Commission Order No. 485, the Commission held three technical conferences in which Valpak participated:

Date	Topic
July 19, 2010	Cost, volume, and revenue forecasts
July 23, 2010	Technical questions regarding pricing
July 27, 2010	Flats Strategy

The Affordable Mail Alliance ("AMA") filed a motion to dismiss on July 26, 2010, seeking, *inter alia*, to have the Commission make a threshold determination of whether the Postal Service's circumstances were extraordinary or exceptional. The Public Representative submitted a response in support of the AMA motion. Responses in opposition were submitted by the U.S. Postal Service; the National Association of Letter Carriers; National Rural Letter Carriers' Association; National Postal Mail Handlers Union; and Saturation Mailers Coalition, Valassis, and Valpak. The Commission took the AMA motion under advisement, deferring a decision until a record had been developed. *See* Order No. 507.

Suggested questions for the Commission to ask of the Postal Service witnesses at the public hearings were submitted by Valpak and the National Association of Postmasters of the United States, National Postal Policy Council, a group of periodical and catalog mailers, the Affordable Mail Alliance, American Postal Workers Union, Time Warner, Greeting Card Association, and eBay.

Public hearings for Commission questioning of Postal Service witnesses were held, including a witness provided by the Postal Service at the Commission's request to testify as to the Postal Service's Flats Strategy:

Witness Corbett	August 10, 2010
Witness Masse	August 11, 2010
Witness Kiefer	August 12, 2010
Witness Neri (Flats Strategy)	August 12, 2010

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint comments.

I. THE POSTAL SERVICE HAS ADJUSTED RATHER WELL TO THE UNPRECEDENTED DECLINE IN VOLUME AND THE ECONOMIC RECESSION.

The Affordable Mail Alliance ("AMA") blames the current liquidity crisis on Postal Service management for having inadequately responded to the recession and resulting reduction in Postal Service volume. AMA Motion to Dismiss, pp. 47-64 (July 26, 2010). This charge is not supported by an examination of Postal Service finances.

A. In FY 2005 and FY 2006, the Postal Service Had Positive Operating Profits and Cash Flow.

In the two fiscal years immediately preceding enactment of PAEA in December 2006, mail volume was still holding up pretty well despite conversion of some First-Class Mail to electronic alternatives. In each of those two years (FY 2005 and FY 2006), the Postal Service turned in a respectable financial performance. For these two years combined, operating income amounted to $2.345 billion. At the end of FY 2006, the Postal Service had only $2.0 billion of debt, offset by over $3.0 billion of prior profits held in an escrow account. Summary financial results are shown in Table I-1.

Table I-1
U.S. Postal Service Operation Revenue and Expenses
FY 2005 – FY 2006
($, millions)

	FY 2005	FY 2006
Operating Revenue		
(Incl. Net investment/interest income)	69,278	72,584
Less: Operating Expenses	68,283	71,684
Operating Income	1,445	900

Source: U.S. Postal Service Annual Reports.

Also noteworthy is that, during the two years FY 2005-06, the Postal Service had positive cash flow, as shown in Table I-2. For the two years combined, after spending almost $5 billion needed for investments in property and equipment (row 4), cumulative "free" cash flow exceeded $2.5 billion.

Table I-2
U. S. Postal Service Cash Flow
FY 2005 – FY 2006
($, millions)

	FY 2005	FY 2006
1. Net Income	1,445	900
2. Depreciation & amortization	2,089	2,149
3. Subtotal	3,534	3,049
4. Purchase of property & equipment	-2,317	-2,630
5. Subtotal	1,217	419
6. Net cash flow from other operating activities	196	717
7. Operating Cash Flow	1,412	1,136

Source: U.S. Postal Service Annual Reports.

Under the Postal Reorganization Act of 1970 ("PRA"), which then was in effect, postage rates were set to achieve financial breakeven (generally over a 3-year period). The Postal Service was not operated as a profit-making institution, nor was it permitted under the PRA to accumulate significant profits in the form of "retained earnings." Hence achievement of the operating income shown in Table I-1, as well as the cash flow shown in Table I-2, comfortably exceeded the breakeven requirement.

B. Since FY 2006, Postal Service Operating Income Has Been Positive Despite the Unprecedented Decline in Volume.

The Postal Service's **operating** performance from FY 2007 through the first nine months of FY 2010 is summarized here in Table I-3. As shown there, cumulative **operating income** over the entire 3-year and 9-month period amounts to $2.424 billion.

The data in Table I-3 reflect all "normal" operating revenues and expenses **except** contributions to the Postal Service Retiree Health Benefit Fund ("PSRHBF") established by the Postal Accountability and Enhancement Act ("PAEA") in 2006.[2] Table I-3 is designed for analytic purposes to isolate the Postal Service's "normal" operating expenses from effects of the additional financial burden imposed on the Postal Service by the statutory requirement to pre-fund all retiree health care benefits over a ten-year period. (In accounting parlance, Table I-3 might be described as a "pro forma" presentation.)

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[2] Payments for current health care benefits for existing retirees are included in operating expenses.

Table I-3
U. S. Postal Service Operation Revenue and Expenses
FY 2007 – FY 2010 (9 mos.)
($, millions)

	FY 2007	**FY 2008**	**FY 2009**	**9 mos. FY 2010**
Operating Revenue (Incl. net invest./int. income)	74,963	74,932	68,036	51,071
Less: Operating Expenses	71,757	72,138	70,430	52,253
Operating Income	3,206	2,794	-2,394	-1,182

Sources: U. S. Postal Service Annual Reports and FY 2010 10-Q for the quarterly period ended September 30, 2010.

Adding to this FY 2007 through FY 2010 Q3 period the results of FY 2005-06 (Table I-1), shows that over an extended 5-year and 9-month period, the Postal Service's operating income exceeded $4.7 billion — even after including all losses in FY 2009 and the first three quarters of FY 2010.

Although the Postal Service had an operating loss in FY 2009, and is projected to have another operating loss in FY 2010, the data in Table I-3 indicate that the Postal Service today would not be in the liquidity crisis that it is in were it not for the PAEA requirement to pre-fund retiree health care benefits. In other words, the unprecedented decline in volume documented in testimony of Joseph Corbett has been, and is being, offset to a remarkable degree by dramatic reductions in size of the labor force and labor hours worked. Attributable costs long treated as volume variable expenses are indeed proving to be variable, albeit with a lag, and the Postal Service is finding ways to downsize operations to meet the decline in mail volume.

It can be concluded from these data that the Postal Service's business model, in the hands of exceptionally capable Postal Service management, has proven to be robust in dealing with cyclical changes in the economy, including the worst recession since the Great Depression of the 1930s. The data in Table I-3 simply do not support AMA's claim that the Postal Service is being badly managed or that costs are not being cut. The economic recession and accompanying decline in mail volume are being adjusted to.[3] However, the business model on which the Postal Service has been relying has not found ways to generate the enormous net funds necessary to adapt to the extraordinary Congressional mandate to pre-fund all future retiree health care benefits over a 10-year period.[4]

C. PAEA Pre-Ordained Eventual Postal Service Financial Insolvency.

Under the PAEA, the Postal Service is required to pre-fund the PSRHBF over a 10-year period to the tune of approximately $5.7 billion per year, for a total of some $57 billion by 2016. As shown in Table I-2, even in the two relatively good years just before PAEA was enacted, the Postal Service's free cash flow averaged less than $1.5 billion per year. Thus, over the ensuing 10 years following enactment of PAEA, the Postal Service optimistically might have been expected to generate free cash flow of $15 billion or, at the outside, perhaps as much as $20 billion. That amount, coupled with borrowing authority of $15 billion, means

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[3] See Statement of Stephen Masse, Docket No. R2010-4, pp. 11-13.

[4] Postal Service statements would appear to support this analysis. "Postal Service revenues would have exceeded costs over the past several years, despite historic volume losses, if it were not for the billion of dollars of retiree health benefits payments paid by the Postal Service since the enactment of the PAEA." Docket No. R2010-4, Response of the United States Postal Service to Motion of the Affordable Mail Alliance to Dismiss Request (Aug. 2, 2010), p. 5.

that the Postal Service might have been able to fund the PSRHBF by $30 to $35 billion — at most.[5] The foreseeable shortfall below $57 billion was at least $20 to $25 billion — more if borrowing authority is excluded from the computation.

While severely upping the bar on required cash flow generation, the PAEA generally capped the Postal Service's ability to raise rates in excess of the CPI. With rate increases thus limited, the only ways for the Postal Service to increase free cash flow significantly beyond the level achieved in FY 2005-06 were to:

- achieve major reductions in costs, or
- use its rate flexibility to reduce the volume of and losses incurred on money-losing products.

Achieving major cost reductions under PAEA is problematical. As explained by Joseph Corbett, the PAEA made no change in the Postal Service's ability to reduce its costs by closing redundant facilities.[6] Nor did the PAEA provide that in any labor arbitration proceeding the arbitrators were to take explicit account of the Postal Service's financial condition.[7]

Hence, even without onset of the recession and resultant decline in mail volume, the Postal Service was going to face serious liquidity problems and possible insolvency about half-way into the 10-year retiree health benefit payment plan. With revenues capped by PAEA, and

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[5] Borrowing from Treasury to fund the PSRHBF is akin to a shell game, and really is no solution at all. *See* Tr. 2/32, ll. 17-25.

[6] *See* Statement of Joseph Corbett, Docket No. R2010-4, p. 7. The PAEA did not include the Presidential Commission's recommendation for something similar to the DOD base-closing procedure.

[7] An amendment by Senator Tom Coburn (R–OK) to establish this principle in title 39 has not yet been enacted. *See* Coburn Amendment to S. 1507 (111st Congress).

major cost reductions blocked by predictable parochial Congressional concerns,[8] an insolvent condition was largely beyond control of the Postal Service. Only the timing of insolvency was unknown. The recession and accompanying decline in volume have brought the Postal Service to the brink of insolvency sooner, rather than later.

The amount of annual funding that PAEA requires for retiree health care benefits was enormous in relation to the size of the Postal Service's expected cash flow. No other organization — not governmental (neither federal, state, nor local) nor private (neither for-profit nor nonprofit) — has been required to pre-fund retiree benefits to the extent required by PAEA. Why Congress singled out the Postal Service for such treatment is unclear. Nevertheless, it did, and the Postal Service, along with all mailers, now is forced to live with the consequences.

D. Using Pricing to Improve Postal Service Liquidity.

Despite commendable management in other areas, Postal Service management needs to do more to use the pricing flexibility given to it under the Postal Accountability and Enhancement Act of 2006 ("PAEA") (Pub. L. 109-435) to reduce enormous planned losses for several products which now contribute to the threat the financial health of the Postal Service.

Insofar as PAEA was accompanied by no conference report and little clear legislative history, how Congress intended the Postal Service to generate the extra cash required for the pre-funding requirement in PAEA is, at best, ambiguous. Since opportunities to develop **new**

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[8] Since closing of even one or two small post offices can result in Congressional inquiry, one can only imagine the response to an effort, or proposal, to close 100 to 200 redundant mail processing facilities along with thousands of small, money-losing post offices, stations, and branches.

products were impeded[9], it is unlikely Congress expected any new sources of revenue. It is now often stated that Congress desired the Postal Service to **cut costs aggressively**, but the truth is that Congress was paralyzed into inaction by competing interests and failed to give the Postal Service meaningful new tools to reign in costs. *See* n.6, *supra*.

With both new revenue initiatives and cost-reduction options severely limited by Congress, it has become evident that the principal tool provided to the Postal Service is the increased **pricing flexibility** given to it by PAEA. The pricing flexibility being referred to here includes the right to file an **exigent rate case** built into PAEA as a relief valve, to be used at a time such as this. But its central feature is the Postal Service's authority to price products so as to **stem losses from unprofitable products**, and **generate additional profits on existing and new volume**. Directed appropriately, pricing flexibility can be a powerful tool for promoting economic efficiency. In this docket, however, the Postal Service appears to have been paralyzed into inaction and has failed to use this pricing tool as is now necessary to fund retiree benefits while staying within the rate cap, thereby ensuring its financial survival and viability.

To elaborate, the Postal Service has a number of "underwater" products that have not even covered their attributable costs — *i.e.*, that lose money each and every day — as well as other products that have barely covered their attributable costs and make only minimal contribution to fixed overhead costs. *See* sections III and IV, *infra*. Under these circumstances, the Postal Service can increase its operating profits and cash flow by focusing

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9 *See* 39 U.S.C. section 404(e).

rate increases aggressively on its underwater, money-losing products. As regards the Postal Service's bottom line, any such focus would have a number of beneficial effects.

First, **some mailers likely would continue using the product**, despite a higher rate increase. From such "remaining" mail the Postal Service would begin to recoup substantially more (perhaps even all) of its attributable costs. In this docket, the 23.3 percent rate adjustment proposed for Standard Parcels provides a good example of how pricing flexibility, used aggressively for selected products, can reduce and even eliminate losses.

Second, a higher rate increase would give an accurate price signal which may induce mailers to **switch to some other product** which the Postal Service handles more efficiently and profitably.[10] Obviously, that also would make a positive contribution to the Postal Service's operating profit.

Third, some may elect to avoid a higher rate increase by sharply **reducing the volume** which they mail. That should not be a worry, though. All reductions in such unprofitable volume would result in attributable costs declining even more than revenues, which in turn would help increase the Postal Service's operating profits.

Fourth, by focusing the major portion of rate increases on its unprofitable products, the Postal Service can restrain, and possibly eliminate altogether, rate increases on the **most**

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[10] Following previous rate hikes, a number of catalog mailers that previously used Standard Flats — a seriously underwater product that regularly loses money for the Postal Service — reportedly changed to a letter format, which the Postal Service handles more efficiently; the result is lower cost, while profitability is higher. *See* Section IV, *infra*, for more discussion concerning Standard Flats.

profitable products that sustain the Postal Service.[11] That, too, would help maintain operating profits. It is to be expected that any rate increase on any product will reduce volume of that product. Focusing reductions in volume on money-losing or marginally profitable products, while exercising tight restraint over increases for highly profitable products with high elasticity, would conform much better with the priority inherent in the Congressional mandate to pre-fund retiree benefits over a 10-year period while existing within the rate cap.

II. PAEA ESTABLISHED EXIGENT RATE CASES FOR TIMES LIKE THIS, BUT THE POSTAL SERVICE'S PROPOSED RATES MUST BE LAWFUL.

A. PAEA Expressly Grants the Commission the Power to Make Rules, and Requires it Determine That Rates Are "Reasonable," "Equitable" and "Necessary," but No Express Power to Decide If "Extraordinary or Exceptional Circumstances" Exists.

Prior to enactment of PAEA, postal rates were set in a manner that generally allowed the Postal Service to break even. PAEA instituted a rate cap set according to changes in the Consumer Price Index for All Urban Consumers ("CPI-U"), along with factors and objectives. *See, generally*, 39 U.S.C. § 3622.

An exception to the cap was provided for an increase in market dominant product prices notwithstanding the cap in "extraordinary or exceptional circumstances…." 39 U.S.C. § 3622(d)(1)(E); 39 C.F.R. § 3010.60 ("Such requests will be known as exigent requests.").

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[11] See Statement of James M. Kiefer on Behalf of the United States Postal Service, p. 13 ("A loss of presort First-Class Mail volume, or even a relatively minor portion of it, would be devastating to the Postal Service's financial health."). Realization that the Postal Service cannot afford to lose even a small portion of highly profitable volume is at almost total odds with a rate adjustment that borders on being across-the-board.

The rate-setting rules of PAEA apply to an exigent rate case, except for the specific terms of the statute below:

> **[Rulemaking]**
> notwithstanding any limitation [the rate cap] set under subparagraphs (A) and (C), and provided there is not sufficient unused rate authority under paragraph (2)(C), **establish procedures** whereby rates may be adjusted on an expedited basis due to either **extraordinary or exceptional circumstances**....
>
> **[Exigent Case Procedures]**
> provided that the Commission determines, after notice and opportunity for a **public hearing** and comment, and **within 90 days** after any request by the Postal Service, that such adjustment is **reasonable and equitable and necessary** to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States. [39 U.S.C. § 3622(d)(1)(E) (emphasis added).]

In sum, the statute:

(i) provides that the Commission **develop procedures** whereby rates may be adjusted above the cap for "either **extraordinary or exceptional circumstances**" and then

(ii) using those procedures, **determine** "that such adjustment is **reasonable** and **equitable** and **necessary** to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States."

While the statute is clear that the Commission makes a determination as to whether proposed rates are "reasonable," "equitable, and "necessary," the statute is silent as to whether the Board of Governors or the Commission decides that "either extraordinary or exceptional circumstances" exist.

In Docket No. RM2007-1, the Commission promulgated regulations implementing section 3622 for rate-cap based price adjustments as well as exigent requests. *See* 39 C.F.R. §§ 3010.60, *et seq.* The Commission intended its rules to establish "a basic framework in place for the new system, [as] it is not practical to attempt to address every eventuality. This is especially the case with respect to exigent requests, which the Commission (and presumably most others) hope does not materialize in the near future." Order No. 43, p. 28. Not addressing every eventuality, the Commission's regulations do not expressly clarify this jurisdictional issue as to who decides whether "extraordinary or exceptional circumstances" exist.

Insofar as the basic pricing function is vested in the Board of Governors (39 U.S.C. section 403), the Postal Service has explained that it views this jurisdictional issue a "close case," but unnecessary to decide at this time, since the "extraordinary or exceptional circumstances" test is met, irrespective of who decides the issue. *See* Postal Service Answer to AMA Motion, p. 11 (August 2, 2010). Postal Service witness Corbett filed a persuasive statement as to how the recent volume losses were far more than the Postal Service had ever experienced in the past. Statement of James Corbett, Docket No. R2010-4, pp. 11-15. And the Postal Service filed a comprehensive and compelling response to each of AMA's claims that the Postal Service has been being badly managed.

Although some mailers have taken the position that an exigent rate case had to involve a circumstance **such as** a terrorist attack, it turns out that these mailers mean that the **only** circumstance that would justify an exigent rate case is a terrorist attack. Of course, a terrorist attack could result in less volume loss to the Postal Service than the economic recession — and, in fact, the attacks of September 11, 2001, prove this point, as detailed by witness Corbett. *Id.*, p. 3.

B. In An Exigent Rate Case, Congress provided the Postal Service With an Opportunity to Rationalize Rates.

Different views have been expressed in prior dockets as to whether the cap trumps the PAEA "requirement" that classes cover their costs (39 U.S.C. section 3622(c)(2)) and the Congressional policy that all mail both cover its costs and make a contribution to institutional costs (39 U.S.C. section 101(d)), or whether the cap can be overridden to solve the problem of underwater classes and products. In Annual Compliance Reviews and Complaint Dockets, the Commission is granted the power to modify rates and even eliminate products, and it would be a strange reading of PAEA to say that Congress would have empowered the Commission to order the Postal Service to discontinue an entire product for being underwater, but powerless to order the price of that product raised a few percentage points more than the cap to recover costs.

The situation with respect to Classes which are above water containing products which are underwater is somewhat different. There, the Postal Service can allocate all of the cap for the Class for increases to a badly underwater product like Standard Flats. It would even be possible to decrease the rates of other extremely high coverage products, like saturation mail, to offset increases in badly underwater products. Of course, in an exigent rate case, the cap does not apply, and there is no revenue requirement — no fixed goal as to how much revenue must be raised (Tr. 2/290, ll. 18-23).

C. If the Commission determines that proposed rates are not reasonable, equitable or necessary, they should be rejected.

The Commission has a clear mandate to ensure that rates for each product meet the statutory standards of "reasonable," "equitable," and "necessary." If the test is not met, the

Commission's duty is to reject the proposed rates, explaining how they violate the statutory mandate. Although the Commission's rules do not currently provide for a form of remand to the Board of Governors, this would appear to be the preferred approach to be used in such a circumstance.

III. THE POSTAL SERVICE CANNOT AFFORD TO ABSORB LOSSES CAUSED BY PRICING UNDERWATER PRODUCTS DESIGNED TO INCUR SUBSTANTIAL LOSSES.

As shown in Table III-A, even after taking into account its proposed price increases, the Postal Service is planning to continue to lose money on several Market Dominant products in FY 2011. Assuming January 2, 2011 implementation of the exigent rate increases, the new, higher rates will be in effect during nine months of FY 2011, but **$727 million in losses are still expected in FY 2011.**

Table III-1
FY 2011 UNDERWATER PRODUCTS
PROJECTED LOSSES

Product	Before Rates Cost Coverage	Before Rates Revenue Loss ($ Millions)	After Rates Cost Coverage	After Rates Revenue loss ($ Millions)[12]
Standard Mail Flats	87.4%	$418	90.6%	$310
Standard Mail NFMs/Parcels	77.7%	$193	94.9%	$44
Periodicals In County	92.1%	$7	97.6%	$3
Periodicals Outside County	79.5%	$452	84.2%	$347
Media and Library Mail	89.6%	$42	94.1%	$23
Total Projected Loss				**$727**

[Source: Masse testimony, attachments 10 and 11.]

Since, no further price change is expected in May 2011, these losses can be expected to continue until prices are changed again, certainly into, and perhaps through FY 2012.

Valpak's concern with these losses is not new. Since the first Annual Compliance Report, Valpak has brought to the attention of the Commission, as regulator, the serious problem of products or classes not covering their attributable costs in violation of PAEA. *See*, Docket No. ACR2007, Valpak Initial Comments, pp. 44-48; Docket No. ACR2008, Valpak Initial Comments, pp. 12-24; and Docket No. ACR2009, Valpak Initial Comments, pp. 9-21.

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[12] After Rates estimates are based on the Postal Service's proposed January 2, 2011 implementation date. Based on the hypothetical October 1, 2010 implementation date, Standard Mail NFMs/Parcels would cover their costs, and the Postal Service's projected loss from underwater products in FY 2011 would be $598 million. Products which cover their costs after rates (but not before rates) are not included.

In comments on the FY 2009 ACR, Valpak warned of the pricing problem now facing the Commission, and believes that these observations are applicable again to the Postal Service's proposed rates.

> Even when the Postal Service is operating in the black, it is neither appropriate nor fair for classes or products to be required to cross-subsidize other classes and products. In the current state of the Postal Service's financial situation, however, the matter is much more serious. **The Commission faces an economic necessity to exercise its regulatory responsibility under PAEA to protect the financial health of the Postal Service.**
>
> In the past, it has been argued that if the Commission were to order the Postal Service to achieve immediate compliance pursuant to 39 U.S.C. section 3622(c)(2), there would be **rate shock and a loss of volume**. It now is clear, however, that it **no longer is possible to take the indefinite wait-and-see approach** of Docket Nos. ACR2007 and ACR2008, as that approach has not only (i) failed to correct the problem, it also (ii) failed to prevent the problem from becoming worse and now (iii) threatens to bring on the insolvency of the Postal Service. One cannot employ the same approach yet again and hope for a different result. It should not be a goal of either the Postal Service or the Commission to tolerate, or even foster growth in the volume or losses of, classes or products that fail to cover their attributable costs.
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> If prices must be adjusted to help the Postal Service achieve financial stability, it is the prices of **loss-making products** that should be adjusted upward. [Across-the-board increases only would perpetuate the inequities of the current price structure and continue to send the wrong pricing signals.] These adjustments could occur in steps instead of all at once, which will help reduce the immediate effects on mailers and maintain stability, but steps of some sort must be taken so the situation does not worsen yet again.... [Docket No. ACR2009, Valpak Initial Comments, pp. 20-21 (emphasis added; footnotes bracketed).[13]]

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[13] In Docket No. ACR2009, Valpak also observed in a footnote that losses will contribute to the need for cutbacks of service, in comments that are now relevant to Docket

The projected $727 million loss in FY 2010 is an improvement resulting from an improvement in Postal Service pricing for certain products.[14] Periodicals went underwater in FY 1997, and through FY 2009 have reduced the Postal Service bottom line for 13 consecutive years. *See* Valpak Initial Comments, Docket No. ACR2009, pp. 14-18. **However, the Periodicals pricing issue has been addressed responsibly by the Postal Service with an above-average 8 percent price increases for both Periodicals subclasses.** Additionally, the problem of Standard parcels was addressed with a 23 percent increase. However, an enormous shortfall in the Standard Flats product has not been appropriately addressed by the Postal Service's proposed pricing. *See* Section IV, *infra*.

No. N2010-1. "It sometimes has been asserted naively that, under PAEA, losses from one class of mail have no effect on other classes because the other classes are 'protected' from extraordinary rate increases by the price cap. One of many flaws in such assertions is revealed by the consideration of system-wide cost saving solutions such as the loss of Saturday delivery, where some mailers might feel much affected by the failure of some classes and products to pay (at least) their attributable costs." *Id.*

[14] The Postal Service lost **$1.1 billion** on underwater products in FY 2008, and **$1.7 billion** on underwater products in FY 2009. Annual Compliance Determination, Docket No. ACR2009, p. 6.

IV. THE PROPOSED RATE ADJUSTMENT FOR STANDARD FLATS IS NEITHER RESPONSIBLE NOR EQUITABLE, AND SHOULD BE REJECTED AS INADEQUATE.

A. Standard Flats Have Been Seriously Underwater, and Are Projected to Remain Underwater.

Over the four year period from FY 2008 to FY 2010 and including FY 2011 After Rates, the Postal Service has had or is projected to have a **negative contribution** from Standard Flats **exceeding $1.6 billion** (Table IV-1).

Table IV-1

Standard Flats Volume, Revenue and Attributable Cost
FY 2008 – FY 2011

Fiscal Year	Volume (million)	Revenue ($, mill.)	Attributable Costs ($, mill.)	Contri-bution ($, mill.)	Cost Coverage (%)
FY 2008		3,664	3,891	-227	94.2
FY 2009	7,794	2,866	3,488	-622	82.2
FY 2010	7,260	2,693	3,147	-454	85.6
FY 2011AR	7,747	2,988	3,298	-310	90.6

Sources: FY 2008, CRA.
FY 2009, ACR FY 2009, p. 26.
FY 2010, Masse, Attachment 9.
FY 2011AR, Masse, Attachment 11

Projections beyond 2011 are not available, but a return to profitability for this product does not appear imminent. The Postal Service has stated its intent to continue pricing Standard Flats below attributable cost for some time period that is less than “extended” — whatever that means.[15] Just how the willingness to continue deliberately pricing Standard Flats below attributable cost conforms with the following statement of the Postal Service pricing witness is not clear.

> The Postal Service's position is that all classes of mail should cover their costs and make a reasonable contribution toward the Postal Service's institutional costs.[16]

When Witness Kiefer testified, he refused the Commission's many requests to articulate a path to "full cost coverage." Tr. 3/462.

It appears that the Postal Service has no will to adjust the prices for Standard Flats to at least cover its costs. The losses being incurred currently on this product are the direct result of below-average Postal Service price increases in the past.

- In **Docket No. R2008-1**, the Postal Service increased average prices for Standard Flats **0.86 percent**. This was the lowest average increase of the six Standard Mail products, a mere 30 percent of the class average increase of 2.875 percent.

- In **Docket No. R2009-2**, Standard Flats prices were increased **2.306 percent**, still well below the class average of 3.781 percent.

Standard Flats has not proven to be a successful product for the Postal Service. The first time the Postal Service reported Standard Flats as a separate product, **FY 2008**, it lost the Postal Service **$227 million**. While the Postal Service has chosen to avert its eyes, the magnitude of these losses were not lost on the Commission:

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[15] "Clearly, we **cannot continue** to price Standard Mail Flats below costs for an **extended** period of time; however, it is prudent to take a judicious step in this price increase and to **move gradually** towards the goal of full cost coverage." Statement of James M. Kiefer on Behalf of the United States Postal Service, p. 30 (emphasis added).

[16] Response of James Kiefer to POIR No. 3, question 10a.

> The Commission is concerned with the $218 million loss for Standard Mail flats. As noted elsewhere in this report, the Postal Service suffered a $1.2 billion loss from products with a negative contribution during FY 2008**. Of that loss, Standard Mail flats account for more than 20 percent. The revenues for Standard Mail flats in FY 2008 failed to satisfy 39 U.S.C. § 3622 (c)(2),** which requires that each class of mail or type of mail service cover attributable costs and make a reasonable contribution to institutional costs. For flats to cover FY 2008 cost, **the rates of flats would have needed to be increased by 6.2 percent** holding all other factors constant. The lack of a sufficiently high cost coverage may be inconsistent with the policy set forth in **39 U.S.C. § 101(d)**, which directs the Postal Service to apportion the costs of the Postal Service on a fair and equitable basis and **39 U.S.C. § 3622(b)(5),** which states that rates must be set to ensure adequate revenues to maintain financial stability. [FY 2008 ACD, p. 61.]

In **FY 2009**, Standard Flats mailers were favored by an even greater cross-subsidy — **$616 million**. Standard Flats' share of the total loss for underwater products in FY 2009 ($1,751 million) grew to 36 percent.

> The revenues for Standard Mail Flats in FY 2009 **failed to satisfy section 3622(c)(2),** which requires that each class of mail or type of mail service cover attributable costs and make a reasonable contribution to institutional costs. For the Postal Service to benefit from additional volume, unit costs and unit revenues need to be realigned. For flats to have covered FY 2009 costs, the rates of flats **would have needed to be 21 percent higher,** ignoring elasticity effects. The lack of a sufficiently high cost coverage directly implicates the requirement of **section 101(d),** which directs the Postal Service to apportion the costs of the Postal Service on a fair and equitable basis and **section 3622(b)(5)**, which requires that rates must be set to ensure adequate revenues to maintain financial stability.
>
> * * *
>
> For the reasons stated above, the Commission finds the rates for Standard Mail Flats neither recover attributable cost nor make a reasonable contribution to institutional cost. *The Commission finds that **the appropriate action is for the Postal Service to devise a plan** to improve the cost coverage of the Standard Mail*

> *Flats product. This plan should include any **operational or mail preparation changes** that the Postal Service deems necessary, as well as a **specific timeline** for achieving a positive contribution for the Standard Mail Flats product. The plan shall be included in the **next ACR or the next general market dominant price adjustment**, if it precedes the ACR.* [FY 2009 ACD, pp. 86-87 (italics original).]

As discussed in Section V, *infra*, the Postal Service failed to comply with the remedy fashioned by the Commission, as it did not present a plan of the sort required by the Commission — and has persistently refused to provide a "specific timeline" to get this product above water. Witness Masse estimated that in **FY 2010** that Standard Flats will have a cost coverage of 85.6 percent, and **will lose $454 million**, representing 39 percent of the total loss from underwater products. These losses cannot be affected by any price changes in this docket — but the losses anticipated for FY2011 can be affected. In FY 2011, after rates, the Postal Service projects it will lose $310 million on Standard Flats. Now that the Postal Service has chosen to disregard the Commission's findings regarding PAEA compliance and direction, and failed to provide a plan of the type required by the Commission, and utterly failed to provide the milestones required to get Standard Flats above-water, the Commission must take more stringent steps and reject the inadequate rates proposed for this product, with direction that higher rates, consistent with PAEA's requirements, be implemented forthwith.

B. Losses on Underwater Products Are Being Cross-Subsidized by Other Mailers, Which is Not Equitable and Does Not Conform to the Intent of PAEA.

Since enactment of PAEA and the CPI rate cap, it often has been asserted that losses incurred for entire classes of mail (and even when losses are incurred for individual products within a class), should not be a matter of concern to mailers using other products because such losses will not result in an increase in their rates as, allegedly, they are protected by the rate cap. Within the context of this filing for an exigent rate adjustment which witness Kiefer admitted is nearly across-the-board (Tr. 3/368, ll. 16-19) and averages 5.6 percent, such assertions obviously cannot withstand scrutiny.

Other mailers, especially those paying a very high cost coverage such as users of Saturation mail, now are being called upon to pay still higher rates and an even higher cost coverage in order to provide the Postal Service with additional revenue, part of which will go to enable (*i.e.*, cross-subsidize) both previous and continuing losses from underwater products such as Standard Flats. Needlessly allowing such cross-subsidization to continue does not constitute a responsible or equitable rate adjustment. Neither "rate flexibility" nor "informed judgement" should be considered an acceptable crutch for rationalizing such irresponsible pricing and cross-subsidization of other mailers.

The inequity is compounded by the fact that the Postal Service has no responsible plan for terminating the cross-subsidization any time within the foreseeable future. Nor does the Postal Service have any plan to increase rates meaningfully above attributable cost so as to recoup any of the extensive losses that have been and will be incurred to support this underwater product. For further discussion concerning cost projections and future profitability, *see* section V, *infra.*

Finally, the inequity of the rate adjustment for Standard Flats is especially glaring in consideration of the facts that:

- "To fully close the coverage gap, Standard Mail Flats prices would need to increase by 16 percent,"[17]
- the overall average rate increase is 5.6 percent,
- rates for Standard Flats increase by only 5.1 percent,[18]
- rates for Standard Parcels increase by 23 percent, and
- rates for Periodicals increase by 8 percent.

Because the proposed rate adjustment for Standard Flats is inequitable, it should be rejected. PAEA intended that the Postal Service cease its eleemosynary ways and become a lean, businesslike organization.

C. The Proposed Rate Adjustment for Standard Flats Fails to Promote Efficiency and Gives Erroneous Signals to Mailers Who Might Switch to Profitable Products.

"The Postal Service is aware that many of its catalog customers use both its Flats and Carrier Route products."[19] Many catalog customers not only use both products, but also some reportedly have found ways to increase their use of Carrier Route when faced with higher rates for Standard Flats. The Carrier Route product has a unit attributable cost of $0.158, which is less than 40 percent of the attributable cost for a Standard Flat, $0.433. Carrier route is projected to have a coverage of 151 percent in 2010 and in the 2011 Before Rates scenario, and thus is a profitable product for the Postal Service.[20]

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[17] Statement of James M. Kiefer, Docket No. R2010-4, p. 30.

[18] *Id.*, p. 10.

[19] Response of James Kiefer to POIR No. 3, questions a-c.

[20] Statement of Stephen Masse on Behalf of the United States Postal Service, attachments 9 and 10. Unit cost data also come from these attachments.

For each Standard Flat that is switched to Carrier Route, the Postal Service reduces its loss on Standard Flats by \$0.06, and simultaneously gains \$0.08 contribution of the Carrier Route flat. The change in contribution from each switched catalog is \$0.14. If the mailer also saves money (the expected rationale), switching is a win-win proposition for both parties. Despite the rather obvious advantage to the Postal Service of a rate adjustment for Standard Flats that is steeper than the rate adjustment for Carrier Route, "both the Flats product and Carrier Route flats category received approximately the same percentage increase (5.1 percent for Flats and 4.9 percent for Carrier Route flats)."[21] When signals to mailers are so misaligned, a rate adjustment that is nearly across-the-board (*i.e.*, mostly between 4 and 6 percent)[22] is not responsible.

Similarly, some catalog mailers reportedly have found ways to revamp the design of their catalog so as to qualify as a Standard Letter.[23] This product has an even higher coverage, 182 percent, than Carrier Route. When an underwater Standard Flat converts to a Letter, the change in contribution exceeds \$0.14. Converting catalogs to letter shape clearly is a big "win" for the Postal Service, yet the Flats product and Standard Letters received

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[21] Response of James Kiefer to POIR No. 3, questions 13a-c, Docket No. R2010-4 (Aug. 9, 2010). Responding to whether "the effect of a greater increase in rates for Flats [could] be tempered by a smaller increase for Carrier Route flats," concern was expressed about "unintended consequences." Response of James Kiefer to POIR No. 3, question 13d, Docket No. R2010-4. When dealing with underwater products, the Postal Service might be well advised to focus more on intended consequences.

[22] *See* Tr. 3/367, ll. 16-18.

[23] The Postal Service has not conducted any studies to determine what percentage of the loss in Flats volume is due to conversion to letter-shaped catalogs. Response of James Kiefer to POIR No. 3, question 9, Docket No. R2010-4 (Aug. 9, 2010).

approximately the same percentage increase (5.1 percent for Flats and 5.0 percent for Letters).[24]

As noted in Section I.D, *supra*, rate flexibility can be a powerful tool for promoting efficiency, and the Postal Service needs to revise its business model so as to employ rate flexibility far more effectively. Knowingly and deliberately pricing a major product below attributable cost — whether for an extended period or some period a little shorter — will not help to pre-fund retiree benefits, and most assuredly is not the business model intended by PAEA.

To summarize, the rate adjustment for Standard Flats gives mailers wrong signals and does little or nothing to promote more efficient use of the mail. It literally flies in the face of the PAEA admonition to promote postal efficiency and the protection of Postal Service finances. The rate adjustment for Standard Flats should not be viewed as reasonable, an should be rejected.

D. The Rationale for Giving Standard Flats a Below-Average Rate Increase in Not Equitable.

The rationale proffered for giving Standard Flats a below-average rate increase is that "the catalog industry, which depends heavily on Standard Mail Flats, is in a delicate financial position." Such an explanation possibly might pass muster if the catalog industry could, by some stretch of the imagination, be considered an unsophisticated infant industry — *i.e.*, just starting up the learning curve and having considerable promise of high profitability in the near future for the Postal Service, profitability that would benefit all other mailers. But it most

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[24] Statement of James M. Kiefer, Docket No. R2010-4, p. 28.

definitely is not an infant industry. The catalog industry has existed for many years, is well-established and highly sophisticated.

The Postal Service itself, facing possible insolvency, could be described equally well as being "in a delicate financial position." Under circumstances where the Postal Service needs to move with considerable urgency to change its business model so as to shore up its finances, giving such preferential treatment to a product so seriously underwater as Standard Flats simply cannot be considered equitable or reasonable.

Finally, premonitions of a massive decline in volume, perhaps some "tipping point" effect, are not supported by the Postal Service's projections. For Standard Flats the Postal Service projects a decline in volume of only 1.0 percent as a result of the 5.1 percent rate adjustment.[25] Risking a loss of volume that loses substantial sums of money each year should not be a matter of undue concern, especially when the product promises to continue losing yet more money in each successive year, with no target for turning profitable. Risk of losing such volume certainly is not in the same league as risk of losing volume that makes a very high contribution to institutional costs. *See* Tr. 1/78, ll. 5-10 (Chairman Goldway questioning of witness Corbett revealing admitted inadequacies in Postal Service proposed rates).

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[25] See Masse, Attachments 10 and 12. Standard Flats volume Before Rates of 7,802 million declines to a volume of 7,723 million After Rates (full year). This 1.0 percent reduction in volume, coupled with the 5.1 percent increase in rates, reduces the negative contribution (loss) by healthy amount: $147 million (from a Before Rates loss of $418 million to $271 million After Rates).

V. THE POSTAL SERVICE'S "FLATS STRATEGY" CANNOT BE RELIED UPON TO ACHIEVE COST REDUCTIONS FOR FLATS BEYOND FY 2011.

In the last ACD, the Commission directed the Postal Service to submit a plan with its next pricing change for remedying the problem of underwater Standard Flats. *See, e.g.,* FY 2009 ACD, pp. 86-87. The Postal Service's response to the Commission is contained in the Postal Service's "Flats Strategy" USPS-R2010-4/9, a library reference.

Neither the "Flats Strategy" alone, nor the attempted clarification of that strategy by Mr. Neri, explained when or how Standard Flats will begin making a positive contribution, through a reduction in unit cost, or an adequate increase in rates, or a combination of both. The Flats Strategy does not respond to the Commission's instruction, and now cannot be relied upon by the Commission as a meaningful plan to get Standard Flats to what witness Kiefer minimally calls "full cost coverage" of 100 percent (see Tr. 3/383, l. 24 (Aug. 12, 2010)), to say nothing of achieving truly "full cost coverage" of 100 percent **plus** some "fair" and "equitable" contribution to institutional costs as required by 39 U.S.C. section 101(d). Since the Postal Service has no phased strategy to keep Standard Flats from sinking the Postal Service ship, it falls on the Commission. As Commissioner Acton succinctly explained: "it's a compliance issue for the regulator." Tr. 3/327, ll. 13-16.

A. All Results of Cost Reductions Anticipated in FY 2010 and FY 2011 Were Incorporated in Attachments 9, 10, 11, and 12 to the Statement of Witness Masse.

Proposed rate adjustments for flat products are reflected in the revenues shown in witness Masse's two After Rates projections, Attachments 11 an 12. In addition:

> All programs for which **cost savings** have been planned or budgeted are contained in Mr. Masse's statement and associated

> materials. [Postal Service Response to POIR No. 1, question 1 (July 23, 2010) (emphasis added).]

Even assuming all of the cost reductions which the Postal Service plans and hopes to achieve, the projections through 2011 show the Postal Service continuing to lose a substantial amount of money on Standard Flats.

B. Cost Reductions Regarding Flats Beyond 2011 are Speculative.

The Commission cannot assume the reductions in the unit attributable cost of Standard Flats in FY 2012 on the various initiatives listed in the Flats Strategy. The Postal Service acknowledges that:

> Beyond these programs [planned and budgeted for FY 2011], **cost savings are more speculative**; they are based on the size of the opportunity, but detailed **plans** for addressing each issue have **not all been developed** yet. Additional savings from the strategies in USPS-R2010-4/9 are part of the Postal Service's productivity goals, and are recognized in the BPI provisions of Mr. Masse's estimates. [Postal Service Response to POIR No. 1, question 1 (July 23, 2010) (emphasis added).]

When asked to be more specific about certain initiatives in the Flats Strategy that are centered more on Flats, the Postal Service responded that:

> Beyond the description in the original document, details on the practical scope or implementation of these **concepts** relies on a number of factors, including feasibility, the cost and effectiveness of new equipment, and negotiations with the unions. Any decision to develop a program will be dependent on evaluations of those factors, which **do not themselves have timelines for completion.** [POIR No. 3, Q. 22 (emphasis added).]

The Commission's questioning of USPS operations witness Frank Neri demonstrated not that the strategy was concrete, but that it was ephemeral. *See*, *e.g.*, Tr. 3/309-10, 325-28 (Aug. 12, 2010).

For Standard Flats, the best that can be said is that the rate adjustment would increase coverage only slightly from **87.4 percent** in FY 2010 to **90.6 percent** in FY 2011. Rate adjustments in this docket, if approved, will take effect on January 2, 2011, in the second quarter of FY 2011. If the rate adjustments are not approved, an adjustment under the rate cap (perhaps in the range of 1-2 percent) could be expected to occur around mid-May, 2011 — only 4½ months from the end of FY 2012. Under either scenario, any hope of having revenues from Standard Flats (and the other still underwater products) exceed attributable costs in FY 2012 thus rests on the Postal Service achieving quite substantial cost reductions not included in Witness Masse's projections, but effective beginning early in FY 2012. The record of this docket demonstrates no likelihood whatsoever of that occurring.

C. Until Hard Evidence Exists of Actual Increases in Productivity and Reductions in Unit Cost, the Commission Should Base Its Consideration and Decision on After-the-fact Data, as Envisioned by the PAEA.

The PAEA did away with cost-of-service rate making, including, among other things, (i) a fixed revenue requirement, (ii) Test Year projections, and (iii) speculation about future cost reductions. Those forward-looking elements have been replaced by annual after-the-fact reviews of actual results, as reflected in the Commission's Annual Compliance Determinations.

In this new rate making environment, it is appropriate to peer into the near future, as the Postal Service has done, and examine immediate and near-term results of the rate adjustment. For FY 2010 and FY 2011, anticipated cost reductions are well documented. Beyond FY 2011, however, possible outcomes are mere speculation, not only unsupported by any Postal Service projection, but also by anything specific in the Flats Strategy.

On the record before the Commission, it is abundantly clear that the underwater Standard Flats product has not covered its attributable cost for several years. Under the Postal Service's proposed rate adjustment, which deliberately maintains the rate for Standard Flats below attributable cost, they will not achieve 100 percent cost coverage in FY 2011, FY 2012, or the foreseeable future. Moreover, in view of Postal Service's refusal to provide a strategy to get Standard Flats at least up to break-even within even "two or three years" (as inquired about by Chairman Goldway, Tr. 3/462) these rates should not be approved.

The Commission needs to determine whether it is reasonable and equitable to approve a rate adjustment for Standard Flats which not only is below attributable cost, but also below the systemwide average.

At some unknown time in the future, some of the various initiatives listed in the Flats Strategy hopefully will provide the Postal Service with greater efficiency and a reduction in the cost of Standard Flats, but the current arrangement, whereby the Postal Service subsidizes the prospecting by catalogers, is not tenable. At such time as unit costs are proven to have declined, then in light of their accumulated deficit Standard Flats should start contributing significantly to institutional costs. Until then, responsible rate adjustments should be based on "what is," not speculation about "what might be," with no timelines or targets for profitability.

VI. THE POSTAL SERVICE'S PROPOSED PRICING OF THE SATURATION MAIL PRODUCTS IS UNREASONABLE AND INEQUITABLE

A. Coverages for Standard Mail Products Implicit in the Postal Service's Proposed Rates Do Not Reflect PAEA's Principles, and Border on the Irrational.

All Standard Mail consists generally of advertising promotions of one sort or another. When the current product list was formulated under PAEA, the Standard Mail Class consisted of six products — three from the former **Regular Subclass** (Standard Letters, Standard Flats, and Parcels/NFMs), and three from the **Enhanced Carrier Route ("ECR") Subclass** (High Density & Saturation Letters, High Density & Saturation Flats and Parcels, and Carrier Route).

Generally, products from the Regular Subclass are targeted to individual recipients based on their potential interests, whereas products from the ECR subclass are directed to most or all consumers in a geographic area.

Geographically-targeted mail almost always has a wider range of alternative forms of advertising competing to reach people located in the same geographic area (*e.g.*, newspaper inserts, shoppers or handbills with private delivery, local radio, signage, etc.). It therefore is more sensitive to changes in price, consistently reporting much higher own-price elasticity than individually-targeted Standard Mail, which lacks this wide range of alternatives.

Demand-based pricing, which the Postal Service says it supports, would indicate that coverage for former ECR products with high elasticity should be lower than coverage for former Regular products with low elasticity. Indeed, for many years the Postal Service has articulated this pricing principle, and voiced a desire to follow it, but always would prefer to implement it in the next docket. For years the Postal Service has maintained in place a pricing pattern which reflects the exact opposite of what it claims its goal to be, with the highest coverages imposed on products with the highest elasticity. Despite additional "pricing flexibility" given to the Postal Service under PAEA, pricing adjustments proposed in this docket not only continue the perverse trend, they also actually exacerbate the problem.

One irony is that in this first exigent pricing change under PAEA, the Postal Service has proposed a near across-the-board set of rates which demonstrates a bureaucratic desire to spread the pain of pricing changes evenly across all products and mailers. Even though faced with an extreme liquidity crisis (*see* Section I, *supra*), except where forced to do otherwise, the Postal Service proposal could be seen as politically-motivated to minimize opposition when it should be adopting PAEA's business-like pricing motivated by the need to stay in business during crisis times. For reasons discussed *supra*, the Commission should not permit the Postal Service to price Standard Mail in violation of the factors and objectives and policies of PAEA.

The average coverage for Standard Mail products proposed by the Postal Service is 158.3 percent. Masse testimony, Attachment 11. Around this average, however, coverages vary widely. The Postal Service's proposed pricing reflects the following after-rates coverages for FY 2011:

Table VI-1
Coverages Implicit in Postal Service Proposed Prices, FY2011, After Rates

	Coverages
Former Regular Subclass Products:	
• Letters	189.3%
• Flats	90.6%
• Parcels/NFMs	94.9%
Formerly ECR Subclass Products:	
• High Density & Saturation Letters	224.9%
• High Density & Saturation Flats	244.6%
• Carrier Route	157.1%

As can be seen, two former Regular Subclass products with low elasticity are given very low[26] coverages, and two former ECR Subclass products with high elasticity are given very high coverages.

B. Rate Adjustments Based on Faulty Pricing Principles Should be Rejected by the Commission.

Valpak and other saturation mailers have not been silent about this pricing problem. For example, in Docket No. R2006-1, Valpak witness Robert Mitchell (VP-T-1) articulated a comprehensive vision for the pricing of Standard Mail and the relationship between coverages, which remains as applicable now as it was then:

> According to the figures in USPS-LR-L-114, at PRC costing and Postal Service proposed rates, the systemwide coverage is 178.4 percent. The coverage of First-Class is 212.6

[26] Of course, to say that Standard Flats is given a low coverage is a bit of an understatement. It would be more accurate to say that it is being given no coverage — being asked to make no contribution to institutional costs in violation of 39 U.S.C. section 101(d). Moreover, it is being given a negative coverage — a cross-subsidy from other mail products — as it is not even being asked to pay its attributable costs. As a result, the offering of this product (as well as other underwater products) at below-cost prices has contributed significantly to the current financial woes of the Postal Service. *See* discussion in sections I, III, and IV, *supra*.

> percent, of Regular is 170.4 percent, and of ECR is 206.7 percent. I believe these are out of alignment. My assessment is that **the coverage on Regular should be somewhat above the systemwide average and that the coverage of ECR should be somewhat below** the systemwide average. [Docket No. R2006-1, Direct Testimony of Robert W. Mitchell Concerning Standard Mail, VP-T-1, p. 96, ll. 3-9 (emphasis added).]

Under PAEA, Valpak has continued to direct the Postal Service's and Commission's attention to this pricing vision. Neither the Postal Service nor the Commission appears to have disagreed with these pricing principles. In the last annual compliance review, Docket No. ACR2009, the Commission noted:

> In its comments, Valpak argues for a "significant reduction in the coverage of High-Density/Saturation products." Valpak Comments at 49. Valpak states that categories with relatively elastic demand should have relatively low cost coverages and thus pricing of High Density and Saturation products is not optimal.
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> In Docket No. R2009-2, the Postal Service gave below average increases to High Density and Saturation Letters (1.248 percent) and High Density and Saturation Flats/Parcels (2.233 percent). The Postal Service explained that the below average increases were in recognition of the market characteristics of these products. Thus, it appears the Postal Service has attempted to be responsive to the concerns expressed by Valpak. [FY 2009 ACD, p. 87.]

While the Postal Service was moving, albeit slowly, in the direction of rationalizing the pricing of the saturation products, the Commission was willing to allow a gradual process to be followed. Now, however, the Postal Service's exigent request would reverse course from what the Commission approved in its FY2009 ACD and head in the opposite direction. As can be seen from Table VI-2, the proposed coverages actually would worsen in FY 2011 the bad situation that existed in FY2009.

Table VI-2
Former ECR Subclass Coverages, FY2008-FY2011 (Request)

	(1) FY 2008	(2) FY2009	(3) FY2011 Request
HD/Sat. Ltrs	230.8%	216.0%	224.9%
HD/Sat. Flts/Par.	257.2%	239.6%	244.6%
Carrier Route	151.2%	144.6%	157.1%
ECR Equivalent	189.8%	181.6%	~194.0%

Sources: Column (1) from FY 2008 ACD, Table VI-6, p. 59; Column (2) from FY 2009 ACD, Table VII-11, p. 83; Column (3) from Witness Masse Statement, Docket No. R2010-4, Table 11.

Valpak opposes the Postal Service's proposed rates for Standard Mail which would reverse the recent trend to ameliorate the burden placed on saturation mail, while continuing the cross-subsidy of Saturation Flats, as being unfair, and inequitable, and not designed to protect Postal Service revenues, as explained more fully in Section VII, *infra*.

C. The Postal Service Has Not Explained the Full Effect of Imposing Higher Rates on High Elasticity Saturation Products.

Based on projections for FY 2011 with the proposed price adjustment, the Postal Service anticipates an additional contribution of $77 million from High Density/Saturation Letters and Flats/Parcels combined. However, the elasticity lags for High Density and Saturation products need five calendar quarters to reflect fully the Postal Service's projections for the volume effects of price adjustments. As the Postal Service did not provide any projection beyond FY 2012, the full volume effects are not before the Commission. (Indeed, some of the largest lag effects occur in the fourth and fifth quarters, which are not included in the FY 2011 projection with January implementation on January 2, 2011.) Since the Postal Service price adjustment does not reflect demand considerations — *i.e.*, it takes little or no account of the high elasticity of the High Density/Saturation products — the Commission might want to consider modifying its rules so as to require an exigent rate adjustment filing to include projections that fully recognize all own-price elasticity lagged effects.

D. Lower Rates are Preferable to Structured Incentive Programs.

The Postal Service provides a "**Growth Initiative**" for "the **highly profitable** High Density and Saturation Mail products," with a rebate for certain additional volume. *See* Statement of James M. Kiefer, Docket No. R2010-4, p. 35, ll. 12, 14-15, and Appendix A (emphasis added). This proposal acknowledges the high coverage and high price elasticity of High Density and Saturation products, but it is awkward and not the best way to go. Whether any particular mailer would be able to benefit from such highly-structured incentives will depend on a variety of factors, including trends in any particular market served by various types of mailers, as well as factors unique to each mailer. As a result, the incentive does not provide all mailer with an equal incentive to mail, either in all areas or all phases of the business cycle. The approach could create considerable mischief. An approach that would be much less haphazard and random in encouraging additional volume, while maintaining a level playing field among competitors, also is the most straightforward — moderating rates for all High Density and Saturation products. These products then would be slightly less "highly profitable" on a unit basis, but more profitable for the Postal Service in the aggregate as it receives the benefit of this product's high elasticity. This is the approach advocated by Valpak.

VII. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE'S PROPOSED RATES FOR THREE PRODUCTS WITHIN STANDARD MAIL.

PAEA requires the Commission to determine that the Postal Service's proposed rates meet the standard of "reasonable, equitable, and necessary." 39 U.S.C. § 3622(d)(1)(E). Rates proposed for the following three products within Standard Mail fail this test:

- Standard Flats,
- High Density & Saturation Letters, and
- High Density & Saturation Flats and Parcels.

A. Rates for Standard Flats are Too Low.

According to Table IV-1, *supra*, Standard Flats lost $454 million in FY2010. In FY2011 Before Rates, it would lose $418 million. After the Postal Service's 5.1 percent proposed increase, it would still lose $310 million. (On a full-year basis, the loss would be reduced to $271 million; *see* Table 1.) The way that the Postal Service pricing continues to allow this product to continue to lose money in FY2011 is nothing less than shocking.

First, Standard Flats receive a below-average rate increase of 5.1 percent. This is to be compared with the systemwide average for all Market Dominant Products of 5.6 percent, and the average increase for Standard Mail products, also of 5.6 percent. No amount of rationalizing can justify a product so badly underwater receiving a below-average rate increase.[27]

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[27] In a survey of the top 600 catalogers, Standard Flats constituted only 18.7 percent of their total volume. Two-thirds of their volume consisted of Carrier Route flats (39.55 percent) and Standard Letters (27.67 percent). *See* Attachment to Response to POIR No. 3, Question 7. Both of those products are fairly profitable to the Postal Service and, presumably, also to the catalog mailers. No record evidence indicates a cross-elasticity such that an increase in the rate for Standard Flats would decrease the volume of either Carrier Route Flats or Standard Letters. In fact, substitution effect well might increase the volume of

Second, this is not a new occurrence. Standard Flats have now lost money at least since FY 2008.[28] See table IV-1, *supra*.

Third, Standard Flats is not an infant industry which the Postal Service is trying to nurse along to maturity. It is a well developed industry, but one which developed a dependency on subsidy. *See* section IV, *infra*.

Fourth, Standard Flats have no ECSI value, which could conceivably justify a product like Periodicals having a very low (but positive) coverage.

Fifth, Standard Flats do not enhance the "mail moment," as it is said Periodicals do.

Sixth, Standard Flats generate fewer pieces of other mail than in previous years. At one time such catalogs generated orders being placed via First-Class Mail. Now, order placement and payment are generally done on-line, with little First-Class Mail being generated. True, catalogs can generate some parcels for the Postal Service, but these parcels seem to be few and may be sent as products which do not have high coverages.[29]

Seventh, despite protestations from the catalog industry, the own-price elasticity of Standard flats is among the lowest of any product, indicating that this mail is relatively

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the two profitable products, which would be beneficial to Postal Service finances.

[28] Prior to FY 2008, separate CRA data on the Standard Flats product are not available.

[29] The Postal Service estimates that every 100 catalogs results in 1.9 shipments, including the original order, plus any backorders, split orders, and returns — *i.e.*, an "overall" response rate of 1.9 percent. Of this 1.9 percent, "It is believed that the Postal Service has a small percentage of the total of fulfillment shipments from catalogers." Response of James Kiefer to POIR No. 3, Question 6, Docket No. R2010-4. A small share of 1.9 percent is indeed small. The result is that the Postal Service loses money to send out catalogs which generate orders which are shipped overwhelmingly via competitors of the Postal Service.

insensitive to increases in price. If the price of this product were brought up to the point that costs were covered and some contribution to institutional costs were made, it would result in the loss of little volume.

B. Rates for High Density & Saturation Letters and High Density & Saturation Flats are Too High.

While the Postal Service bent over backwards to accommodate Standard Flats, the two saturation products — High Density & Saturation Letters, and High Density & Saturation Flats — received the opposite treatment.

Where Standard Flats is underwater (85.6 percent), Saturation mail has one of the highest coverage of any class of mail — FY 2010 coverage of 218.9 percent (letters) and 242.2 percent (flats). These are the highest coverages for any Standard Mail product.

In prior dockets, the Postal Service has conceded that these saturation coverages are much higher than can be justified, and that coverage for all Standard Mail products should be approximately the same. *See*, *e.g.*, Postal Service FY 2009 ACR, Docket No. ACR2009, pp. 29-31. However, under the Postal Service's proposed rates in this docket, the coverage of both products would actually increase — to 224.9 percent (letters) and 244.6 percent (flats). No product should be asked to contribute 125 percent or 150 percent **over** its attributable costs to cover institutional costs, while other Standard Mail products are underwater.

Yet the average rate increase being sought by the Postal Service for Standard Flats is the same as the average price increase being sought for High Density & Saturation letters — 5.1 percent — and just above the average price increase being sought for High Density & Saturation Flats — 4.8 percent.

Where Standard Flats have low elasticity (-0.244), Saturation mail has among the highest measured own-price elasticity (-0.839). The Postal Service has no separate elasticity measure for Standard Flats, so it uses the elasticity measure for Standard Mail. This is the elasticity by which this product has been measured by the Postal Service for years. By this measure, Standard Flats could sustain an above-average price increase without loss of significant volume. On the other, Saturation mail would see sharp volume declines from even a small price increase.

Virtually all Postal Service revenues come from mailers. It receives only a tiny Congressional appropriation. If the Postal Service allows Standard Flats to lose $310 million in FY2011, this loss will have to be made up from other mailers. One of the other products which is hit with particularly high coverage to pay for these losses is Saturation mail. It is fundamentally unreasonable and inequitable for the Postal Service to allow Standard Flats to be cross-subsidized by other high-coverage products such as the two Saturation products.

C. The Postal Service has made clear that No Revenue Requirement Exists in the Current Exigent Rate Case.

The Postal Service has gone out of its way to explain that in this docket, unlike cases under the Postal Reorganization Act of 1970, that there is no fixed revenue requirement. Witness Corbett explained that he asked pricing to generate from 4 to 6 percent increase in rates, and pricing subsequently developed the current 5.6 percent increase. To achieve "reasonable" and "equitable" rate adjustments, some rates could be adjusted downward without concern about failing to achieve a preset revenue target. Witness Kiefer testified that he was instructed to raise rates in the range of 4-6 percent for Market Dominant products. Tr. 3/367, ll. 16-18.

However, as demonstrated below, it is possible to develop rates which meet both objectives: bring Standard flats toward meeting costs, while protecting Saturation mail from high increases.

D. Standard Mail Rates Which meet the PAEA Standard Could Be Fashioned to Generate the Same Revenue Requirement as Postal Service Rates.

From the proposed Saturation rate increases, the Postal Service would lose so much volume from High Density & Saturation Letters that it would net only $22 million, and so much volume from High Density & Saturation Flats that it would net only $55 million, for a total of $77 million.

If a decision were reached to freeze the current rates of the Saturation products in this docket, for the reason that their coverage is already much too high (and has been for many years), would reduce the contribution gained by $77 million. Moreover, it would keep much mail in the system. Witness Corbett explained when testifying before the Commission, that all mail volume is important, as it helps offset the network costs of the Postal Service. Tr. 1/77, l. 14 - 78, l. 3. Assuming this to be accurate, no increase in Saturation mail would keep an additional **169 million** pieces (53 million High Density & Saturation Letters and 116 million High Density & Saturation Flats in the system).

Moreover, giving no increase to saturation letters and flats would lose so little money that it appears that it could be offset entirely by a **8.9 percent** price increase for Standard

Flats, which would increase net contribution by an extra $79 million in FY 2011. And it would cause the loss of only **96 million** Standard Flats.

If it were deemed impossible to give the two Saturation mail products no increase, it certainly should not be increased more than 0.3 cents per piece. From a hypothetical 0.3 cent increase, the Postal Service would lose $12.6 million from High Density & Saturation Letters, and $31.4 million from High Density & Saturation Flats, for a total loss of $44 million. Such a loss could be easily offset by a **7.3 percent** increase for Standard Flats, raising an extra $45 million (for a total increase of $122 million, as compared with the $121 million increase in net revenue from the rates proposed by the Postal Service). Since the Postal Service has proposed to increase Periodicals (which have ECSI value) by 8.0 percent, there should be little objection to increasing rates a lesser amount for Standard Flats (which do not have ECSI value).

By any standard, the Postal Service proposed rates for these three Standard Mail products are not reasonable and equitable, and the Commission should reject the rates for these three products.

CONCLUSION

Because Valpak needs a financially healthy and robust Postal Service, it does not at this time oppose a rate adjustment, so long as it is reasonable and equitable. Valpak is opposed, however, to an "exigent" rate adjustment that essentially reflects a "business as usual" approach in pricing, which has contributed to the Postal Service's liquidity problems. PAEA requires that any exigent rate adjustment must be reasonable, equitable, and necessary, and near across-the-board pricing adjustments within certain Standard Mail products do not meet these tests.

Valpak recommends that the Commission (i) reject the Postal Service's proposed 5.1 percent increase for badly underwater Standard Flats as far too low, and, (ii) since the coverage for saturation mail is already much too high and would get worse under the Postal Service's proposal, reject the proposed 4.8 percent increase for Saturation Letters, as well as the 4.4 percent increase for Saturation Flats, as far too high.

In light of rate adjustments for other underwater products that range between 8.0 and 23.3 percent, Valpak suggests that an appropriate rate adjustment for Standard Flats would be no less than 8.0 percent (the level of increase given to Periodicals). And in light of the already very high coverage on saturation mail, along with its high elasticity of demand, either no rate increase, certainly no more than a 2.0 percent increase, would constitute a serious move to the demand pricing which the Postal Service claims to favor, retaining and incentivizing the most highly-profitable products within the Standard Mail Class.

Respectfully submitted,

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