Postal Regulatory Commission
Submitted 2/2/2011 4:15:09 PM
Filing ID: 71786
Accepted 2/2/2011

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2010	)))	Docket No. ACR2010

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2010 ANNUAL COMPLIANCE REPORT**
(February 2, 2010)

William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.

TABLE OF CONTENTS

Page

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2010	)))	Docket No. ACR2010

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2010 ANNUAL COMPLIANCE REPORT
(February 2, 2010)

INTRODUCTION

On December 29, 2010, the Postal Service timely filed its "United States Postal Service FY 2010 Annual Compliance Report" ("ACR"), which is required to be filed within 90 days after the end of each fiscal year. The Postal Service FY 2010 Annual Compliance Report was the fourth annual report filed in accordance with the requirement imposed by 39 U.S.C. section 3652 by enactment of the Postal Accountability and Enhancement Act ("PAEA"), Pub. L. 109-435.

On January 4, 2011, the Postal Regulatory Commission ("Commission") issued Order No. 636, Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments, seeking initial comments by February 2, 2011, and reply comments by February 17, 2011.

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint initial comments in response to the Commission's Notice.

COURSE OF PROCEEDINGS

The Commission issued Order No. 636, commencing proceedings in this docket. The Commission's Notice gave special attention to what may be the greatest single issue that the Commission will need to address and resolve in this docket — the seemingly intractable problem of underwater products:

> The Postal Service … maintains that a **significant question** about the requirements of title 39 with respect to **cost coverage shortfalls** has arisen. It notes that the Commission characterized cost coverage shortfalls as so pervasive as to be a **systemic problem** in the FY 2009 ACD, and directed the Postal Service to develop and present a plan to address the problem.… The Postal Service says it presented its plan in its exigency request, but **no longer considers that plan workable**, given the Commission's disposition of the exigency request.… It says results in its current ACR filing show that the cost coverage problem continues to exist and remains **systemic**.… It also says that even if it achieves its most optimistic efficiency enhancements, it **does not foresee** that such enhancements, combined with annual rate increases within the statutory price cap will result in Periodicals, Standard Mail Flats, and Standard Mail NFMs/Parcels **reaching full attributable cost coverage**. [Order No. 636, pp. 3-4 (emphasis added).]

Accordingly, the Commission specifically "invites public comment on the cost coverage matters…" *Id.* at 6.

On January 14, 2011, evidencing continuing concern with underwater products, Chairman's Information Request No. 1 asked the Postal Service to explain its "plan to improve cost coverage for Media/Library Mail" (p. 5) — one of the four products within the Package Services class which "failed to recover sufficient revenue to cover attributable costs," and are part of the systemic problem mentioned above. Valpak comments on this "systemic problem" in section II, *infra*.

After filing its Annual Compliance Report, the Postal Service filed its "Notice of Market-Dominant Price Adjustment" on January 13, 2011, commencing Docket No. R2011-2. Under this notice, price adjustments for market dominant products will occur on April 17, 2011. The Postal Service used virtually all of its Consumer Price Index-based adjustment authority of 1.741 percent for each class of mail. *Id.*, p. 3.

STATUTORY CRITERIA

Section 204 of PAEA requires the Postal Service to submit to the Commission an "**annual report**" within 90 days after the end of each (fiscal) year:

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

After the Postal Service has filed its annual report, the Commission has 90 days in which to make a "determination of compliance" with Chapter 36 ("Postal Rates, Classes, and Services") of Title 39 of the U.S. Code, as well as to determine "whether any service standards in effect during such year were not met." 39 U.S.C. § 3653(a)-(b).

If, at the end of the Commission's annual compliance review, the Commission makes a finding of "noncompliance," the Commission is required to "take appropriate action," as follows:

> (c) Noncompliance With Regard to Rates or Services.—If, for a year, a timely **written determination of noncompliance** is made under subsection (b), the Postal Regulatory Commission **shall take appropriate action** in accordance with subsections (c) and (e) of section 3662 (as if a complaint averring such noncompliance had been duly filed and found under such section to be justified). [39 U.S.C. § 3653(c) (emphasis added).]

I. PAEA'S REQUIREMENT THAT THE POSTAL SERVICE ENDOW THE RETIREE HEALTH BENEFIT FUND AT THE RATE REQUIRED HAS DECIMATED POSTAL SERVICE FINANCES, LEAVING THE POSTAL SERVICE'S CURRENT BUSINESS MODEL POTENTIALLY INADEQUATE TO RESTORE FINANCIAL STABILITY.

A. In FY 2010, the Postal Service Suffered a Net Operating Loss of $3.0 Billion.

The Postal Service's financial condition at the end of FY 2010, and since, is so dire it will not just need, but **require**, Congressional remedial action before the end of FY 2011.

Unfortunately, the source of this financial crisis is often misunderstood. Press and Congressional attention too often focuses on the Postal Service's **gross loss.** That reported loss includes "artificial" financial burdens imposed on the Postal Service by Congress, and includes expenses such as payments into the Postal Service Retiree Health Benefits Fund ("PSRHBF") to prefund health care benefits for future retirees, as mandated by PAEA. Real understanding of Postal Services finances and evaluation of its business model requires focus on Postal

Service **net loss**, based on its **current** operating revenues and expenditures, which is where this analysis begins.[1]

Table I-1, *infra*, shows Postal Service operating revenues and operating expenses over the four-year period FY 2007–FY 2010 during which finances have been reported by the Postal Service in its Annual Compliance Reports since enactment of PAEA. In that table, "**operating expenses**" **include** all costs of health benefits for **current retirees**, but **exclude** money set aside to pay health benefits for **future retirees** — *i.e.*, payments to the PSRHBF are shown separately.[2] Thus, the $8.5 billion loss reported for FY 2010 includes two components:

- a $3.0 billion loss from operations, referred to in these comments as the **"operating loss,"** and
- the $5.5 billion PAEA-required contribution to the PSRHBF.

Starting in FY 2008, the economy, mailers, and the Postal Service fell victim to what has been called the Great Recession.[3] That recession was responsible for accelerating the

---

[1] For FY 2011, the Postal Service has adopted operating income, or profitability — the difference between operating revenues and expenses — as a key corporate financial goal. *See* 2010 Comprehensive Statement on Postal Operations, http://www.usps.com/strategic planning/cs10/CSPO__12_2010.pdf, p. 6.

[2] Prior to PAEA, the Postal Service funded retiree health care costs on a **current** basis, but did not prepay **future** costs. The Postal Service's Annual Report and SEC Form 10-K now are required to include contributions to the PSRHBF as operating expenses because they became statutorily-mandated outlays under PAEA. Adding confusion, operating expenses also exclude changes in workers' compensation expense resulting solely from changes in interest rates.

[3] On November 28, 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research ("NBER") identified December 2007 as being the peak prior month in economic activity in the U.S. economy — thereby constituting both the end of the last expansion and the beginning of what now is referred to as the Great Recession. According to the NBER, the recession technically ended in June 2009.

decline in mail volume,[4] accompanied by an unprecedented decline in total revenues: $6.9 billion in FY 2009 and a further $1.1 billion in FY 2010. From FY 2008 to FY 2010, expenses were reduced by $2.1 billion (*see* Table I-1). But no matter how effectively the Postal Service managed its costs, it has been unable to reduce operating expenses as fast as mail volume and revenue declined. Consequently, the Postal Service swung in four short years from an **operating profit of $2.8 billion** in FY 2008 to an **operating loss of $3.0 billion** in FY 2010.

Table I-1 reveals a lesser known fact — that during the last four years the Postal Service actually had a **cumulative operating net income,** or operating "profit," of $0.6 billion. Generating a cumulative four-year operating profit of $0.6 billion must be considered an outstanding accomplishment. That amount, however, was far from sufficient to fund the $20.9 billion contribution to PSRHBF demanded by Congress under PAEA for the same four-year period.

Moreover, as discussed in section II, *infra*, during those same four years, a **collection of loss-generating products** failed to cover their attributable costs by over **$5.09 billion**.[5]

---

http://www.nber.org/cycles/dec2008.html.

There are those who believe that the American economy is at risk of entering the second phase of a "double-dip" recession. *See, e.g.,* http://www.dailyfinance.com/story/investing/double-dip-recession-one-reliable-measure-says-its-inevitable/19568906/.

[4] Decline in mail volume, especially the volume of First-Class Mail, now is reckoned by most observers to be permanent. *See, e.g.*, USPS 2010 Annual Report, p. 3, Volume Forecasts to 2020.

[5] Annual losses from loss-generating products during this period were: FY 2007, $0.57 billion; FY 2008, $1.08 billion; FY 2009, $1.75 billion; and FY 2010, $1.69 billion. *See* section II, *infra*. These continuing losses from underwater products, including the Postal

Therefore, it is reasonable to conclude that the Postal Service has reduced workhours and costs by significant amounts, but the Postal Service's overall finances have been severely harmed by Postal Service pricing. Had the Postal Service been able to avoid those losses on underwater products, its operating profits during the last four years would have been around $5.7 billion.

Although the cumulative record of operating income under PAEA has been commendable, the downward trend in FY 2009 and FY 2010 needs to be reversed, with the Postal Service returned to annual profitability. Operating losses in the most recent two years reflect serious pricing problems the Postal Service has with respect to underwater products. These pricing problems need to be fixed, either by the Postal Service or by the Commission. However, even those serious pricing problems are dwarfed by the aggressive funding of retiree health benefits required by PAEA; this statutorily-created problem can be fixed only by Congress.

Service's inability to eliminate them, has been labeled a "systemic" problem by both the Postal Service and the Commission. *See* FY 2010 ACR, p. 7; FY 2009 Annual Compliance Determination ("ACD"), p. 20. The problem of underwater products is discussed in section II, *infra*.

Table I-1
Postal Service Operating Revenue and Expenses
FY 2007 – FY 2010
($, millions)

	FY 2007	**FY 2008**	**FY 2009**	**FY2010**
Operating Revenue (includes net investment/interest income)	74,963	74,932	68,036	66,921
Less: Operating Expenses	71,757	72,138	70,430	69,926
Operating Profit (Loss)	**3,206**	**2,794**	**(2,394)**	**(3,005)**
Funding of PSHRBF	8,358	5,600	1,400	5,500

	FY 2007 - FY 2010
Four-year Operating Profit	**601**
Four-year cost of PSHRBF	**20,858**

Sources: USPS 2010 Annual Report, p. 63; USPS 2009 Annual Report, p. 55.

The PSRHBF issue alone is driving the Postal Service to the very brink of insolvency, and is the subject of separate discussion in section I.E, *infra*. Therefore, sections I.B, I.C, and I.D, which follow, rest on the premise that Congress, one way or another, will fix the funding requirement in a manner that permits the Postal Service to continue operating at least to the end of FY 2012.

B. Under PAEA, Postal Service Indebtedness Increased to $12.0 Billion, and Net Worth Has Sunk to a Negative $13.9 Billion.

In order to pay Congressionally-required contributions to the PSRHBF that could not be funded with net cash flow from operations, the Postal Service has had to resort to extensive borrowing. Its net worth has plummeted. As a result of this disastrous legislation:

- Postal Service **indebtedness** has increased from **$2.1 billion** at the end of FY 2006, only months before PAEA was enacted, to **$12.0 billion** at the end of FY 2010.[6]
- The Postal Service's **net worth** has gone from a **positive $6.3 billion** at the end of FY 2006 to a **negative $13.9 billion** at the end of FY 2010.[7]

One of the nine objectives contained in PAEA, 39 U.S.C. section 3622(b)(5), states that the modern system for regulating rates for market dominant products should be designed:

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

The PAEA-imposed burden on the Postal Service to pre-fund all future retiree health care benefits within only 10 years, while operating under a CPI rate cap, has ensured Postal Service noncompliance with this critical rate-setting objective. With the price cap constraint, no rate-making system designed by the Commission could have prevented the current financial crisis. Moreover, even without the price cap, it seems unlikely that any rate-making system would have been able to have generated sufficient cash flow to fund the PSRHBF as mandated by

---

6 Postal Service borrowing authority has been restricted, under both the Postal Reorganization Act of 1970 ("PRA") and PAEA, to no more than $3 billion per year, and an aggregate amount of no more than $15 billion. 39 U.S.C. § 2005(a). *See* 2009 Comprehensive Statement on Postal Operations, p. 62. To the extent that the Postal Service borrows money to fund payments to the PSRHBF, it is shifting onto its balance sheet liabilities that always were known to exist, but previously were neither funded nor accrued in the financial statements. The current balance sheet neither includes the amount of money currently held in the PSRHBF as an asset, nor reflects the estimated actuarial liability for future retiree health benefits. Such information is available, however, in footnotes to the financial statements. *See* USPS 2010 Annual Report, p. 49.

7 USPS 2010 Annual Report, p. 65.

PAEA, given market considerations (including, most especially, increasing competition from the Internet). The FY 2011 Integrated Financial Plan ("IFP") explains:

> Total liquidity **entering 2010** was **$6.9 billion** and consisted of $3.9 billion in cash and the statutory authority to increase debt by up to $3.0 billion. During 2010 we borrowed $1.8 billion of the $3 billion statutory limit and ended the year with a total debt balance of $12.0 billion. The **end result for 2010** was a cash balance of **$1.0 billion**. [FY 2011 IFP, p. 6 (emphasis added).]

See section I.E, *infra*, for further discussion of these concerns.

C. The Postal Service Expects Yet Another Operating Loss in FY 2011.

In the current year, FY 2011, despite the anticipated decline in volume and revenue, the Postal Service expects operating expenses to increase by $1 billion, resulting in a **net operating loss of $0.9 billion** (even before a further scheduled payment of $5.5 billion to the PSRHBF).[8] The FY 2011 IFP explains this problem in greater detail:

> After the recent economic recession, the **FY2011** IFP is based on a slightly better economic outlook. It introduces new operational efficiencies and revenue initiatives to mitigate the impacts of the **continuous volume loss in First Class Mail** and the damage caused by the recession and diversion of communication to the internet. However, these efforts are not sufficient to bring the Postal Service to profitability in 2011. The Plan reflects an **operating loss of $0.9 billion** before the impact of the $5.5 billion Retiree Health Benefits (RHB) pre-funding payment and a net loss of $6.4 billion. [FY 2011 IFP, p. 2 (emphasis added).]
>
> Based on a projected net loss of $6.4 billion for 2011 and expected capital cash outlays of $1.3 billion, the net cash to be used in operating the Postal Service during 2011 is estimated to be $6.7 billion. With a beginning cash balance of $1.0 billion plus $3.0 billion of borrowing authority, we expect to **end the**

---

[8] *See* FY 2011 Integrated Financial Plan, p. 2. The $0.9 billion operating loss includes payments for current retiree health benefits.

> **year with a cash shortfall of $2.7 billion,** having reached our total borrowing limit of $15.0 billion. [FY 2011 IFP, p. 6 (emphasis added).]

As the FY 2011 IFP notes, at the end of FY 2011 the Postal Service will not have sufficient liquidity to comply with the pre-funding requirement for the PSHRBF established by PAEA. Assuming that Congress resolves this liquidity problem in a manner that permits financial solvency and continued operation at least to the end of FY 2012, the question raised by (i) the continuing loss of volume in First-Class Mail, (ii) the projected operating loss in FY 2011, and (iii) the lack of any financial cushion in the form of net worth or borrowing capability, is whether the Postal Service's business model is sufficiently robust to repair the financial damage inflicted by PAEA and achieve a return to sustainable profitability.[9]

D. The Postal Service's Business Model May Not Be Adequate to Restore the Postal Service to a Financially Self-sustaining Status.

In March 2010, the Postal Service published *Ensuring a Viable Postal Service for America: an Action Plan for the Future* ("Action Plan"). The Postal Service's Action Plan was an impressive effort to take a long-range view of Postal Service finances.

> The Postal Service's **business model** dates to **1970**, when it became an independent agency of the Executive Branch.... [T]he Postal Service was designed to operate like a business, financing its operations from the sale of its products and services. [*Id.*, p. 2 (emphasis added).]

---

[9] Although the Commission's ACD is generally retrospective in nature, in its report to Congress on the functioning of PAEA for FY 2010, the Commission truly needs to address whether the Postal Service's business model, with all existing statutory constraints, will enable the Postal Service to continue operating as a viable self-sustaining entity.

Since postal reorganization in 1971, financial independence was, and continues to be, a major over-arching goal of the Postal Service.[10] That self-financing model presumed that mail volume, particularly First-Class Mail volume, would continue to grow along with the population and the economy. Another underlying premise was that the monopoly would remain an effective barrier to competition and allow the Postal Service to continue raising prices as necessary to support a number of activities, regardless of how costly or unprofitable those activities might be, or might become. Essentially the same fundamental premises underlay PAEA. The March 2010 Action Plan notes that:

> In **2006** Congress passed new legislation that significantly **modified** the postal business model. It provided limited pricing freedom in Competitive Products but offered little flexibility for the remainder of the business.[11] [*Id.*, p. 2 (emphasis added).]

It goes on to explain that, with the permanent decline in the volume of First-Class Mail and the heavy expenses and other restrictions imposed by Congress, the new business model created by PAEA is no longer sustainable. *Id.*, pp. 3-6.

The Postal Service's Action Plan proposes a number of changes to the Postal Service's business model. However, even if all further payments to the PSRHBF were eliminated immediately, and all of the Postal Service's desired changes to its business model were

---

[10] It would appear to be an implicit goal of Congress as well, since Congress has not indicated any desire to appropriate money to support small post offices, or help pay any of the other unfunded mandates imposed on the Postal Service.

[11] This statement does not acknowledge the Postal Service's increased flexibility with respect to pricing market dominant products. However, it is consistent with the Postal Service's reluctance to exercise its flexibility under PAEA to adjust prices of underwater market dominant products.

adopted, such "improvements" apparently would not be sufficient to restore the Postal Service to the status of a healthy self-sustaining entity. To "right the ship," the Postal Service will need to think in somewhat more aggressive terms than thus far envisioned.

The Postal Service has not yet fully adjusted to new realities and the changes which will be required. This year's ACR acknowledges the fundamental sea changes undercutting its business model. It fails, however, to draw appropriate conclusions. For instance, First-Class Mail and the contribution which it makes are acknowledged to be of great importance:

> First-Class Mail traditionally has made the highest contribution to covering institutional costs due to the combination of the high volume of First-Class Mail and its high cost coverage.... The **continued health of First-Class Mail is of critical importance to the Postal Service,** both to assure adequate revenues and, given its large volume and contribution, to help create price predictability and stability by providing a solid and reliable base. [FY 2010 ACR, pp. 17-18 (emphasis added).]

Then the following two somewhat contradictory statements occur on the same page:

> A. First-Class Mail volumes continued to **decline at a significant pace in FY 2010.** After experiencing an 8.6 percent decline from FY 2008 to FY 2009, First-Class Mail volumes declined another 6.6 percent from FY 2009 to FY 2010....
>
> B. This [high cost coverage] is a reflection of the **high value** of service in terms of delivery, privacy, and other features of First-Class Mail. [FY 2010 ACR, p. 17 (emphasis added).]

The continuing decline in the volume of First-Class Mail, noted in preceding statement A (and projected by the FY 2011 IFP to continue in FY 2011), has several implications:

> First, the Internet has substantially eroded effectiveness of the Postal Service's monopoly over most written communication,

> *i.e.*, the contents of most First-Class Mail.[12] The economic "rent," or surplus, previously enabled by the monopoly essentially has been largely eroded — perhaps forever. The monopoly now confers on the Postal Service much less economic value than in the past.[13]
>
> Second, the marketplace is sending a strong message: First-Class Mail no longer has the value traditionally asserted, as demonstrated by declining demand. If First-Class single-piece mail represented such "high value" to users (as the above statement B asserts), the decline in volume would be less.
>
> Third, the decline in volume of highly profitable mail also should be informing the Postal Service that mailers are using new electronic options to avoid using products where rates include high coverage.

The FY 2011 Integrated Financial Plan (filed Nov. 19, 2010) states that:

> First-Class Mail volume is forecasted at 75.2 billion pieces and shows a decrease of 4 percent or 3 billion pieces compared to 2010 levels … the profit contribution of one piece of Standard Mail is only one-third of the contribution of a piece of First-Class Mail. [FY 2011 IFP, p. 3.]

Continued decline in the volume of First-Class Mail and the important contribution which that mail makes, coupled with continued substantial losses on underwater products, eventually could cause the Postal Service to seek still higher rates and coverage on its most

---

[12] The Postal Service is not alone. The Internet has disrupted permanently the business models (and profitability) of a number of firms in industries such as: (i) music (both recording companies and retailers); (ii) newspaper publishing; and (iii) book publishing (including book retailers).

[13] The Commission recently concluded that since 2007 the value of the postal monopoly has declined sharply (by $1.37 billion), but its current value nevertheless is still significant. PRC Annual Report to the President and Congress, FY 2010, p. 31. That finding is based on the dubious and dated **assumption** that, if the monopoly ceased to exist, widespread entry (and investment) by profit-seeking entrepreneurs then would occur even though the postal industry is in a state of rapid economic decline.

profitable products. Such residual value as the monopoly may still have, if any, is totally inadequate to sustain the infrastructure (*i.e.*, uneconomic post offices, residential delivery 6 days a week, etc.) that Congress has imposed upon the Postal Service. Recommendations by the Commission with respect to cost reduction efforts by the Postal Service (*e.g.,* 5-day delivery) should not assume that the monopoly has value capable of subsidizing uneconomic activities.

As noted previously, volume variable costs are proving to be variable, with a lag — *i.e.*, those costs are coming down. That, however, is not sufficient. In this new environment the Postal Service needs to do far more than simply adjust volume variable costs downward.[14] Substantial reductions in costs traditionally considered "fixed" are required. Moreover, the Postal Service's precarious financial condition would indicate that those reductions need to occur sooner rather than later in order to restore operations to financial viability.

The Postal Service needs to focus on increasing **operating income** (its newly adopted corporate goal) with a vengeance, on several fronts.

1. Utilizing pricing flexibility as quickly as possible, making **every postal product** profitable in the sense that revenues from each product:

(i) at least exceed attributable costs, and

---

[14] Suppose that many costs are variable and decline by 6, even 7 percent for every 10 percent decline in volume, as has been long assumed. Then, in order to achieve financial breakeven in the face of a large decline in volume, the Postal Service would need to increase rates higher than the CPI rate cap would permit. The rate cap aside, however, an increase in rates is not the way to stem a permanent volume decline. To the contrary, in such an environment rate increases on anything other than underwater products can be self-defeating. The order of the day needs to be retrenchment and cost reduction that go well beyond volume variable costs.

(ii) make a reasonable contribution to institutional costs (*see* 39 U.S.C. sections 3622(c)(2) and 101(d)).

Of course, if each postal product covers its attributable costs and makes a reasonable contribution, that will help ensure that the Postal Service generates adequate revenue (in compliance with 39 U.S.C. section 3622(b)(5)). Rate increases on highly-profitable, highly-elastic products should be avoided. Rather, any upward rate adjustment should be focused on products that either are underwater or are only marginally profitable.[15]

2. Reducing the costs of **city carrier routes** by:

(i) beginning to replace expensive door delivery with curb delivery on all such routes where the revenues from mail delivered are less than the cost of delivery,[16] and

---

[15] For reasons not clear, the Postal Service continues to nurture underwater products by proposing below-average rate adjustments. In view of the Postal Service's financial condition, the Commission might address in this year's ACD the issue of whether rate adjustments that do little or nothing to stem losses on underwater products should be considered "out of bounds." *See* Docket No. RM2009-3, Order No. 536, pp. 15-18. *See also* section II, *infra*.

[16] Door delivery to 39 million residential addresses has an average annual cost that exceeds the average cost of curb delivery by almost $5 billion. *See* Government Accountability Office ("GAO") Report No. GAO 10-455 (April 12, 2010), *U.S. Postal Service: Strategies and Options to Facilitate Progress toward Financial Stability*, p. 36, Table 8. The Postal Service should consider all options to reduce these costs, such as charging for high-cost, high-quality delivery service, with a goal of improving the annual operating profit from such delivery by at least $2.5 to $3.0 billion. Door delivery alone has an average daily cost of $1.15. The job description of the Deputy Postmaster General position circulated by the Postal Service's executive search firm states that "[i]n FY 2009 $1.40 in revenue was generated per delivery stop. That number is **expected to drop to $1 by 2020**." Spencer Stuart, Position and Candidate Specification, United States Postal Service Deputy Postmaster General, p. 2 (January 2011) (emphasis added) http://postcom.org/public/2011/USPS%20Deputy%20Postmaster%20General%20SPC.pdf. For the 39 million residential delivery points that receive door delivery, elimination of Saturday delivery alone will not result in revenue per delivery stop exceeding the cost of

(ii) eliminating Saturday delivery.

3. Reducing the cost of the **retail network** by:

(i) closing uneconomic, redundant post offices, numbering at least in the hundreds, possibly thousands, within the next 2 to 3 years, replaced by lower cost alternatives.

(ii) selectively offering new services at under-utilized retail facilities.

During the current Great Recession, the Postal Service demonstrated that volume variable costs are within control of the Postal Service, and can be reduced as volume declines. However, costs considered to be non-volume variable have been another matter altogether. One reason some costs are non-volume variable is that they are mandated by Congress. In its Annual Compliance Determination, the Commission has the responsibility to make recommendations to Congress for changes needed to reduce these costs. In that way, the Commission can urge Congress to change the Postal Service's business model to facilitate efforts by the Postal Service to regain financial health in accordance with 39 U.S.C. section 3622(b)(5).

E. PAEA-Mandated Funding for Retiree Health Care Benefits Needs a Permanent Reform.

The Postal Service's requirement to pay for retiree health benefits is not a new obligation. Retiree health benefits are a longstanding obligation for all levels of governments, as well as for many large corporations. The Postal Service has been funding pension benefits

---

delivery alone. On routes where delivery cost exceeds revenue, no degree of reduction in processing cost can enable an operating profit.

on a regular basis since 1971. In contrast, retiree health benefits traditionally have been an "off-balance sheet" item for the Postal Service, as well as the rest of the federal government. PAEA's aggressive funding schedule can be viewed as constituting an extraordinary requirement insofar as no other federal, state, or local government is required to pre-fund any of their retiree health care benefits.

The driving force underlying the Postal Service's current financial bind is the fact that PAEA requires the Postal Service, **over the course of 10 years**, to deposit in the PSRHBF[17] sufficient funds to pay **all estimated** future retiree health care benefits which have been accumulating over decades. This aggressive funding schedule mandates annual payments of $5.5 billion, while a variety of operating constraints also are imposed on the Postal Service. For example:

(1) a statutory CPI cap that limits the ability to increase prices;

(2) statutory requirements that have resulted in the underpricing of certain postal products, *e.g.*, Periodicals;

(3) a statutory proscription against closing small post offices solely for economic reasons;

(4) tight restrictions on products which the Postal Service may offer;

(5) by-now-predictable Congressional resistence to closing and consolidation of plants;

(6) under annual appropriation riders, a requirement to deliver mail 6 days a week; and

---

[17] As of October 1, 2010, the balance in the PSRHBF was $42.5 billion. *See* USPS 2010 Annual Report, p. 49. http://www.usps.com/financials/_pdf/annual_report_2010.pdf

(7) statutory debt limit provisions.

In light of the constraints just described, it was completely unrealistic for Congress in December 2006 to expect the Postal Service to be able to generate sufficient free cash flow to meet PAEA's annual funding requirement for the PSRHBF.[18] The CPI price cap alone guaranteed that the Postal Service could not generate such excess cash flow. If the federal government were to attempt to fund all of its retiree health care obligations in the same aggressive manner as PAEA requires the Postal Service to do (*i.e.*, over a 10-year period), massive tax increases far above any politically acceptable level would be necessary. No doubt, these are just some of the reasons that in 2006 the Board of Governors felt constrained, as fiduciaries for the mailing public, to take the politically-difficult step of strongly opposing passage of PAEA.[19]

As discussed in section I.B, *supra*, the Postal Service has been forced to borrow money to enable it to make payments to the PSRHBF. The result of incurring such indebtedness has been to shift onto the Postal Service's balance sheet a portion of its pre-existing liability for retiree health benefits. True funding of those benefits will not occur until the Postal Service is able to generate operating profits sufficient at least to reduce its debt to the existing level when

---

[18] Unlike PAEA, the PRA had a financial breakeven requirement which prevented the Postal Service from generating sustained excess cash flow or increased net worth.

[19] *See, e.g.,* U.S. Postal Service Board of Governors letter to Senator Susan M. Collins, January 24, 2006 ("[W]e believe there are critical elements missing from this bill, as well as numerous burdensome provisions that would make it extremely difficult for the Postal Service to function in a modern, competitive environment.... [I]n keeping with our concerns that the Postal Service be able to provide the quality of service and reasonable rates … we must oppose the passage of this bill.") http://www.usps.com/communications/news/press/2006/pr06_003.htm.

PAEA was enacted ($2.1 billion). That cannot happen until Congress enables the Postal Service to implement major cost reductions.

Looking back, in its Initial Comments on the Postal Service's FY 2009 ACR, Valpak discussed the desirability of avoiding a short-term Congressional "fix" in favor of a more permanent remedy that would endure over a longer term.[20] Subsequently, the Postal Service submitted to Congress a request that in FY 2010 it be relieved from making the full required payment to the PSRHBF — *i.e.*, it requested a fix for one year only. Congress declined to take any action on the Postal Service's request, however, and on September 30, 2010, the Postal Service managed to make the full payment.

Looking forward (as discussed in section I.C, *supra*), the FY 2011 IFP unhesitatingly states that by September 2011 the Postal Service will be faced with a shortfall well in excess of $2.0 billion, and insolvency. This forecast for FY 2011 seems set to demonstrate that the only thing worse than a short-term Congressional fix may be no fix at all. It thus would appear that this year Congress will be required to address the Postal Service's fiscal situation. In FY 2011, Congress cannot avoid granting any relief from the PAEA funding requirement for the PSRHBF — unless it decides to have the government cease providing mail service to the country.[21]

---

[20] Valpak Initial Comments, Docket No. ACR2009, pp. 22-28 (Feb. 1, 2010).

[21] The Postal Service FY 2009 SEC Form 10-K notes that "[a]lthough P.L. 109-435 dictates the funding requirements through 2016, the amounts to be funded and the timing of funding can be changed at any time with passage of a new law or upon an amendment of existing law as passed by Congress and signed into law by the President." *Id.*, p. 20. http://www.usps.com/financials/_pdf/FY_2009_10K_Report_Final.pdf

Broadly speaking, Congress has two options. One option would be to enact some short-term, stop-gap fix, as it so often is wont to do, one that would allow the Postal Service to continue operating at least for another year, but keep it on the precipice of insolvency. Alternatively, Congress could enact a longer-term, hopefully more permanent, reform, one designed to provide Postal Service management with a more stable planning horizon.

The first option is not a particularly efficient way to run a business. The reputation of the United States Postal Service as a reliable delivery service has great value which Congress should strive to protect, not destroy. A continued high level of uncertainty and anxiety could induce some mailers to leave the Postal Service permanently in favor of competitive alternatives. That would be counterproductive to the goal of a financially-viable Postal Service which should be able to continue contributing to the PSRHBF according to a reasonable schedule. Valpak urges the Commission to recommend to Congress that it enact remedial legislation that extends beyond a year-to-year band aid.

Valpak also supports Congressional examination of, and action on, the overfunding of pension benefits for postal employees participating in the **Civil Service Retirement System** ("CSRS"), as estimated by the Postal Service Inspector General at $75 billion[22] and by the

---

[22] Postal Service Office of the Inspector General ("OIG"), USPS-OIG Report Number RARC-WP-10-001, Jan. 20, 2010.

Segal/PRC Report at $50-55 billion.[23] These excess CSRS funds should be directed to prefunding PSRHBF.[24]

Due to the Postal Service's dire financial condition, Valpak would urge the Commission, in developing this year's compliance determination, to add new topics in its analysis.

1. Rather than limiting its report to "current law" (which cannot be reasonably assumed to remain unchanged), the Commission also should present a review based on one or more alternative scenarios assuming no, or at least lower annual payments for the PSRHBF.

2. When discussing the Postal Service's continuing inability to comply with conflicting statutory requirements, the Commission could help Congress by framing the issues and options in terms that would encourage an urgent and early resolution from Congress.[25]

---

[23] Report to the Postal Regulatory Commission on: Civil Service Retirement System Cost and Benefit Allocation Principles (June 29, 2010) by the Segal Company.

[24] Sadly, irrespective of the merits of the issue, Congress may be reluctant to transfer these funds from CSRS for fear of unmasking Congressional underfunding of these payments for other federal workers.

[25] PAEA envisions that the Commission will monitor and report to the President and Congress on the financial condition of the Postal Service, specifically including "the extent to which regulations are achieving the objectives under sections 3622 and 3633…." *See, e.g.*, 39 U.S.C. § 3651(a) ("Annual Reports by the Commission"). *See also* PAEA § 701 (uncodified, set out as notes under 39 U.S.C. § 501) (five-year "assessments of ratemaking, classification, and other provisions").

II. THE POSTAL SERVICE REPORTS THAT RATES FOR MANY UNDERWATER PRODUCTS CONTINUE TO VIOLATE THE POLICIES AND REQUIREMENTS OF PAEA, AND, FOR THE FIRST TIME, HAS ASKED FOR COMMISSION ASSISTANCE IN REMEDYING THIS STATUTORY VIOLATION.

A. PAEA Requires that Each Product Cover Its Attributable Costs and Make a Contribution to Institutional Costs.

Current postal law mandates that postal rates cover attributable costs as well as make a contribution to institutional costs. This requirement was contained in the Postal Reorganization Act of 1970, and continues in current postal law, unamended by PAEA:

> **[p]ostal rates shall** be established to **apportion the costs** of **all postal operations** to **all users of the mail** on a **fair and equitable** basis. [39 U.S.C. § 101(d) (emphasis added).]

PAEA reiterated and clarifies this principle as a "requirement,"[26] as follows:

> the **requirement** that each **class of mail or type of mail service** bear the direct and indirect **postal costs attributable** to each class or type of mail service through reliably identified causal relationships **plus that portion of all other costs** of the Postal Service **reasonably assignable** to such class or type. [39 U.S.C. § 3622(c)(2) (emphasis added).]

In the FY 2009 ACD, the Commission noted that "The desirability of rates that recover attributable costs and make reasonable contributions to institutional costs is also supported by [39 U.S.C. §] 3622(b)(1) ["To maximize incentives to reduce costs and increase efficiency"], and [39 U.S.C. §] 3622(b)(5) ["To assure adequate revenues, including retained earnings, to

---

[26] Although placed in a list of so-called pricing "factors," this principle is identified as the only "requirement" among the "objectives" and "factors" in section 3622(b) and (c), respectively.

maintain financial stability]."[27] FY 2009 ACD, p. 68, n.5. The Commission has also concluded that underwater rates are unfair to other mailers. *Id.*, p. 31.

If, during an annual compliance review, the Commission finds that any rates are not in compliance with these principles of postal law or implementing regulations, it has no discretion to ignore the problem, as PAEA requires that the Commission (i) "shall make" a written determination that non-compliant rates are "not in compliance" with PAEA, and then (ii) "shall take appropriate action…."

> (b) Determination of Compliance or Noncompliance.—
> Not later than 90 days after receiving the submissions required under section 3652 with respect to a year, the Postal Regulatory Commission **shall make** a **written determination** as to
> (1) whether any **rates or fees** in effect during such year (for products individually or collectively) were **not in compliance** with applicable provisions of this chapter (or regulations promulgated thereunder); or
> (2) whether any service standards in effect during such year were not met.
> If, with respect to a year, **no instance of noncompliance** is found under this subsection to have occurred in such year, the **written determination** shall be to that effect.
>
> (c) Noncompliance With Regard to Rates or Services.—
> If, for a year, a timely **written determination of noncompliance** is made under subsection (b), the Postal Regulatory Commission **shall take appropriate action** in accordance with subsections (c) and (e) of section 3662 (as if a complaint averring such

---

[27] In its FY 2009 ACD, the Commission applied 39 U.S.C. section 3622(c)(2) at the product level. *See, e.g.*, FY 2009 ACD, pp. 68 (First-Class Presort Parcels), 86 (Standard Mail Flats), 95 (Single-Piece Parcel Post, Bound Printed Matter Parcels, Media Mail/Library Mail, and Inbound Surface Parcel Post), 104 (Registered Mail and Stamped Cards), 106 (Address List Services), 107 (Confirm service), 111 (inbound letter post from Canada and Inbound Surface Parcel Post), and 112 (international inbound Registered Mail). *See also* FY 2008 ACD, pp. 72-73, 77.

> noncompliance had been duly filed and found under such section to be justified). [39 U.S.C. § 3653 (emphasis added).]

The Commission has believed it has latitude to defer a finding and action when the Postal Service has made pricing changes. *See* FY 2009 ACD, p. 16. Now that the Postal Service has sought the Commission's assistance in remedying underwater products, the Commission's duty is unambiguous. In taking appropriate action," the Commission exercises its broad remedial powers under 39 U.S.C. section 3662(c) relating to complaints[28]:

> (c) Action Required if Complaint Found To Be Justified.—
> If the Postal Regulatory Commission finds the complaint to be justified, it shall order that the Postal Service take such action as the Commission considers appropriate in order to achieve compliance with the applicable requirements and to remedy the effects of any noncompliance (such as **ordering unlawful rates to be adjusted to lawful levels**, ordering the cancellation of market tests, **ordering the Postal Service to discontinue providing loss-making products**, or requiring the Postal Service to make up for revenue shortfalls in competitive products).

The Commission acknowledges these powers. FY 2009 ACD, p. 16.

These comments begin with an overview of the magnitude of the statutory violation implicit in underwater products (section II.B), and then analyze the underwater product

---

[28] In addition, under 39 U.S.C. section 3662(d), the Commission has further authority in such cases:

> Authority To Order Fines in Cases of Deliberate Noncompliance.—
> In addition, in cases of **deliberate noncompliance** by the Postal Service with the requirements of this title, the Postal Regulatory Commission may order, based on the nature, circumstances, extent, and seriousness of the noncompliance, a **fine** (in the amount specified by the Commission in its order) for each incidence of noncompliance. Fines resulting from the provision of competitive products shall be **paid from the Competitive Products Fund** established in section 2011. All receipts from fines imposed under this subsection shall be deposited in the general fund of the Treasury of the United States.

problem at both the class and product levels — Periodicals (section II.C) and Standard Mail Flats (section II.D) — and conclude with an analysis of what must now be done (section II.E).

B. Underwater Products Continue to Plague the Postal Service, Seriously Jeopardizing Its Financial Health.

In its FY 2010 ACR, the Postal Service has reported that it has continued to hemorrhage enormous sums on money-losing products. These underwater products (excluding special services) are detailed in Table II-1.

Table II-1
Loss-Generating Market Dominant Products, FY 2009-2010
(Exclusive of Special Services)

Product	FY 2009 Deficit ($, millions)	FY 2009 Cost Coverage	FY 2010 Deficit ($, millions)	FY 2010 Cost Coverage
First-Class Parcels	N/A	N/A	$1.2	99.9%
Inbound Int. Single-Piece First-Class Mail	$105.2	60.5%	$53.3	79.3%
Standard Mail Flats	$622.3	82.2%	$581.9	81.6%
Standard Mail NFMs and Parcels	$208.1	75.2%	$177.9	77.2%
Periodicals Within County	$14.5	86.2%	$25.4	74.2%
Periodicals Outside County	$642.8	75.0%	$598.0	75.0%
Single-piece Parcel Post	$62.0	91.9%	$134.0	82.1%
Inbound Surface Parcel Post	$2.4	84.5%	N/A	N/A
Bound Printed Matter Parcels	$8.5	97.7%	$27.6	92.1%

Media and Library Mail	$75.0	84.1%	$89.8	80.4%
Total	**$1,740.8**		**$1,689.1**	

Sources: Tables 1-4, FY 2009 ACR; Tables 1-4, FY 2010 ACR.

The Postal Service reports on this problem extensively in its ACR. Because of the significance of the Postal Service's comments to the Commission's review, the Postal Service's comments are reproduced here verbatim.

> A significant question regarding the requirements of title 39 arises with respect to **cost coverage shortfalls**. In the FY 2009 ACD (March 29, 2010), the Commission observed that "fourteen market dominant products and services failed to cover attributable costs, **losing in the aggregate $1.7 billion**." FY 2009 ACD at 6. Approximately $1.5 billion of the loss resulted from **Periodicals** ($642 million), **Standard Mail Flats** ($616 million), and Standard Mail Non-Flat Machinables (NFMs) and Parcels ($205 million). FY 2009 ACD at 65. The Commission stated that "[t]he problem of individual market dominant product revenues failing to cover either attributable or overhead costs was so pervasive in FY 2009 that it has become a **systemic problem**." ACD at 20. To address the problem, the Commission required the Postal Service to "**develop and present a plan** explaining how the Postal Service expects to increase cost coverage on these products to a level where each makes a reasonable contribution to institutional cost." FY 2009 ACD at 65. The Commission directed that the plan be included in the next ACR or in the next general market dominant price adjustment.
>
> The Postal Service **presented its plan** in its request for an exigent rate increase in **Docket No. R2010-4.** The Postal Service detailed how **price increases,** efficiency improvements, and expected improving economic conditions would bring the fourteen products to full cost coverage. *See*, *generally*, Statement of James M. Kiefer on Behalf of the United States Postal Service (July 6, 2010), Docket No. R2010-4 (Kiefer Statement). The Postal Service estimated that its proposed price increases would result in ten of the fourteen products covering their attributable costs fairly quickly…. Kiefer Statement at 8. For the remaining four products – Outside County Periodicals, Within County

Periodicals, Media Mail, and Standard Mail Flats – the Postal Service explained how the products could be brought to full cost coverage over a lengthier period. For example, the Postal Service presented a detailed plan for capturing efficiencies for Standard Mail Flats that, when combined with consecutive above average price increases, would result in full attributable cost coverage. See Operations Strategies for Capturing Flats Efficiencies, USPS-R2010-4/9 (July 6, 2010).

With the Commission's denial of the Postal Service's exigent rate increase request in Docket No. R2010-4, **the Postal Service's plan** for bringing the fourteen products to full attributable cost coverage **is no longer workable**. The results contained in the present ACR show that **the cost coverage problem continues to exist and remains systemic**. As the Postal Service has indicated to the Commission over the course of their joint work on the **Periodical Study**, even if the Postal Service achieves the **most optimistic efficiency enhancements possible**, it **does not foresee** that such enhancements, combined with annual rate increases within the statutory price cap, will result in Periodicals, Standard Mail Flats, and Standard Mail NFMs/Parcels **reaching full attributable cost coverage**. In other words, it **seems impossible** for the Postal Service, acting with the powers granted to it and within the **constraints imposed by title 39,** to present any realistic plan that would result in these **products** fully covering their attributable costs, much less making any contributions to institutional costs. Therefore, it seems most appropriate for the **Commission to determine whether it can exercise any of its powers to remedy the cost coverage shortfall** of the **products** in question.

Other parties have advocated that the Commission possesses such powers. Most notably, the Public Representative argued during the FY 2009 Annual Compliance Review that, while the price cap provisions and exigent rate increase provisions of title 39 are the cornerstone of the Postal Service's rate authority for market dominant products, the Commission possesses its own rate authority which it can exercise outside of Postal Service requests, even in some cases *sua sponte*. *See*, *e.g.*, Public Representative Reply Comments (Feb. 23, 2010), Docket No. ACR2009. The Greeting Card Association (GCA) similarly stated that the Commission has the statutory power to call for the Postal Service to increase certain market dominant

> rates in **excess of the price cap**. *See*, *e.g.*, Reply Comments of the Greeting Card Association (Feb. 23, 2010), Docket No. ACR2009. In light of these statements, **it would be useful for the Commission to determine exactly what the contours of its powers are under title 39.**
>
> On the other hand, it is unclear to the Postal Service **whether the Commission's statements** in the FY 2009 ACD regarding the need for products to cover their attributable costs and make contributions to institutional costs **are still operative**, given the Commission's subsequent statements in Order No. 536 (September 14, 2010) in Docket No. RM2009-3 (Workshare Order) regarding products. In the Workshare Order, the Commission presented an analysis of the term "product" in title 39, as amended by the PAEA. Order No. 536 at 24-27. The Commission concluded that the **product level** is not the appropriate level for applying pricing standards, suggesting instead that the **class level** is the appropriate level. *Id.* at 27. It is not clear to the Postal Service how to reconcile this conclusion with the Commission's statements regarding cost coverage shortfalls in the FY 2009 ACD. If the Commission's statements in the Workshare Order regarding products mean that cost coverage shortfalls are acceptable at the product level so long as there is full attributable cost coverage and appropriate institutional cost contribution at the class level, then Commission action to remedy product-level cost coverage shortfalls may not be necessary.... [FY 2010 ACR, pp. 7-10 (emphasis added).]

The Postal Service is correct that the Commission needs to clarify its position on pricing principles, but it is even more important that the Commission assist the Postal Service in resolving the problem of underwater products, which is recurring, systemic, and threatening to the financial health of the Postal Service.

The Postal Service raises an issue as to whether the Commission has authority under 39 U.S.C. section 3662(c) to increase rates over the cap, but Valpak believes this issue is completely clear: the Commission has such authority. Indeed, the Commission has express statutory authority to "order[] unlawful rates to be adjusted to lawful levels...." 39 U.S.C. §

3662(c). Moreover, if the Commission has the almost draconian authority to eliminate an entire product, which it unambiguously has under section 3662(c), then it certainly has the power to increase rates above the cap. Indeed, the authority of the Commission to increase rates over the cap appears so clear that Valpak cannot identify any plausible reading of the statute to deny that power to the Commission.

The Postal Service analysis assumes, *sub silentio*, that the Commission's review of the pricing of underwater products is limited to the requirement set forth in 39 U.S.C. section 3622(c)(2). Indeed the Postal Service never once mentions 39 U.S.C. section 101(d), which requires that all "postal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." Of course, on the authority of this section alone, the Postal Service has the duty to remedy underwater products as well as classes. Contrary to the Postal Service's implicit assumption, the Postal Service's ACR is not based only on section 3622, but on "all applicable requirements of this title." 39 U.S.C. § 3652(a)(1). *See also* FY 2009 ACD, p. 15.

Valpak agrees with the Postal Service, however, that it must be decided by the Commission whether the requirement of section 3622(c)(2) applies at the class level or the product level; however, the difference for the Commission is not nearly as great as the Postal Service believes.

- If section 3622(c)(2) applies only to the **class level**, and since the CPI-based price cap of section 3622(d) is applied at the class level, and if an entire class is underwater by more than can be remedied by an increase of the amount of the cap (*e.g.,* Periodicals and Package Services), then the Postal Service has no pricing remedy, but the Commission has the power and the duty to remedy shortfalls in those classes.

- However, if section 3622(c)(2) applies at the **product level**, and since the CPI-based price cap of section 3622(d) is applied at the class level, and the entire class is not underwater, then the Postal Service has the power to target its price increases on underwater products (*e.g.*, Standard Mail Flats) to remedy shortfalls in those products.

The Postal Service's general statement that it "seems impossible for the Postal Service" to set rates by which "products" would fully cover "attributable costs" (FY 2010 ACR, pp. 8-9) is only true for classes like Periodicals and does not apply to products like Standard Mail Flats. Since the Postal Service has deliberately allowed extensive intra-class subsidy of underwater products (*e.g.,* Standard Mail Flats), Valpak urges the Commission to determine the Postal Service has not used its pricing powers in accordance with PAEA, in violation, *inter alia*, of 39 U.S.C. section 101(d), and the Commission must now order the Postal Service toward cost-coverage compliance for those underwater products in money-making classes.

If for some reason the Commission were to believe it is powerless to resolve these problems, it must advise Congress that PAEA is badly flawed and needs immediate revision. Further delay or deferral is not an option. Although it might have been possible at one time to have believed that the Postal Service could generate sufficient revenue from high-coverage products to offset losses from underwater products, it now should be clear that those days are over. As demonstrated in Table II-1, the combined loss of the 11 products in FY 2010 was $1,689.1 million. That amount constitutes the majority (56.4 percent) of the operating loss of the Postal Service. Responsibility to take action now rests squarely on the shoulders of the Commission in this docket.

C. The Periodicals Class Continues for the 14th Year in a Row to Be Underwater — with the Lowest Coverage Ever during FY 2010.

In FY 2010, the Periodicals class completed its fourteenth year of being subsidized by other mailers, adding another **$611 million** to a cumulative deficit that now has exceeded $4.3 billion in those 14 years. *See* Table II-2. Moreover, in FY 2010, the Periodicals class achieved a new all-time low coverage of **75.46 percent**, with both Periodicals subclasses underwater.

A rate increase averaging **32 percent** would be necessary to bring revenues from periodicals up to attributable cost in one step, and a rate increase of **16 percent** would be needed this year (and another next year) to bring Periodicals up to attributable cost in two equal steps. Such a large price increase would not have been necessary if smaller price increases had been ordered in the past — illustrating the danger of repeatedly deferring unpleasant but necessary action into the future indefinitely.

Under PRA, it took a decade for the Periodicals class to lose $2.2 billion for the Postal Service. Under PAEA, it has taken only four years for Periodicals to lose an additional $2.1 billion. Under PRA, the lowest coverage for Periodicals was 85.08 percent (FY 2005). Under PAEA, the coverage has never exceeded 84 percent, and it now has dropped almost another 10 percentage points.

If Periodicals covered their attributable costs and were priced to make even a **minimal contribution** to institutional costs of 10 percent, the Postal Service's operating loss would have been reduced by over $700 million. In view of the requirement that institutional costs be shared by all mail users, it is more accurate to consider the true losses from the Periodicals class to be at least $700 million in FY 2010.

Table II-2
Periodicals Class — Revenue, Cost, Coverage, and Cross-Subsidies
FY 1997 — 2010

	(1)	(2)	(3)	(4)
PRC CRA	Revenue	Costs	Cover-age	Revenue – Costs
Year	($, mill.)	($, mill.)		($, mill.)
Under PAEA				
2010	1,878.8	2,489.8	75.46%	-611.0
2009	2,038.0	2,680.0	76.04%	-642.0
2008	2,294.9	2,732.1	84.00%	-437.2
2007	2,187.9	2,635.6	83.01%	-447.7
Subtotal	**6,520.8**	**8,047.7**	**81.03%**	**-2,137.9**
Under PRA				
2006	2,124.8	2,487.6	85.42%	-362.8
2005	2,068.9	2,431.6	85.08%	-362.7
2004	2,100.0	2,323.3	90.39%	-223.3
2003	2,139.6	2,196.2	97.42%	-56.6
2002	2,066.9	2,280.4	90.64%	-213.5
2001	2,106.9	2,367.1	89.01%	-260.2
2000	2,076.3	2,354.8	88.17%	-278.5
1999	2,017.7	2,213.1	91.17%	-195.4
1998	1,972.8	2,129.0	92.66%	-156.2
1997	1,964.6	2,038.5	96.37%	-73.9
Subtotal	**20,638.5**	**22,821.6**	**90.43%**	**-2,183.1**
	------------	------------	-----------	-----------
TOTAL	**27,159.3**	**30,869.3**	**87.98%**	**-4,321.0**

The problem of underpricing of Periodicals has been raised in each prior ACR.

1. The Commission Has Deferred Action on Periodicals in Each of the Three Prior ACRs.

a. Docket No. ACR2007.

In the first Annual Compliance Report under PAEA, Docket No. ACR2007, the Postal Service reported that Periodicals had failed to cover attributable costs, with class-wide cost coverage of **83.01 percent**. *See* Docket No. ACR2007, USPS-FY07-1, FY 2007 Public Cost and Revenue Analysis Report.

Valpak urged the Commission to exercise its authority under 39 U.S.C. sections 3653(c) and 3662(c), make a finding of noncompliance with respect to Periodicals,[29] and order at least some Periodicals price changes. Docket No. ACR2007, Valpak Initial Comments (Jan. 30, 2008), pp. 50-51.

The FY 2007 ACR was a transitional ACR since the rates in effect for FY 2007 were established under PRA. The Commission acknowledged that it was required to "consider whether rates generate revenue in excess of attributable costs in the year under review," but decided to delay action.

> In addition to increasing efficiencies, the rates implemented in July 2007, were designed to generate a very substantial increase in revenue. The recent further **rate increases** approved for the Periodicals class in Docket No. R2008-1 reasonably approximate the allowable CPI cap. At this point in time, it is most appropriate to allow the recently adopted **strategy**

[29] During the rulemaking mandated by PAEA, Valpak had previously addressed the cost coverage requirement of 39 U.S.C. section 3622(c)(2). *See*, *e.g.*, Docket No. RM2007-1, Valpak Reply Comments on Regulations Establishing a System of Ratemaking in Response to Commission Order No. 2 (May 7, 2007); Docket No. RM2007-1, Valpak Comments on Regulations Establishing a System of Ratemaking in Response to Commission Order No. 26 (Sept. 24, 2007).

> for overcoming the Periodicals **revenue-cost relationship** a **reasonable interval of time** to succeed. [FY 2007 ACD, p. 70 (emphasis added).]

b. Docket No. ACR2008.

The Postal Service's FY 2008 ACR revealed another losing year for Periodicals. The class's cost coverage for that year was up slightly, to **83.99 percent**. *See* Docket No. ACR2008, USPS-FY08-1, FY 2008 Public Cost and Revenue Analysis Report.

Valpak argued that new prices could not be expected to cover attributable costs in FY 2009 and, in order for Periodicals to reach 100 percent cost coverage, there would need to be both a substantial increase in unit revenues and a substantial decrease in unit costs. Docket No. ACR2008, Valpak Initial Comments (Jan. 30, 2009), p. 21.

This time, the Commission clearly saw both the violation of PAEA and the threat that Periodicals posed to Postal Service finances, but chose to await results of the Joint Task Force on Periodicals:

> Results for the past fiscal year clearly show that Periodicals remain, in the Postal Service's words, "a challenged class" in terms of cost coverage. The need to bring Periodicals revenues into closer alignment with attributable costs is not simply a matter of achieving technical **compliance** with PAEA requirements for this class, but also of fostering broader assurances of **systemwide financial stability** and **fairness to other mailers**.
>
> Both of these considerations highlight the **imperative need** to reduce the extent to which Periodicals are exposed to manual sorting operations, to control other costs, to improve cost modeling, to align the pricing structure more closely with cost incurrence, and to employ pricing objectives that also send **clear signals to mailers**. Toward these ends, *the Commission anticipates exploring the feasibility and impact of including allied piece costs in worksharing cost. It supports and encourages the* ***Joint Task Force*** *effort to improve the data used in the*

> *Periodicals cost model, to search for practices that will improve operational efficiency handling and transporting Periodicals, and to consider whether the discount or rate structure can help the Postal Service and its customers to become more efficient users of the mail. It also strongly encourages the Postal Service and Periodicals mailers to consider administrative solutions to processing decisions that currently elevate service decisions over cost considerations*. [FY 2008 ACD, p. 59 (italics original; bold added).]

c. Docket No. ACR2009.

FY 2009 resulted in another loss for Periodicals, with the Postal Service reporting that cost coverage had plummeted to **76.04 percent**. *See* Docket No. ACR2009, USPS-FY09-1, FY 2009 Public Cost and Revenue Analysis Report.

Valpak made specific recommendations with respect to how the Commission should respond. Valpak urged the Commission to:

> (i) adopt the Postal Service finding that "the Periodicals class does not satisfy section 3622(c)(2) of title 39" and make the required finding that the Periodicals class for FY 2009 is **not in compliance** with 39 U.S.C. section 3622(c)(2), and then
>
> (ii) enter such order under 39 U.S.C. section 3653(c) as the Commission determines best to **abate the hemorrhage** from Periodicals and **move the class toward compliance** with 39 U.S.C. section 3622(c)(2) over an established period of time. [Docket No. ACR2009, Valpak Initial Comments (Feb. 1, 2010), pp. 17-18 (emphasis added).]

Valpak advanced the view that an immediate price change to achieve full coverage was not required by PAEA even when the Commission made a determination of noncompliance, but that some steps had to be taken and the Periodicals pricing structure needed to send better signals for more efficient preparation and handling. *See* Docket No. ACR2009, Valpak Reply Comments (Feb. 23, 2010), pp. 9-26.

Again the Commission chose to defer action, using the rationale of the still-pending Joint Task Force report that it had relied on 12 months before. However, it urged the Postal Service to make appropriate intra-class price changes, and required that it submit a plan with its next price change or in its next compliance review.

> In considering various options, 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. The Commission is **hopeful** that the report, which it **anticipates will be issued shortly,** will provide helpful guidance in this area. There are, as discussed below, current opportunities for the Postal Service to improve Periodicals cost coverage by **modifying** container and bundle **passthroughs**.
>
> *The Postal Service shall develop and present a* ***plan*** *explaining how it intends to* ***increase Periodicals cost coverage to a reasonable level*** *in its next notice of general price adjustments for market dominant products, or its next annual compliance report.* [FY 2009 ACD, p. 75 (italics original; bold added).]

The Postal Service plan that was submitted in Docket No. R2010-4 is discussed in section II.D, *infra*.

2. The Previous Rationales for Deferring Action on Periodicals Are No Longer Available.

a. The Joint Task Force Report on Periodicals Cannot Solve the Problem.

In two successive ACD's, the Commission has deferred action on Periodicals due to the "soon-to-be-released" report of the Joint Task Force on Periodicals required by PAEA section

708 (uncodified).[30] The report has been under construction for the past several years with promised deadlines for issuance long past.[31] PAEA did not set a deadline for the report, and nothing would indicate that the report is near completion and is going to be submitted to the President and Congress any time in the near future. However, we now know that the significance of this report to lawful pricing of Periodicals is now past, as the Postal Service's FY 2010 ACR states that during the course of the preparation of the report it has been determined that there will be nothing the Postal Service can do, within the confines of cost cutting and within-CPI price increases, that will adequately move Periodicals towards covering its costs. FY 2010 ACR, pp. 8-9. Accordingly, there is no justification for delaying Commission action based on the pendency of the long-delayed report of the Joint Task Force.

---

[30] SEC. 708. RATES FOR PERIODICALS.

(a) In General.—The United States Postal Service, acting jointly with the Postal Regulatory Commission, shall study and submit to the President and Congress a report concerning—

(1) 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

(2) any opportunities that might exist for improving efficiencies in the collection, handling, transportation, or delivery of periodicals by the Postal Service, including any pricing incentives for mailers that might be appropriate.

(b) Recommendations.—The report shall include recommendations for any administrative action or legislation that might be appropriate

[31] "The PAEA section 708 provided a study of Periodicals conducted jointly by the Commission and the Postal Service. **That study will be published this spring** [2009] and will, among other things, address service issues of Periodicals mail." FY 2009 ACD, p. 55 (emphasis added).

b. Periodicals Costing Has Been Found Accurate.

Periodicals mailers have alleged that Periodicals costing is badly flawed and it is impossible to conclude that Periodicals cost coverage is under 100 percent.[32] The Postal Service Office of the Inspector General conducted an audit of Periodicals data collection systems and issued its report on December 7, 2010. That report concluded: "we found that Postal Service data collection systems and procedures accurately attribute costs to Periodicals based on existing cost attribution models." *See* Postal Service OIG Report No. CRR-AR-11-001 (Dec. 7, 2010), p. 2.[33] Accordingly, there is no justification for delaying Commission action based on supposed flaws in Periodicals costing.

D. The Standard Mail Flats Product Continues to Hemorrhage Losses from within a Profitable Class.

Although the enormous annual losses from Periodicals occurs in that class of mail that is subject to the price cap, the Postal Service has no excuse for allowing Standard Mail Flats to lose hundreds of millions of dollars each year. The issue did not arise in the FY 2007 ACD, but the Commission acknowledged the problem in its FY 2008 ACD:

> 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

---

32 *See, e.g.,* Docket No. ACR2009, Initial Comments of American Business Media (Jan. 29, 2009), p. 3.

33 http://www.uspsoig.gov/foia_files/CRR-AR-11-001.pdf

> 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 (footnote omitted, emphasis added).]

Again, in its FY 2009 ACD, the Commission addressed the problem and required the submission of a plan.

> 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.* In addition to adjusting prices and cutting costs, the Postal Service may consider changing the minimum qualifying volume for Carrier Route (from 10 to 6 piece bundles) to attract mail volume away from flats to the profitable Carrier Route flats category. The Postal Service could try a market test or a limited duration "mail preparation sale." [FY 2009 ACD, pp. 86-87 (italics original; bold added).]

1. Standard Flats Lost an Additional $581.9 million in FY 2010.

Standard Flats are one of six products in the Standard Mail Class.[34] The Postal Service's Cost and Revenue Analysis ("CRA") report began providing data on the Standard Mail Flats product in FY 2008. In the three years since then, revenues from the Standard Mail Flats product have failed to cover attributable cost by a cumulative total of $1.4 billion. *See* Table II-3.

Table II-3

Standard Mail Flats Revenue, Costs and Contribution
FY 2008 – 2010
($, millions)

Fiscal Year	Revenue	Attributable Cost	Contribution	Volume
2008	$3,663.7	$3,891.0	-$227.3	10,010.875
2009	2,866.0	3,488.3	-622.3	7,793.511
2010	2,579.4	3,161.3	-581.9	7,049.230
TOTAL	$9,109.1	$10,540.6	-$1,431.5	

Source: CRA for each respective year.

Although the CRA did not report on Standard Flats as a product in the CRA prior to FY 2008, separate cost and revenue data were available for flats, and from those data flats profitability could be determined. The Standard Mail Flats product is — obviously — exclusively flats,

---

[34] The six Standard Mail class products are Letters, Flats, Parcels/NFMs, Carrier Route Letters, Flats, and Parcels, High Density and Saturation Letters, and High Density and Saturation Flats and Parcels. All of those products generate significant contribution, except for Standard Flats and Parcels/NFMs.

while the Carrier Route Letters, Flats, and Parcels product is almost exclusively (over 97 percent) flat-shaped pieces (*i.e.,* catalogs).

No evidence has been located demonstrating that what is now the Flats product has ever been profitable, but the problem long has avoided much attention. From testimony submitted in Docket No. R2006-1, it appears that Flats then were deeply underwater.[35] As a result of the record evidence in that docket, the Commission substantially increased the Flats rate, effective on May 14, 2007. Despite that rate increase in 2007, Flats have continued being an underwater product since then, as Table II-3 clearly demonstrates. Available evidence does, however, support two inferences:

- The volume of Flats grew to a substantial level only on account of — and for so long as — other products in the Standard Mail class heavily subsidized Flats.

- So long as the Postal Service continues heavily subsidizing Flats, the decline in catalog volume may be ameliorated and possibly stabilize around current levels.

In its current ACR, the Postal Service admits that Standard Flats are not expected to become a profitable product for the Postal Service (despite the fact that operating profit is now a major goal adopted this year by the Postal Service). *See* FY 2010 ACR, p. 8. Unfortunately, this year's ACR minimizes the scope of the problem:

> In each of the last four fiscal years, these two [Standard Mail] products [Flats and NFMs/Parcels] did not cover costs. This is **of concern** to both the Postal Service and the Commission. [FY 2010 ACR, p. 24 (emphasis added).]

---

[35] *See* Docket No. R2006-1, testimony of Robert W. Mitchell, VP-T-1, pp. 160, 196, and supporting workpapers (tab INPUTS and Current-1).

Losing $581.9 million in one year should seem to be more than a matter "of concern" to the Postal Service. It certainly would be a concern to a for-profit company. Since NFMs/Parcels are the subject of a separate classification docket,[36] the remainder of the discussion here will focus on Standard Flats.

2. Standard Mail Flats Continued to Drown the Postal Service in Red Ink in FY 2010.

For FY 2009-2010, Table II-4 shows the unit revenues, costs and contribution of Flats. Since rates were not adjusted in FY 2010, unit revenues were approximately equal in those two years. The unit cost in FY 2009 and FY 2010 also changed very little, despite continuing deployment of the Flats Sequencing System ("FSS") machines throughout FY 2010. Failure of unit cost to respond to increased FSS processing and any of the other ongoing cost-reduction initiatives of the Postal Service is indicative of how difficult it is to increase coverage by reducing unit cost. Without Commission-directed price increases, continued large losses on Flats can be anticipated by the Postal Service, as well as by mailers of other profitable products who subsidize those losses.

The only good news discernable from Table II-3 is that the loss on Standard Flats in 2010 compares favorably with the loss in 2009 — *i.e.*, a loss of "only" $582 million in 2010 versus a loss of $622 million in 2009. That reduction in net outflow was attributable solely to the decline in volume, not cost reduction.[37] It is not fair or equitable for mailers of other

---

36 *See* Docket No. MC2010-36.

37 In the absence of significant cost reduction, the chief hope for a further reduction in the annual subsidy would appear to lie in a further reduction in volume, a passive strategy not permitted to the Commission under PAEA.

profitable products to be required to continue subsidizing Flats' catalog mailers — particularly not at 8 cents for each catalog sent.

Table II-4

Standard Flats Unit Revenue, Cost and Contribution
FY 2009 – 2010

Fiscal Year	Revenue	Attributable Cost	Contribution
2009	$0.368	$0.448	-$0.080
2010	$0.366	$0.448	-$0.083

Source: CRA for each respective year.

3. No Plan Has Ever Been Developed by the Postal Service to Decrease the Cost of Handling Flat-Shaped Products and Increase Rates.

The Postal Service's plan for reducing the cost of handling Flats (including Periodicals) submitted by the Postal Service in the exigent rate case (Docket No. R2010-4) consisted largely of a series of vague, unsupported statements about various ongoing or contemplated initiatives that might, at some unspecified time in the future, decrease costs by some unspecified amount. In no way did the submission constitute a plan specifically aimed at improving coverage of Flats.

Most of those cost reduction initiatives were applicable to all postal products. The one initiative directed explicitly at reducing the cost of handling flats generally was the ongoing installation of the FSS. Regrettably, the plan in Docket No. R2010-4 provided no meaningful information concerning the potential for cost reduction from FSS, despite explicit prior criticism by the Commission in its most recent ACD.[38] The so-called "plan" failed to provide any meaningful information either as to timing or the extent of specific initiatives that might be expected to reduce flats costs and bring Standard Flats coverage into compliance.

In its current ACR, the Postal Service now states that even its earlier "plan" to bring Standard Flats and Periodicals to full cost coverage "is no longer workable." *Id.*, p. 8. The ACR alludes to difficulties in reducing the cost of handling flat-shaped mail as follows:

> As the Postal Service has indicated to the Commission over the course of their joint work on the Periodical Study, even if the Postal Service achieves the **most optimistic efficiency enhancements possible,** it does **not foresee** that such enhancements, combined with annual rate increases within the statutory price cap, will result in Periodicals, **Standard Mail Flats**, and Standard Mail NFMs/Parcels reaching **full attributable cost coverage**. [FY 2010 ACR, p. 8 (emphasis added).]

Although the Commission's only action in its FY 2009 ACD was to require a "plan" (FY 2009 ACD, pp. 86-87), it is now clear that there is no Postal Service plan.

---

[38] With respect to FSS, the Commission's FY 2009 ACD stated:

> For example, Intelligent Mail barcode, **Flats Sequencing System**, and Network Distribution Centers, all major Postal Service initiatives that could be fairly characterized as program activities, are either **not detailed** fully, **lack specificity** as to performance goals and a basis for comparing results with goals, or are **not addressed at all** in terms of performance plans.
>
> The discussion of **FSS** is illustrative.... **No information is provided quantifying the intended benefits of FSS** or the progress made towards achieving those intended benefits. According to section 2803, in the absence of quantification or measurement, a description of a minimally effective or successful program is to be provided. **No such description by which an assessment of the FSS program can be made is offered**. Even at high level categories such as processing, transportation, or delivery there is no quantification or method for measurement. [FY 2009 ACD, p. 45 (emphasis added).]

4. Increasing the Coverage for Standard Flats by Increasing Prices — An Obvious Option Yet Elusive.

The FY 2010 ACR's discussion about the Postal Service's exigent rate proposal to eliminate deficits from underwater products contains the following statement:

> For [ ] four products – Outside County Periodicals, Within County Periodicals, Media Mail, and Standard Mail Flats – the Postal Service explained how the products could be brought to full cost coverage over **a lengthier period.** For example, the Postal Service presented a detailed **plan** for capturing efficiencies for **Standard Mail Flats** that, when **combined with consecutive above average price increases,** would result in full attributable cost coverage. [FY 2010 ACR, p. 8 (emphasis added).]

Consecutive above-average price increases, mentioned in passing, are an obvious way to increase coverage for an underwater product like Flats. PAEA gives the Postal Service significant flexibility and latitude when setting prices for market dominant products within profitable classes. What the ACR fails to mention, much less discuss, is that in every price adjustment it has noticed under PAEA, the Postal Service has used that new-found flexibility to keep each successive price adjustment for Standard Mail Flats **below the systemwide average**. There have been no "consecutive above average price increases."

Table II-5

Standard Mail and Flats Percentage Price Increase

Docket No.	Flats	Standard Mail
R2008-1	0.865%	2.838%
R2009-2	2.306%	3.781%
R2010-4 (rejected)	5.134%	5.616%
R2011-2 (pending)	0.835%	1.739%

In the exigent rate case the Postal Service proposed a price increase for Standard Flats that was below the systemwide average. When that case was filed, Flats had a coverage of only 82 percent. In order for revenues to cover attributable costs, a price increase of about 22 percent would have been needed. The proposed increase went barely one-fourth of the way toward eliminating this shortfall.

In the price adjustment filed January 13, 2011, the Postal Service has proposed a price increase for Flats (0.835 percent) that is only one-half of the CPI cap and the average increase for all Standard Mail (1.739 percent).[39] Even though the Postal Service is fiscally strapped, it is not clear that the Postal Service is serious about increasing the coverage of Flats — at least for now. *See* Docket No. R2011-2, United States Postal Service Notice of Market Dominant Price Adjustment, p. 16.

Considering the substantial amount of money that the Postal Service already has lost, and continues to lose by virtue of using money extracted from other mailers to subsidize Flats,

[39] A price increase of 22 percent is still needed to bring revenues from Flats up to attributable cost, and a coverage of 100 percent.

the discussion in this year's ACR is quite brief. The Postal Service offers no hope for price adjustments designed to comply with the objectives and factors in section 3622(b) and (c), nor does it offer a defense for continued underpricing of Flats and failure to comply with section 3622(b). The FY 2010 ACR merely states that:

> Table 2 shows that the Flats product has a cost coverage of **81.6 percent** in FY 2010. The Postal Service believes that **pricing** and **efficiency measures need to be taken to ensure that this product covers its costs and makes an appropriate contribution toward institutional costs.** [FY 2010 ACR, p. 31 (emphasis added).]

The FY 2010 ACR then concludes by turning the problem over to the Commission, with the statement that:

> it **seems impossible** for the Postal Service, acting with the powers granted to it and within the constraints imposed by title 39, to present any realistic plan that would result in these products fully covering their attributable costs, much less making any contributions to institutional costs. Therefore, it seems most appropriate for **the Commission** to determine whether it can exercise any of its **powers** to remedy the cost coverage shortfall of the products in question. [*Id.*, pp. 8-9 (emphasis added).]

Valpak urges the Commission to take up this challenge.

E. The Commission Is Duty-Bound to Act Decisively to Address the Problem of Underwater Products.

1. Underwater Products Violate the Policies of 39 U.S.C.

Underwater products are noncompliant with 39 U.S.C. section 101(d) (discussed in section A, *supra*), and the following objectives and factors of 39 U.S.C. section 3622:

(b)(1) "To maximize incentives to reduce costs and increase efficiency." Under no circumstance can deliberate below-cost pricing be viewed as maximizing incentives to reduce costs.

(b)(5)	"To assure adequate revenues, including retained earnings, to maintain financial stability." By definition, when any product is underwater, its revenues are inadequate, and all such products reduce any opportunity to retain earnings as well as undermine financial stability.
(b)(8)	"To establish and maintain a just and reasonable schedule for rates and classifications, however the objective under this paragraph shall not be construed to prohibit the Postal Service from making changes of unequal magnitude within, between, or among classes of mail." Postal reorganization under the PRA was intended to eliminate subsidization within and between classes of mail. The PAEA neither repealed that underlying constraint of the PRA, nor did it authorize extensive subsidization within and between products or classes of mail.
(c)(2)	"the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type." When any class of mail, or product or type of service such as Standard Mail Flats fails to cover attributable costs, it clearly is not compliant with this factor.
(c)(12)	"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." Any products that impose attributable costs in excess of the revenue which they provide cannot be construed as compliant with the need for the Postal Service to increase its efficiency and reduce its costs.

2. Underwater Products Harm the Postal Service and All Other Postal Products.

The inability of the Postal Service to stop the financial hemorrhaging from any underwater class or product should be a matter of concern not only to the Postal Service and the Commission, but to all mailers as well. Cumulative losses on underwater products have helped put the finances of the Postal Service in a significant hole, and continuation of those annual losses threaten to do even more serious damage.

It often is stated that, under PAEA, the rate cap protects other mailers from an increase in their rates on account of subsidies to underwater products. That does not mean, however, that the cumulative effect of recurring deficits from underwater products will not affect other mailers, perhaps severely so, in a variety of ways.

An operating deficit is an operating deficit, and the Postal Service has to find ways to pay its bills. Concurrently, the rate cap severely restricts increases in revenue, especially in an environment of little or no inflation. By way of illustration, the pending proposal in Docket No. N2010-1 to eliminate Saturday delivery to every residential address in the country is one such initiative. Its purpose is to help cover operating deficits that in no small way are attributable to underwater products such as Standard Flats. Elimination of Saturday delivery, if adopted, would affect every residential delivery point, and apply equally to all mailers and all products, not just underwater products. In view of these adverse effects for all mailers, substantial justification should be required for subsidization of any product.

3. Continued Large Losses on Underwater Products Need to Be Justified as Much as Expenditures on Other Investments.

The Postal Service appears to have viewed the continued subsidization of Standard Flats as an **investment** made to nurture a product that will become profitable for the Postal Service at some future time. *See*, *e.g.,* Docket No. R2010-4, Statement of James M. Kiefer, p. 29, ll. 21-23. Any continued subsidy then would be viewed as adding to prior "investment" (*i.e.*, cumulative prior subsidies). However, these losses can in no way be rationalized as an investment.

Whenever the Postal Service invests many millions of dollars in, say, automation equipment, it requires a detailed **Decision Analysis Report** ("DAR") — a good business practice. However, when the Postal Service elects to continue "investing" (*i.e.*, extensively subsidizing) an existing underwater product such as Flats to the tune of half a billion dollars a year, no such analysis is required — either by the Governors or by the Commission. To prepare and submit for approval a detailed document akin to a DAR, one would provide information such as:

- the cumulative subsidy to date (*i.e.*, prior losses);
- projected cumulative subsidy at the time the product is predicted to start producing profits for the Postal Service;
- estimated year when the product will become profitable;
- projected level of profitability after the product finally becomes profitable;
- time required to recoup the total investment (*i.e.*, the cumulative subsidy);
- the return on investment during the first five years after the date when the cumulative subsidy has been recouped; and
- all facts, factual analysis, and key assumptions underlying the analysis.

The Postal Service would never invest a half billion dollars without such a detailed plan, yet it is choosing to lose a half billion dollars of revenue based on subjective feelings and hopes. This is unacceptable business practice.

4. Under PAEA, Responsibility to Adjust Rates for Underwater Products Now Rests with the Commission.

In its FY 2009 ACD, the Commission ordered the Postal Service to implement a plan to remedy the problem of underwater products. FY 2009 ACD, pp. 75, 86-87. But, in Docket No. R2010-4, it rejected the Postal Service's exigent price request which was partly an effort to begin to move Periodicals closer to cost coverage. In light of the Commission's exigent request rejection, the Postal Service now concludes that, despite the most optimistic cost cutting in the future, Periodicals, Standard Mail Flats, and Parcels cannot achieve cost coverage under the rate cap.

> In other words, it **seems impossible** for the Postal Service, acting with powers granted to it and within the constraints imposed by title 39, to present any **realistic plan** that would result in these products fully covering their attributable costs, much less making any contributions to institutional **costs. Therefore, it seems most appropriate** for the Commission to determine whether it can exercise any of its **powers to remedy** the cost coverage shortfall of the products in question.... [I]t would be useful for the Commission to determine exactly what the contours of its powers are under title 39. [FY 2010 ACR, pp. 8-9 (emphasis added)]

The Postal Service has exhibited refreshing candor in its plight. It believes it is powerless under the law to abate the financial hemorrhage, and is asking the Commission to use its powers under PAEA.

The Commission's decision to reject the Postal Service's exigent rate increase is now subject to a petition for review in the U.S. Court of Appeals for the D.C. Circuit. In that case, the Commission has taken the position that specific pricing proposals are improper in the context of an exigent price request. It criticized the Postal Service for attempting to take advantage of the "'unique opportunity to take some steps toward increasing Periodicals revenue and improving cost coverage.'" Instead, the Commission stated, "the authority to raise prices due to either extraordinary or exceptional circumstances was not designed to provide a 'unique opportunity' to address problems that have persisted 'for years.'" Postal Service v. Postal Regulatory Commission, Brief for Respondent Postal Regulatory Commission, U.S.C.A. D.C. (No. 10-1343) (Jan. 14, 2011), p. 35. In other words, it is the Commission's position that the Postal Service is powerless to remedy the problem by pricing for underwater classes in an exigent price increase docket.

If the Commission's position is accurate and if the Postal Service cannot achieve cost coverage for Periodicals and Package Services through (i) cost cutting and (ii) cap-limited price increases, or as part of (iii) an exigent price adjustment, then the last available tool is for the Commission to do what is within its remedial powers under sections 3653 and 3662(c).

For the reasons set out above, Valpak urges that, in the pending FY2010 ACD, the Commission act now to take the following steps:

1. Standard Flats Product.

a. Find that the rates for the Standard Flats Product are not in compliance with PAEA, and

b. Direct the Postal Service to immediately increase prices for Standard Flats by **8.0 percent** — the amount which would move the product half-way to full coverage in this Docket — followed by another similar increase in the next round of pricing adjustments to get Standard Flats at least to full coverage.

2. Periodicals Class.

a. Find that the rates for Periodicals Class are not in compliance with PAEA, and

> b. Direct the Postal Service to immediately increases prices for Periodicals by **16.0 percent** — the amount which would move this class half-way to full coverage in this Docket — followed by another similar increase in the next round of pricing adjustments to get Periodicals at least to full coverage. To the extent possible, these price increases should be focused on the least profitable components of Periodicals.

Thereafter, the Commission can consider what further increases will be necessary to have this product and this class make a reasonable contribution to institutional costs.

The only other alternative would appear to be for the Commission to determine that Congress incorporated a fatal flaw into PAEA, and urge that Congress act immediately to correct such a grievous mistake.

III. THE POSTAL SERVICE MUST HAVE THE MANAGERIAL AUTHORITY TO CONTROL COSTS AND ENHANCE EFFICIENCY.

Postal Service management has made strenuous efforts to reduce costs in the face of declining mail volume (discussed in section I, *supra*). Much more cost cutting will be needed, though, (i) to restore the Postal Service to profitability by repaying the billions of dollars it has been forced to borrow in order to fund future costs of retiree health benefits, as well as (ii) to pay whatever amount Congress will require for this purpose in the future.

Like PRA before it, PAEA exhorts management to operate the Postal Service in a business-like manner, and toward that end it continued grants of managerial discretion to the Postal Service to control costs and operate efficiently. *See, e.g.,* 39 U.S.C. §§ 101, 401, 403, 404(a) and (b). Of course, a general grant of Postal Service managerial authority may be limited by Congress, but the Commission should not seek to create new limitations.

Many limitations now in the law were enacted at a time of relative economic plenty, when the postal monopoly could be relied upon to generate significant net income, and by earlier Congresses, which directed those monopoly profits to achieve political objectives. Times have changed. The Postal Service is evolving, and now must implement a new, much leaner business model. Toward that goal, the Commission should demonstrate to Congress and all mailing interests that it fully supports Postal Service efforts to remove impediments to cost reduction wherever feasible.

Such support would be particularly helpful with the House and Senate Appropriations Committees with respect to moving to 5-day delivery. It would difficult enough for the Postal Service to implement cost-cutting initiatives with support from the Commission, and Valpak urges the Commission to use its Annual Compliance Review to help remove, not insert, obstacles in the Postal Service's way as it seeks to regain a measure of financial stability.[40]

A. The Commission Should Support the Postal Service's Move Toward 5-day Delivery.

On March 30, 2010, the Postal Service filed a request for the Commission to issue an Advisory Opinion under 39 U.S.C. section 3641 to address the Postal Service's proposal to eliminate regular Saturday delivery. In response, the Commission convened Docket No.

---

[40] In Docket No. ACR2009, Valpak urged the Commission to "report to Congress about the urgent need of the Postal Service to have the flexibility, as needed, to move to 5-day delivery, to increase its efficiency, reduce its costs, increase revenues, and increase its free cash flow." Docket No. ACR2009, Valpak Initial Comments, p. 39 (Feb. 1, 2010). Thereafter, the Commission testified before the House Committee on Oversight and Government Reform opposing various Postal Service cost cutting proposals, characterizing them generally as proposals to "reduce service." *See* Testimony of Ruth Y. Goldway, Apr. 15, 2010, http://prc.gov/Docs/67/67687/Chairman's%20House%20Testimony%204%2015%2010_836.pdf

N2010-1. The Postal Service's request was demonstrably necessary to eliminate the substantial cost of Saturday delivery because it no longer can be justified in view of the decrease in mail volume over the past decade. Continuing volume decreases projected in the FY 2011 IFP and the Postal Service 2010 Annual Report reduce even further any necessity for Saturday delivery. Valpak participated in Docket No. N2010-1, filing both an Initial Brief[41] and Reply Brief[42] explaining why it believed that the record evidence in the docket overwhelming supported the Postal Service's proposal.

It had been thought that the Commission's Advisory Opinion would be issued in December 2010, but the docket remains open and the issue is still under consideration at the end of January 2011. The Postal Service estimates that 5-day delivery could save it over $3 billion per year. It now has been 10 months since the Postal Service filed its request, and until the Commission issues its Advisory Opinion, Congress has a reason to defer action.

Of course, even if the Commission were to issue an Advisory Opinion supporting 5-day delivery, it will be necessary for Congress to remove the appropriations rider which for nearly 30 years has required the Postal Service to maintain 6-day city and rural residential delivery service at the 1983 level. *See, e.g.*, Consolidated Appropriations Act, 2010, Pub. L. 111-117, 123 Stat. 3034, at 3200. Even if only to help fund the PSRHBF as required by PAEA, Congress needs to make a tough decision to permit the Postal Service management to adjust delivery service to match the decreasing volume and increasing number of delivery points.

---

41 http://prc.gov/Docs/70/70513/VP%20N2010-1%20Initial%20Brief.pdf

42 http://prc.gov/Docs/70/70607/VP%20N2010-1%20Reply%20Brief.pdf

With Congress yet to approve any appropriations bills for FY 2011, the federal government has been operating under a series of continuing resolutions. This gives the Commission an opportunity to give timely support to Postal Service efforts to overcome its fiscal problems (as discussed in section I, *supra*) by issuing an Advisory Opinion strongly supporting the Postal Service's proposal. That would provide Congress with helpful guidance so that implementation of the significant cost savings to the Postal Service might begin sometime in FY 2011. With every passing month the Postal Service is forced to incur the cost of Saturday delivery for yet another month. Even if the Commission were to issue a favorable Advisory Opinion there is no guarantee that Congress will act prudently, but at least the Commission will have discharged its responsibility under PAEA.

B. The Commission Should Not Entertain Appeals of the Closing of Stations and Branches because such Are Beyond Its Jurisdiction.

The Postal Service has both the authority and the responsibility to create and maintain post offices and other facilities as needed. 39 U.S.C. § 404(a)(3). The Postal Service also has the authority to close or consolidate post offices and other facilities, but closures of independent "post offices" with their own postmasters are subject to certain notice requirements and are subject to appeal to the Commission. 39 U.S.C. § 404(d). The ability to both open and close stations and branches are important managerial prerogatives of the Postal Service. Efforts to impede the Postal Service in these cost-cutting efforts are highly detrimental to Postal Service finances.

In Docket No. N2009-1, the Postal Service requested the Commission to determine whether its plan to consider closing certain stations and branches was a change that needed an

Advisory Opinion under section 3641, and if so, to issue an Advisory Opinion. Valpak questioned the jurisdiction of the Commission, filing an Initial Brief[43] and Reply Brief.[44] Nevertheless, the Commission did issue an Advisory Opinion, advising the Postal Service to follow similar procedures when closing stations and branches as used to close independent post offices. Advisory Opinion Concerning the Process for Evaluating Closing Stations and Branches (Mar. 10, 2010), pp. 61-65.[45]

The Commission has received several appeals under section 404(d) which relate not to closing of independent post offices, but to closure of stations and branches. Congress knew what a "post office" was when it used that term, and limited the Commission's authority to the closing of "post offices." Yet the Commission has refused to dismiss these purported appeals on the ground that certain members of the public did not know the difference between (i) an independent post office and (ii) a station or branch.[46] Deficiencies in the Commission's legal analysis were discussed at length by Valpak and the Association of Priority Mail Users, Inc. in a 2010 appeal docket. *See* Docket No. A2010-3, Answering Brief of Valpak Direct Marketing Systems, Inc., Valpak Dealers' Association, Inc., and Association of Priority Mail Users, Inc.

---

[43] http://www.prc.gov/Docs/65/65865/VP%20N2009-1%20Initial%20Brief.pdf

[44] http://www.prc.gov/Docs/66/66094/VP%20N2009-1%20Reply%20Brief.pdf

[45] http://www.prc.gov/Docs/67/67174/Advisory_Opinion_031010.pdf

[46] The Commission holds to the view that it has authority over the closing of stations and branches despite the clear language used by Congress — independent "post offices" only. *See* Order No. 477, Order Dismissing Appeal (Jun. 22, 2010) pp. 5-6, http://www.prc.gov/Docs/68/68568/Order_No_477.pdf.

(Apr. 19, 2010).[47] *See also* Docket No. A2010-3, Comments of United States Postal Service Regarding Jurisdiction Under (Current) Section 404(d) (Apr. 19, 2010)[48] and Docket No. A2011-5, Comments of United States Postal Service (Jan. 31, 2011) ("Congress has been presented with numerous bills that would expand the meaning of the term 'Post Office' to include subordinate stations and branches, but it has declined these opportunities to alter the original meaning of the term 'Post Office.'" P. 2.).[49]

At the January 11, 2011 Public Forum on possible changes to PAEA (in the context of PAEA section 701's five-year review), Chairman Goldway offered opening remarks that included the following statement:

> We have also identified several problems, **areas of confusion** and/or unanticipated **conflicts that may or may not require legislation action**. Among these are whether the term **Post Office** in law where PO closing appeals are cited refers to its simple language meaning or the administrative designations of the USPS.[50]

It is submitted that PAEA is completely clear on the point, and therefore this is an area that does "not require legislative action." Valpak strongly recommends that the Commission withdraw its assertion of jurisdiction over the closing of stations and branches unless Congress amends 39 U.S.C. section 404(d).

---

[47] http://prc.gov/Docs/67/67733/VP-APMU%20Answering%20Brief.pdf.

[48] http://www.prc.gov/Docs/67/67732/Comments_USPS.pdf.

[49] http://www.prc.gov/Docs/71/71727/A2011-5%20Comments.pdf.

[50] http://www.prc.gov/prc-docs/home/whatsnew/Chairman%27%20remarks%20at%20Public%20Forum_1586.pdf (emphasis added).

Fortunately, Postmaster General Donahoe recently announced that the Postal Service will begin the process of closing 2,000 postal facilities, starting in March 2011. *See* "Postal Service Eyes Closing Thousands of Post Offices," Jan. 24, 2011, *Wall Street Journal*.[51] The Commission will have enough to do without taking on appeals of hundreds of stations and branches not expressly authorized by Congress. Such closures, and the costs savings which they enable, are an essential part of any leaner business model for the Postal Service.

IV. DESPITE IMPROVEMENTS IN STANDARD MAIL COSTING, SOME ANOMALIES PERSIST.

In its comments in prior ACRs, Valpak has addressed costing issues in Standard Mail, including problems with cost presentations on detached address labels ("DALs") (*see* section II.C, *infra*). *See* Docket No. ACR2007, Valpak Initial Comments, pp. 27-40; Docket No. ACR2008, Valpak Initial Comments, pp. 25-40; and Docket No. ACR2009, Valpak Initial Comments, pp. 39-44. Valpak believes that accurate costing is the foundation for rational pricing, and appreciates continued support for accurate costing by the Commission, as well as progress made by the Postal Service.

A. Some Improvements Have Been Made in Standard Mail Costing.

In this year's ACR, the Postal Service reviews changes in analytic principles that affected its costing system during FY 2010. Of 14 proposed changes, only one (proposal seven) focused on costing problems in Standard Mail. FY 2010 ACR, p. 5. That proposal,

---

[51] http://online.wsj.com/article/SB10001424052748704881304576094000352599050.html

addressing mail processing costs for Standard Parcels and NFMs, could be considered a partial response to the following comments by the Commission in its FY 2009 ACD:

> Carrier Route, High Density and Saturation Letters, and High Density and Saturation Flats/Parcels unit **mail processing** and unit **delivery costs** are **anomalous** and the Postal Service should review and improve its costing analysis for these products. [FY 2009 ACD, p. 82 (emphasis added).]

B. An Explanation Is Needed for Certain Standard Mail Costs.

In its discussion of Standard Mail cost differences between rate categories in the last ACD, the Commission also identified certain anomalous costs:

> Two worksharing categories are problematic. The **passthroughs for Saturation Letters and High Density Parcels are negative.** The Postal Service believes that "[b]oth of these have **anomalous estimated cost differences,** where the category with the higher address density has a higher unit cost than the category with the lower address density." 2009 ACR at 69. Because the costs are anomalous, the Commission cannot determine whether the discounts are consistent with section 3622(e).
>
> Since the 2007 ACD, the Commission has urged the Postal Service to **identify the source of these anomalies**. The Postal Service has not yet reported any progress towards that end. Although the issues in Docket No. RM2009-3 have not yet been resolved, the Postal Service should work towards developing **better cost data** for the former ECR products both to permit the calculation of passthroughs as required by 39 U.S.C. 3622(e) and to **gain a better understanding of the underlying costs associated with these products.** [FY 2009 ACD, pp. 88-90 (emphasis added).]

In FY 2010, the anomalous cost difference between Saturation and High Density letters worsened. Unit delivery cost for Saturation letters increased by 5 percent, while unit delivery cost for High Density letters declined by 6 percent. *See* USPS-FY09-19 and USPSFY10-19, File UDCmodel, Tab Table 1. The unit delivery cost difference increased from less than 0.2

cents to slightly more than 0.6 cents. Any negative cost difference for letters with higher density is not only anomalous, it also raises issues concerning accuracy of the Postal Service's costing system. The Postal Service needs to explain this cost difference and its persistence in the costing system.

It is true that, in Docket No. RM2009-3, the Commission determined that the cost difference between Saturation letters and High Density letters does not reflect worksharing. *See* Order No. 536, pp. 59-61. But the fact that the unit cost of Saturation letters continues to be higher than the unit cost of High Density letters is still problematical. Saturation letters obviously have greater density than High Density letters. When both are delivery point sequenced ("DPS'd"), they arrive at carrier units in trays already presorted. The unit cost for DPSing, as well as delivery, should be approximately equal. And when not DPS'd, the higher density of Saturation letters means they either (i) are taken directly to the street as an extra bundle — which incurs virtually no in-office costs (similar to Saturation Flats) and is an option not applicable to High Density letters — or (ii) are cased faster and at lower unit cost.

Additionally, a new problem this year is the sudden unexplained surge in the delivery cost of Carrier Route letters, to 17.758 cents. *See* USPS FY-10-19, File UDCmodel10, Tab Table 1, Cell column 3, row 74. The unit cost of delivering a Carrier Route letter is **up 133 percent** from last year's cost (7.611 cents), with no explanation provided. Carrier Route letters, which are presorted to line of travel, in FY 2010 reportedly cost 64 percent more to deliver than Carrier Route flats (10.817 cents in column 7, row 74), and almost 500 percent more than High Density letters (3.658 cents in column 3, row 75). Within Carrier Route mail, letters constitute only 2 percent of total volume, and that relatively small size may create a sampling problem. The Commission should ask the Postal Service to explain in the ACR any unit cost that, on a year-to-year basis, fluctuates substantially. Problems arising from small sample size need to be highlighted because they are pertinent to any proposal to decrease the size of In-Office Cost System ("IOCS") sampling frames.

C. The Postal Service Continues to Lose Significant Sums on DALs.

In FY 2010, the volume of DALs decreased significantly. FY 2010 billing determinants (USPS-FY10-4) recorded 762 million DALs, which is 15 percent below the 902 million DALs recorded in the FY 2009 billing determinants. City and rural carrier cost systems counted 672 million Saturation DALs, plus another 73 million High Density DALs, and 17 million Carrier Route DALs. USPS-FY10-19, UDCInputs10, Tabs CCSDALs and RCSDALs. Those counts now are consistent with the billing determinants, and are a considerable improvement over prior years when they did not reconcile fully.

In FY 2010, the surcharge for using optional DALs remained unchanged at 1.7 cents, and resulted in revenue of $12.85 million according to the billing determinants. Revenue from the surcharge applicable to DALs is estimated to have covered somewhat less than one-half of their actual mail processing and delivery cost — *i.e.*, DALs had an attributable mail processing and delivery cost (including piggybacks) somewhere in the neighborhood of $30 to $32 million.[52] In general, whenever the volume of a money-losing product declines, the Postal Service's bottom line can be expected to improve because costs should decline more than revenues. (This is especially true when the attributable cost of an item is more than twice its

---

[52] For DALs, neither the cost nor the passthrough of cost into price is readily available, hence both must be estimated.

revenue.) In this particular instance, Saturation host pieces are quite profitable for the Postal Service, but whenever mailers elect to use optional DALs they diminish that profitability.[53]

V. PRICING AND COST COVERAGE ON HIGH DENSITY/SATURATION MAIL REMAIN TOO HIGH.

A. High Density/Saturation Mail Continues to Exhibit High Elasticity.

The most recent estimates of elasticity for all market dominant products are set out in Table V-1.[54] The former Standard ECR subclass, which includes three Standard products (High Density/Saturation Letters, High Density/Saturation Flats, and Carrier Route), had a measured elasticity of **0.727** (row 7). Of all computed elasticities, the former ECR subclass continues to be in the highest group. High elasticities were estimated for only three other products: First-Class Presort Cards, Bound Printed Matter, and Media/Library Mail.

---

[53] The recent decision to allow simplified addressing of Saturation Flats on city routes (*see* Postal Bulletin PB22300, Dec. 16, 2010, p. 46), starting this year, could lead to a reduction in the volume of DALs.

[54] *See* Demand Analysis submitted to the Commission on Jan. 20, 2011 in accordance with Commission Rule 3050.26, Folder: Market Dominant; File Demand Equation Tables, pp. 1-14. In certain instances elasticities are estimated only for former subclasses, or groups of products — *e.g.*, Standard Regular Mail or Standard ECR — not for individual products within Standard Mail.

Table V-1

Elasticity of Market Dominant Products
(Absolute value)

1.	First-Class Single-piece letters	0.182
2.	First-Class Presort letters	0.346
3.	First-Class Single-piece cards	0.249
4.	First-Class Presort cards	1.397
5.	Periodicals	0.133
6.	Standard Regular Mail	0.286
7.	**Standard ECR Mail**	**0.727**
8.	Standard Nonprofit Mail	0.177
9.	Standard Nonprofit ECR	0.513
10.	Parcel Post	0.389
11.	Bound Printed Matter	0.719
12.	Media/Library Mail	0.847

B. Within Standard Mail, Coverages and Elasticities Exhibit a Perverse, Inverse Relationship.

Table V-2 shows coverages of Standard Mail products alongside their subclass elasticity. Examination of Table V-2 shows that of six commercial products within Standard Mail, revenues from two products did not cover their attributable cost — Flats and NFMs/Parcels were substantially underwater. In FY 2010, the underwater portion of the attributable costs of these two products had to be subsidized from operating profits earned on other products. As discussed in section II, *supra*, pricing of those two products obviously came nowhere close to complying with PAEA. For Standard Mail Flats, a price increase of 22 percent would have been needed during FY 2010 in order for that product to have covered its attributable costs.

Table V-2

Standard Mail
Product Cost Coverages and
Elasticities by Former Subclass

Product	Cost Coverage	Commercial Elasticity
High Density/Saturation Letters	211.4%	0.727
High Density/Saturation Flats/Parcels	223.8%	0.727
Carrier Route	142.5%	0.727
Regular Letters	180.3%	0.286
Regular Flats	81.6%	0.286
Regular NFMs/Parcels	77.2%	0.286
Standard Class Weighted Average	146.6%	

Source: Coverages from USPS-FY10-1; Elasticities from Table V-1.

The two products with coverages **under 100 percent** stand in stark contrast to the two High Density/Saturation products, with cost coverages **exceeding 200 percent.**[55] Such high coverage on the two products helped the Postal Service offset the continuing losses on Standard Flats and NFMs/Parcels. If this were not bad enough, it is counter-intuitive, but true, that within Standard Mail, the two products with the **highest elasticity** have the **highest coverage**, and the two products with the **lowest elasticity** have the **lowest coverage.**[56] With pricing

---

[55] Computation of coverages shown in Table V-2 includes revenues and costs of the respective nonprofit counterparts. Nonprofit ECR letters and ECR flats comprise, respectively, 12.7 percent and 4.4 percent of all ECR letters and flats. Cost coverage of the commercial products alone is understated, since nonprofit mail is heavily discounted pursuant to section 3626.

[56] The Commission noted "the chronic underpricing of Standard Mail Flats" in its FY 2009 ACD, p. 31.

relationships like this, it is a wonder that Postal Service finances are not in worse financial disarray. Deliberately pricing products substantially below attributable cost, pricing inelastic products favorably, and pricing elastic products unfavorably, raises serious questions as to Postal Service pricing.

C. Underwater Products Substantially Reduce Standard Mail's Contribution to Institutional Costs.

The FY 2010 contribution from each Standard Mail product is shown in Table V-3. In FY 2010, the total contribution from Standard Mail was $5.4 billion, providing 25.1 percent of the contribution from all market dominant mail.[57] Contribution from the four profitable products was $6.2 billion. (That figure could be viewed as reflecting Standard Mail's potential contribution.) However, losses incurred on the two underwater products, $0.8 billion, materially detracted from that potential. If the Postal Service had eliminated all losses on Flats and NFMs/Parcels, the contribution from all Standard Mail would have increased by $0.8 billion, increasing Standard Mail's share of total contribution by market dominant products from 25.1 to 28.6 percent. Alternatively, if the Postal Service can live with a contribution from Standard Mail of only $5,412.7 million, by eliminating all losses on the two underwater products, it could give the other four Standard Mail products a 12 percent across-the-board price decrease.

[57] Pursuant to 39 C.F.R. section 3015.7(c), the contribution from Competitive Products must be at least 5.5 percent of total institutional costs. In FY 2010, it was 7.12 percent. *See* USPS-FY10-39.

Table V-3

Contribution from Standard Mail Products

	Product Dist. ($, millions)	Contribution Share
High Density/Saturation Letters	388.4	
High Density/Saturation Flats	1,022.4	
Carrier Route	663.1	
Regular Letters	4,098.6	
Subtotal, profitable Standard products	6,172.5	100.0%
Regular Flats	(582.0)	
Regular NFMs/Parcels	(177.8)	
Subtotal, underwater Standard products	(759.8)	(12.3%)
TOTAL, All Standard Mail	5,412.7	87.7%

Source: USPS-FY10-1.

D. Cost Coverages Are Far From Optimal, and Deferral of Appropriate Price Increases Has Done Nothing to Rectify the Imbalance.

Regardless of whether viewed in terms of (i) profitability of the Postal Service, (ii) value of service, (iii) economic efficiency, or (iv) basic notions of fairness, one cannot help but conclude that, within Standard Mail, those categories with relatively-elastic demand should have significantly lower cost coverages.[58] The existing situation is far from optimal. In fact, it is upside down. Just to comply minimally with PAEA and basic notions of fairness among mailers, prices of Flats and NFMs/Parcels should be increased by an amount sufficient to at

[58] Notions of fairness are subjective, to be sure. Nevertheless, mailers of Standard Mail Regular letters may wonder why they should pay a markup of 80 percent while mailers of Standard Mail Flats are being subsidized to the tune of over 18 percent. They legitimately can ask what makes Flats so much more "worthy."

least cover their respective attributable cost and make some contribution to institutional costs, even if some volume is lost, while coverage of High Density/Saturation products should be decreased to avoid volume losses and perhaps attract additional volume to the Postal Service.

Mailers of underwater products, especially those that are heavily subsidized, argue recurringly that movement toward optimal positions should occur in small steps instead of large ones, so as to reduce negative effects on subsidized mailers and help maintain stability (no doubt only incidentally continuing as much subsidy as possible, for as long a period as possible). For those products that today are severely underwater, however, small steps have not increased coverage. Quite the contrary. They have led to diminution of coverage, movement away from an optimal position, and continued noncompliance with Title 39. Consequently, despite any perceived undesirability, large steps are now necessary, even vital, to financial health of the Postal Service.[59] We can identify no postal policy considerations in Title 39 of the U.S. Code that justify prolonged continuation of the current pricing relationships in Standard Mail.[60]

---

[59] Valpak strongly favors restraining price increases — and even instituting price reductions — based on cost reductions to the maximum feasible extent. However, when that is not possible, Postal Service pricing officials need to face up to reality and ensure each product covers its attributable costs.

[60] 39 U.S.C. section 3622(b)(4) provides that "pricing flexibility" be accorded the Postal Service. But it would be strange indeed to give this section weight in the context of a compliance review. The ACD is designed to assess Postal Service compliance with the provisions and policies of 39 U.S.C. Would Congress really want the Commission to exempt noncompliant pricing decisions by the Postal Service because doing otherwise would reduce its flexibility? If so, what protection does PAEA afford mailers who are innocent victims of such noncompliant pricing decisions?

In the exigent rate case, the Postal Service sought a **23.3 percent** increase for NFMs/Parcels. Then, in Docket No. MC2010-36, it subsequently filed to transfer NFMs/Parcels to the competitive products list, an action which would necessitate immediately raising prices to a level sufficient to cover attributable costs. To prepare for that move, in the currently pending price adjustment docket, the Postal Service proposes an increase of **11.346 percent**.

Postal Service pricing of Flats stands in stark contrast to NFMs/Parcels. In the exigent rate case, the Postal Service moderated its proposed rate adjustment to a **5.1 percent** increase so as to be below the systemwide average increase of 5.6 percent.[61] While a 5.1 percent increase was deemed acceptable in the context of an exigent rate increase on January 2, 2011, the Postal Service now believes that the increase can only be **0.835 percent** on April 17, 2011. Even the Postal Service should concede that Standard Flats could be increased by a minimum of 5.1 percent. Valpak believes these rates should be increased by the same level proposed for NFMs/Parcels — about **11 percent**, or about half of the increase necessary to stop the financial hemorrhage from Standard Flats. *See* Section II, *supra*.

---

[61] The Postal Service also moderated the rate adjustment on Flats in every prior rate adjustment under PAEA, and the predictable result has been an almost relentless decline in coverage. At that time, the principal justification offered, from a perspective of the Postal Service's own finances, was that "Over the long run the Postal Service sees the catalog industry as a growth segment in its business." Docket No. R2010-4, Statement of James M. Kiefer, p. 29, ll. 21-23. The "long run" is a totally undefined term. Also, this statement focuses narrowly on volume growth, with no hint of profitability any time in the foreseeable future.

VI. REPORTING ON SERVICE PERFORMANCE NEEDS IMPROVEMENT.

A. PAEA Requires Detailed Reporting on Service Performance.

PAEA charges the Commission with examining the Postal Service's performance in terms of (1) **speed of delivery** and (2) **reliability** for all market dominant products.[62] These two performance standards are separate and distinct. The Commission's final rules for service performance measurement reporting establish statistical measures for each type of reporting.[63]

Succinctly, a measure of, or proxy for, **speed of delivery** is on-time performance against an established service standard. **Reliability,** on the other hand, pertains chiefly to that portion of the mail which fails to meet the established performance standard, *i.e.*, the tail-of-the-mail. For each mail product, reliability is to be assessed by variance reports showing the percentage of mail delivered one, two and three days beyond the established service standard, *i.e.*, delivered late.[64]

According to the Postal Service's 2010 Comprehensive Statement on Postal Operations, improved service performance is a strategic goal of the Postal Service.[65] Although that goal

---

[62] PAEA requires that the Annual Compliance Report "shall, for each market-dominant product provided in such year, provide — … (B) measures of the quality of service afforded by the Postal Service in connection with such product, including — (i) the level of service (described in terms of speed of delivery and reliability) provided…." 39 U.S.C. § 3652(a)(2)(B)(i).

[63] PRC Order No. 465, Order Establishing Final Rules Concerning Periodic Reporting of Service Performance Measurements and Customer Satisfaction, Docket No. RM2009-11, May 25, 2010.

[64] If all mail were delivered by the established service standard, separate statistics for reliability would be unnecessary.

[65] 2010 Comprehensive Statement on Postal Operations: 2010 Performance Report and 2011 Performance Plan, http://www.usps.com/strategicplanning/cs10/CSPO__12

applies to all classes of mail, the Comprehensive Statement focuses exclusively on single-piece First-Class Mail.

B. The FY 2010 Annual Compliance Report Provides Minimal Information on Service Performance.

The narrative in this year's ACR continues to provide little discussion of service performance. The overview of "Contents" in section I of the ACR describes four distinct **major** categories of items that are included in the appended material:[66]

- Costing material for domestic products;
- Costing material for international products;
- Intra-product cost analyses; and
- Billing determinants for domestic and international mail.

From this description, service performance measurement, including the extensive body of data pertinent thereto, seems to be a minor issue, at best. Valpak would expect that to change as size and substance of the service report expand in conformance with Order No. 465.

Section II of the ACR contains a brief discussion on Service Performance:

> The Postal Service set for itself aggressive on-time targets of 90 percent or above for all market dominant products. Overall, **the Postal Service has been successful in continuously improving these scores….** These targets are intended to guide longer-term improvement and are based on the evolution of Intelligent Mail barcode systems and on customers' participation in data collection that enables performance measurement at the necessary levels. The specific reasons why national scores have not been met are discussed in USPS-FY10-29. [FY 2010 ACR, p. 12, (emphasis added).]

_2010.pdf, pp. 2-3. For First-Class Single-Piece Mail, that report shows actual on-time performance for FY 2008-2010, as well as the established target, or plan, for FY 2010 and FY 2011.

[66] FY 2010 ACR, pp. 2-3.

The library reference on performance (USPS-FY10-29) consists of two documents, and five spreadsheets containing data for First-Class Mail, Standard Mail, Periodicals, Package Services, and Special Services.

The first document provides a brief, one-page overview on USPS-FY10-29. The second document (29 pages) uses the following 8-part format to discuss the data in each of the five spreadsheets:

a. Measurement Description (*i.e.*, sources of data for each product);

b. Results;

c. System/Sample Coverage;

d. Statistical Validity of Measurement Results;

e. Descriptions and Justifications of Proxies;

f. Exceptions;

g. Changes in the Reported Fiscal Year; and

h. Reasons for Service Targets Not Being Met and Mitigation Plans.

Service performance measurement is still in the developmental stage for every class of mail. The second document describes the data that were used in FY 2010 to measure performance in each class of mail, as well as the inclusiveness — or exclusiveness — of mail included in this year's data collection effort. Some key limitations mentioned by the Postal Service are[67]:

- During the first three quarters of FY 2010, for many products, data collection was limited to a group of cooperating mailers using the Intelligent Mail barcode

[67] *See* USPS-FY10-29 for a more detailed discussion.

(IMb) in a pilot test. For the products so tested, the number of mailers and mailing locations was limited.

- In the fourth quarter of FY 2010, data collection was expanded to include other mailers using the Full Service Intelligent Mail system for performance measurement. That increased the number of mailers and mailing locations, but they were still limited and not representative of the broader universe.

- A number of gaps still exist, especially for flats (both Standard and Saturation flats).

On-time performance for each major class of mail is shown in four separate spreadsheets containing both quarterly and annual aggregate data. Those spreadsheets provide data only for FY 2010, even when comparable data for prior years are readily available for certain products (*e.g.*, single-piece First-Class Mail and Parcel Post). Omission of data for prior years means that service data provided in the ACR cannot verify or support any claim such as "the Postal Service has been successful in continuously improving these scores." Such claims can be evaluated only by research and reliance on data not included in the ACR. The Postal Service needs to expand its data presentation or omit statements that cannot be verified or supported by the data presentation in the ACR.

Presentation of the aggregate data commendably shows actual on-time performance, as well as the established target, which is 90 percent for every market dominant class except First-Class, which has higher targets. This presentation format facilitates comparison of actual versus target on-time performance, which is salutary.

Reliability is not even mentioned, much less discussed, in this year's presentation. No data are provided on tail-of-the-mail for any product or class of mail, even where such data should be readily available, *e.g.*, single-piece First-Class Mail (EXFC data have been collected for many years), or Parcel Post (Delivery Confirmation was in place throughout 2010). An equally glaring omission, if not more so, is the lack of any established **targets for reliability.** Such targets do not rely on actual performance or data availability. They can and should be established independent of any problems associated with actual data collection.[68]

In terms of the standard adopted in Order No. 465 for variance reporting, the Postal Service needs to establish a target for the cumulative percentage of mail to be delivered within one, two, and three days of the established delivery standard (*see* Table VI-2, *infra*). Since the on-time target for each class of mail is 90 percent, the targets for delivery one, two, and three days late presumably would be higher. In order for the Commission to be able to fulfill its statutory responsibility to assess performance in terms of reliability, Valpak would suggest that the Commission request that the Postal Service explicitly address reliability and the tail-of-the-mail in the section "Reasons for Service Targets Not Being Met and Mitigation Plans."

C. Service Performance for Standard Mail.

For Standard Mail letters and non-Saturation flats, the Postal Service's service performance measurement system uses documented arrival time at a designated postal facility to start the clock. All pieces with an Intelligent Mail barcode are scanned when they go through automated processing (*e.g.*, delivery point sequencing). Stop-the-clock occurs when pieces are scanned by external, third-party reporters (anonymous households and small businesses) who report delivery information directly to the contractor. The service measure

---

[68] In the absence of any reliability target established by the Postal Service, the Commission would have to improvise its own standard when assessing and reporting to Congress on reliability.

for eligible Standard Mail thus consists of two parts: (i) how long mail pieces take to get through processing, and (ii) how long mail takes from the final processing scan to delivery.

Mailpiece tracking from IMb in-process scans is used in conjunction with the external data from reporters to extrapolate results for the entire volume of Full Service Intelligent Standard Mail — *i.e.*, results are considered to be representative for that portion of Standard Mail that uses the IMb with the Full Service option.[69] The second portion is used as a delivery factor differential to determine the percentage of all Standard Mail delivered on the last processing date versus the percentage delivered after the last processing date. Service performance is measured by comparing the transit time to the service standard to determine the percentage of mail delivered on time.[70]

For all shapes combined, such on-time performance data as are available for Standard Mail in FY 2010 are reported separately in USPS-FY10-29 for (i) mail entered at destinating facilities, and (ii) mail that requires end-to-end handling. On-time performance data reported for Standard Mail for FY 2010 are **not** broken down by shape.[71] That means, of course, that no information is available by product within each shape (*e.g.*, Saturation letters vs. Standard

[69] The extent to which performance results may be extrapolated to the remaining portion of Standard Mail is not clear, nor is it discussed by the Postal Service.

[70] The spreadsheet for Standard Mail indicates that the FY 2010 volume of destination entry pieces in the data base was 3,065,951,540, and the volume of end-to-end pieces was 40,415,857. The Postal Service does not indicate how many or what portion of the pieces in either category were subjected to a final stop-the-clock scan by an external third-party reporter. The relatively small volume of end-to-end pieces may reflect that Standard Mail with the Full Service IMb option was submitted chiefly by larger mailers who availed themselves of destination entry.

[71] *See generally* Docket No. RM2011-1.

letters). Hopefully, sometime during FY 2011 the Postal Service performance measurement system will be able to distinguish between, and begin to provide separate data for, letters and flats.

The Postal Service correctly notes that Order No. 465, including the reporting format prescribed therein, was not issued until late in FY 2010 (May 25, 2010). However, FY 2011, which began on October 1, 2010, marked the 3-year, 9-month anniversary of enactment of PAEA and the mandate for the extant performance measurement effort. Service performance measurement has been under development for a long time. It would seem reasonable to have expected that a larger and more robust data base would have been available for the FY 2010 ACR.

Valpak also had hopes that service performance measurement results reported in next year's ACR would be a giant step forward, reflecting inclusion of far more data from many more mailers. That hope now has been dashed by the Postal Service's decision to continue offering automation prices for mail with POSTNET barcodes indefinitely beyond May 2011, coupled with no increased incentives for (i) adopting the IMb code, and (ii) participating in the Full Service option.[72] The Postal Service announcement stated that "[t]he POSTNET code was to sunset this May to enable broad adoption and use of the IMb."[73] Removal of the sunset provision predictably means that mailers not already participating will defer adoption of the

---

[72] Participation in the Full Service option is critical to performance measurement, as the IMb alone does not provide adequate information.

[73] USPS.com/news, Release No. 11-004 (Jan. 13, 2011).

IMb indefinitely, or for as long as possible. Failure to switch from POSTNET to the IMb, of course, precludes the Full Service option.

Previously planned expansion of the performance measurement system likely will come to a grinding halt without appropriate incentives to overcome mailer inertia. Because continued use of the POSTNET code does not involve any surcharge, Valpak suggests that, as soon as possible, and preferably this year, **the $0.001 discount for adoption of the IMb should at least be doubled**. In addition, a **further discount** should be offered to all mailers who use the **Full Service** option. In the absence of incentives adequate to induce a mailer response sufficient to produce statistically reliable results, the Commission will not be able to carry out its mandate to monitor and report on service performance. At this juncture, such an outcome is highly undesirable. It could necessitate the Postal Service implementing other, more expensive, ways to measure service performance.

VII. DIFFICULTIES CREATED BY THE TIMING OF ANNUAL COMPLIANCE REVIEW AND PRICING CHANGES PERSIST.

PAEA requires the Postal Service's annual compliance report to be filed 90 days after the end of the fiscal year, or at the end of December of each year, and limits the period of the Commission's review to 90 days, or by the end of March of the following year. *See* 39 U.S.C. §§ 3652 and 3653.

Rule 3010.7 requires the Postal Service to "file with the Commission a Schedule for Regular and Predictable Rate Changes" designed to "provide mailers with estimated implementation dates for future Type 1-A rate changes for each separate class of mail…." An initial schedule had been filed on February 22, 2008. Recently, on January 13, 2011, the same day that the Postal Service filed its "Notice of Market-Dominant Price Adjustment" in Docket No. R2011-2, the Postal Service filed an "Updated Schedule of Regular and Predictable Price Changes." This schedule provides that the Postal Service "expects to implement price changes for all of the market-dominant classes on April 17, 2011 [and] to implement price changes for all of the market-dominant products in mid-April of each subsequent year."[74] This represents a change from past practices when price changes for market dominant products occurred each May (May 14, 2007; May 12, 2008, May 11, 2009).[75]

Advancing the date of pricing changes makes the work of the Commission, and mailers and mailer associations seeking to provide input to the Commission, more challenging, as the period of review of noticed rates overlaps with the period of review of the annual compliance report. However, as explained below, there is no change in two problems that existed under the previous May price change regimen.

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

---

[74] The schedule for price increases for competitive products is unchanged by this update.

[75] http://www.prc.gov/docs/63/63552/RateHist0709.xls.

operating costs." Evaluating compliance with this objective using data from two or more rate regimes during the prior fiscal years presents a recurring problem.

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

Valpak has commented on these problems before, and recommended that the Postal Service use its flexibility for implementation of price changes in the fall, so that they could take advantage of Commission input through the ACR process. Valpak had been hopeful that a more rational schedule might be adopted,[76] but these recommendations appear to have been overtaken by a series of events, including the Commission's rejection of the Postal Service's exigent rate case (which had been proposed to take effect on January 2, 2011), and the financial crisis of the Postal Service. Should Postal Service finances ever normalize, Valpak will revisit this recommendation.

CONCLUSION

As detailed in these comments, the Postal Service has demonstrated exemplary abilities to cut costs to adjust to new volume realities. It is encouraging that these cost-cutting efforts are now being expanded to include stations and branches. They should be expanded to finding ways to reduce the non-volume variable portion of city carrier costs.

---

[76] *See* Valpak Reply Comments, Docket No. R2010-4, pp. 36-38 (Sept. 2, 2010), http://www.prc.gov/Docs/70/70092/VP%20R2010-4%20Reply%20Comments%20final.pdf.

However, the Postal Service has proven unable or unwilling to use its new pricing authorities to price underwater products within profitable classes so as to avoid massive financial hemorrhaging. This will require the Commission to order the Postal Service to adjust prices for Standard Flats, Periodicals, and perhaps other underwater products so that in a relatively short period of time the Postal Service could avoid most of the $1.75 billion in such losses the Postal Service incurred in FY 2010.

However, in most other ways, the future of the Postal Service is more in the hands of others. The Postal Service needs the Commission to issue an Advisory Opinion in Docket No. N2010-1 which lays the groundwork for Congress to allow the Postal Service to move to 5-day delivery, which could save over $3.0 billion per year. And beyond that, the Postal Service needs help in dealing with a Congress that has required it to spend billions of dollars inefficiently while criticizing the Postal Service for losing money

Despite the financial difficulties the Postal Service faces, its goal should be to enter a new pricing paradigm that may be essential for the next several years — a period of **price stability for all profitable products** — year after year, through good times and bad. This is a remarkable, but attainable, goal.

Respectfully submitted,

William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.