

mailings) are high enough to cover associated costs.¹ In the instant proceeding, however, little information about the relation of revenues to costs is available. The revenue likely to be realized under the new rates is not estimated. Neither is a corresponding cost estimated.

The only reference point available on costs is that for FY 2010, a 12-month period that began over 2 years ago, on October 1, 2009. In previous comments, ACMA raised numerous questions about the validity of those costs. It also asked whether it is reasonable to allow low Nonprofit revenues to dilute the unit revenues of the Commercial category, and then to use the diluted revenues to evaluate the level of the Commercial rates. These questions have not been addressed, and are included here by reference.² Also, it is well known that, in unusual degree, the Postal Service has been, and is, reducing costs and tightening operations.³ And since excess capacity is widely thought to exist, in the area of flats processing especially, it is reasonable to believe that the costs for flats, as currently developed, have been reduced more than other costs. Any finding based on the 2010 costs, then, would not be indicative of current relationships.

¹ See: Fiscal Year 2010 Annual Compliance Determination (ACD), March 29, 2011, espc. pp. 5-6, directing the Postal Service to “eliminate” the result of revenues being below reported costs.

² See: ACMA comments and reply comments in Dockets No. ACR2010 and R2010-4, and comments in Docket No. R2011-2.

³ See: FY2010 ACD, pp. 24-25, pointing to significant cost reductions and a 10-year plan “to increase revenues and control costs.” Also, p. 37 refers to the Postal Service cutting “75.1 million workhours” in FY 2010, implying that the cost levels at the end of FY 2010 were significantly lower than the cost levels at its beginning. Therefore, comparing the revenues for the year to the costs for the year does not relate to the revenue/cost ratio at the end of the year, much less now. That is, if costs are declining during the year, the costs at the end of the year will be below the average for the year.

Also: The Postal Service submitted in Docket No. R2010-4 a Flats Strategy (July 6, 2010). It points to a strong focus on flats costs throughout the organization.

For Standard Flats, the Postal Service has proposed a rate increase of 2.209 percent, higher than the price cap of 2.133 percent. ACMA accepts this proposal as a reasoned response to past concerns, despite questions that still exist. In fact, we might have expected the increase amounts applied to Carrier Route and Standard Flats to have been reversed, and we wonder why Carrier Route received a higher increase percent. Additional comment on costing difficulties is provided in the following sections.

1. Costing Requires a Stable System Behavior. If changes, including changes in rates, *are not* contemplated, cost information is not needed. The future will roll out in the same way, with or without cost estimates. If changes *are* being contemplated (or if decisions of almost any kind are to be made), cost information may be needed. What is important is that the costs need to be relevant to the decision being considered. Otherwise, the decision has little chance of being a good one.⁴

For rate purposes, holding it axiomatic that decisions on rates should be made in view of the likely *effects* of those decisions, economists are of one accord that costing should be based on small-volume-change incremental costs, which are approximated by first-derivative-type marginal costs. That is, one of the effects of a lower rate instead of a higher rate is increased volume and associated costs. It is a cost increase of this kind, causal in nature, that is relevant. This explains the Commission's reliance on notions of volume variability as the primary bases for the attribution of costs.⁵

⁴ Thus the Commission said in Docket No. R71-1, RD at I-127: "The Act thus requires the application of sound economic principles in the establishment of postal rates. It envisions a two-step process: 1) the identification and assignment of causally-related 'attributable' costs, and 2) the allocation of the remaining 'institutional' costs among the various classes" (internal citations omitted). In Docket No. R74-1 at 85, the Commission observed: "If a business-man ignores the volume variability of costs, he ignores a critical, and controlling, cost-causal relationship resulting in imprudent expenditures and (more importantly) wasted resources."

⁵ By definition, unit volume variable costs are marginal costs. In Docket No. R83-1, the Commission said: "Volume variability has been the bedrock of Commission costing since its first rate

Analysis is required to estimate marginal costs. If a productive system *has* a stable, systematic behavior, its costs can usually be analyzed. If volume increases, costs increase. If volume decreases, costs decrease. Costs do not have to be at an efficient level to be analyzed; they can behave in a systematic way even if they are above efficient levels. The key question in all cases is whether a volume change has a cost effect that is well-defined. If the answer to this question is that it *does not*, if costs are changing variously, and particularly if the costs are not tied in a causal way to volumes, then the end of costs that are valid and meaningful cannot be achieved.⁶ It may be not due to spurious data or a failure of the analysis to be powerful enough; it may be a failure of an answer to even exist.⁷

When cost estimates are developed, it is common to both make assumptions and conduct supporting analyses. For example: (a) a cost pool may be assumed to be 100 percent variable with volume, based perhaps on a perception of how the system behaves, and (b) a separate analysis may be done of the behavior of certain costs, such as the street costs of city carriers. Whether the “separate analysis” is econometric in nature is irrelevant. But even if it is arguable that the behavior of the system was stable during an analysis period, it is equally important that any assumptions continue to hold and that supporting analyses continue to apply. In this regard, John C. Panzar

case.” RD at 187, para. 5004, footnote omitted. In Docket No MC95-1, the Commission said: “To the extent that prices for postal services reflect their marginal costs (or average incremental costs), they promote three types of efficiency.” RD, at IV-116, para. 4254.

⁶ It is the stable behavior requirement that John C. Panzar referenced when, in his testimony in Docket No. R97-1, USPS-T11 at 3, he said: “Thus, in explaining how to use Postal Service cost accounts to measure economic cost concepts, I assume that Postal Service operations follow an operating plan.”

⁷ Costing is best thought of in terms of a controlled experiment. A system is set up and is running at equilibrium. Then a volume increase or decrease is applied, and the result is observed. It is a “what if” question. If the result is beyond reason, out of bounds, of the wrong sign, or is different each time the experiment is performed, then the only conclusion is that a meaningful answer does not appear to exist, certainly not one that can be relied on.

observed: “Any attempt to determine empirical values for inherently *forward looking* economic cost concepts using historical accounting data must implicitly presume that the process which generated the data will continue to be valid in the future.” Docket No. R97-1, USPS-T11 at 3, italics in original.

It is not as difficult as might be imagined to detect when the system is unstable, the assumptions are wrong, or a supporting analysis no longer applies. In some cases consistency checks can be made. In others, questions with known answers can be asked. Some understanding of the system being analyzed can be helpful. Much more can usually be done than to look for coefficients with the “wrong” sign. For example, a cost increase of 15 percent when the factor prices increased only 3 percent might be taken as more disturbing than a coefficient of +0.003 that, based on a perception of how the system behaves, was expected to be negative.

We believe it is evident that difficulties in costing exist. ACMA has pointed in previous comments to a string of outcomes that appear either anomalous or inconsistent with what would be expected. These matters should be addressed. Until this is done, no confidence can be had that the costs being generated are valid, meaningful, and relevant.

An outcome of “no confidence” in the costing results should not come as a surprise. Questions relating to flats costs are not new.⁸ Furthermore, it is clear that the

⁸ The attention given to Standard Flats increased under the PAEA due to ensuing product designations. An early observation on a loss for these flats in FY 2008 was the Commission noting that “in previous years [they] had been profitable.” FY 2008 ACD at 5. But before Standard Flats became a product, a great deal of attention was directed at Periodicals costs, which derive almost entirely from the same flats processing system. In Docket No. R2000-1, for example, the Commission observed “[s]harply increasing mail processing costs ... for Periodicals ... [and] pressed the Service to assist in identifying definitive reasons for the historical pattern of above-average ... increases.” RD at 407. The Postal Service responded with certain data and then “expressed doubt about its analytical utility.” *Id.* at 408. The Commission then “directed the Service to present detailed evidence explaining the causes of the trends in the costs.” “It also asked for an explanation of why First-Class Mail and Standard A Regular

Postal Service is in turmoil and that significant adjustments are being made. Concerns about excess capacity are being discussed broadly and are making their way into proposed legislation.⁹ Under these conditions, it is not rational to expect that cost levels have a systematic and stable relation to volume levels. In effect, the behavior of the system is not stable. It is better to recognize that valid costs are not available than to proceed to act on a cost that is known to be deficient. Doing the latter is a prescription for making ineffective decisions.

2. In Carriers, Another Example of Outcomes that Are Difficult to

Rationalize. In this section, we look at the behavior of city carrier costs for Standard Letters and Standard Flats. In-office costs and street costs are analyzed differently and are covered separately here. All of the costs reviewed are obtained from the UDCmodel.xls spreadsheets, as contained, for example, in PRC-LR-8 in Docket No. ACR2010. The in-office direct costs are found in the segment “6.1 In-Office Direct Labor, Casing” column, and the direct street costs in the segment “7.1 Delivery Activities” column, of the summary tab for the base year. This tab also shows the proportion of letters DPSed. The CCS volumes are contained on tab ‘9.DeliveryVols’. The figures for FY 2005 are base-year figures in Docket No. R2006-1. All these costs

(which have large volumes of flat mail) had exhibited a sharp increase in unit flats processing costs in FY 1998.” *Id.* at 408. The Postal Service supplied two operating witnesses. In the end the Commission concluded: “Notwithstanding its attempt to address the disturbing Periodicals cost trend, the Commission’s inquiry found no definitive reasons why Periodicals mail processing costs have increased. ... The only conclusion is not comfortable: there are many reasons for believing that costs should have decreased; only a few factors that could be associated with increases; and a persistent net upward trend.” *Id.* at 411-12. The Commission went on to recommend a cost coverage for Periodicals of 100.1 percent.

⁹ For example, a Senate bill, drafted in early November 2011, known as the P-21 Act, requires, for below-cost classes, that the costs of excess capacity be estimated and that the attributable costs be adjusted accordingly.

are before the application of indirect costs and piggyback factors. They are consistently *after* the new street time analysis of Docket No. R2005-1.¹⁰

As a reference point, we refer to the weighted-average factor price index for the overall Postal Service, contained in its Total Factor Productivity analysis—see FY 2010 ACD at 38, fn. 17. This index was used by the Commission in its Periodicals Report to the President and Congress, September 2011, p. O-2, Table 1. The Commission points out that this index accounts for recent changes relating to CSRS contributions and PAEA healthcare requirements. We understand that this index does not necessarily parallel the wage rates of city carriers. However, the index is dominated by labor costs and is taken as indicative.

A. City Carrier In-Office Direct Casing Unit Costs. The casing activity of city carriers is assumed to be 100% variable with volume, and is thus attributable. Thinking in terms of typical or weighted-average pieces, the reasoning is that if 10% more pieces need to be cased, the time required will increase 10 percent. These costs are distributed to piece categories, such as letters and flats, according to tallies in the In-Office Costing System. If a flat takes longer to case than a letter, more tallies per unit volume will be recorded for flats, leading to more costs being attributed to them. This happens because the tallies are taken at random points in time.

From FY 2005 to FY 2007, a 2-year period, the unit casing cost of letters increased 6.4% and of flats increased 28.8%. The DPS proportion (city and rural combined, which applies to letters only) increased from 82.64% to 89.13%. The factor

¹⁰ Unit *rural* costs can be obtained from these same sources. They are reasonably well-behaved, due undoubtedly to the unit times accorded to rural carriers for various types of pieces, and are not reviewed here. They are not, however, above reproach. In FY 2010, for example, the unit rural cost of letters *decreased* 4.24 percent while that for flats *increased* 1.19 percent. On average, these are probably below the increase in rural-carrier wage rates. The outcome for letters was influenced slightly by the change in the DPS proportion.

price index increased 10.1%. Relative to the latter, a casing cost increase for flats of 28.8% is difficult to explain. Although these are approximations, it appears there was excess capacity in FY 2007, perhaps parading as low productivity. Another way of saying it is that these costs are not 100% volume variable, so the assumption relating to volume variability is wrong.

From FY 2007 to FY 2008, the unit casing costs each decreased, letters by 2.9% and flats 0.8%, while the DPS proportion increased by 1.23 percentage points. The factor price index increased 3.5%. These results suggest a small reduction in excess capacity. From FY 2008 to FY 2009, the unit casing costs each increased, letters by 14.6% and flats by 16.7%, while the DPS proportion increased by 1.00 percentage points. These increases are much larger than the factor price change of 5.3%, suggesting further increases in excess capacity.

From FY 2009 to FY 2010, the unit casing cost of letters *decreased* 11.3% and of flats *increased* 13%, while the DPS proportion increased 1.03 percentage points. The factor price index increased 5.1%. Such results are difficult to explain. The thought that excess capacity would decrease for letters and increase for flats cannot be digested. Note that any increases in these costs are magnified when factors are applied to account for indirect costs (including piggyback factors).

B. City Carrier Street Costs for Delivery Activities. The costing procedure used for city carrier street delivery activities was proposed by Postal Service witness Bradley in Docket No. R2005-1, USPS-T-14. See *a/so* RD at 54-74. The outcome of Bradley's work is a certain number of additional seconds on the street for each additional piece. This is viewed as a quantification of the behavior of the delivery system. Attaching a wage rate to these additional seconds yields an additional cost,

which is a legitimate and proper marginal cost. The Commission's Table 4-3 (at 68) shows an additional letter takes an additional 1.4 seconds and an additional flat also takes an additional 1.4 seconds. For comparison purposes, it is noted that an additional letter or flat in a mailing handled on the street as an extra bundle is shown to take an additional 0.8 seconds.¹¹

As we understand it, the equation proposed by Bradley and adopted by the Commission is a quadratic with second order terms for both letters and flats. USPS-T-14 at 36, Table 5, Docket No. R2005-1. The marginal times are obtained by taking a partial derivative with respect to the variable of interest (e.g., the volume of letters or flats). Using the coefficients in Table 5, the marginal time for letters would be $1.419120 - 2 * 0.0000004 * \text{letter volume}$, and the marginal time for flats would be $0.7019600 + 2 * 0.0000279 * \text{flats volume}$. An implication of these results is that a decrease in letter volume would cause an *increase* in the marginal cost of letters, and a decrease in flats volume would cause a *decrease* in the marginal cost of flats. We see this implication as out of line with what would be expected, and would appreciate the Commission giving further thought to the matter, now and later.

If marginal times for piece types are a behavioral characteristic of the delivery system, and wage rates are attached to these times, one would expect unit delivery costs to increase with wages, perhaps adjusted for volume levels as quantified in the previous paragraph. It appears, however, that the Bradley results have been converted into variability factors that are applied to cost pools, the result of which is then

¹¹ Whether the additional time of 0.8 seconds for extra-bundle mail (generally saturation mail) is a legitimate marginal cost is open to question. A rate decline *would be* expected to cause additional saturation mail, but the additional mail would come in the form of additional saturation mailings, i.e., as lumps, not in the form of additional pieces. This makes the "margin" much different from the usual focus on one piece or on a small number of pieces (either randomly distributed or distributed according to the pieces already on the route).

distributed to rate categories on a distribution key. We have not been able to track this process in detail, but wonder if it internalizes excess capacity costs and, as though they were marginal, makes them a part of attributable costs. In view of the results in the following paragraphs, we would appreciate the Commission giving thought to this question as well.

From FY 2005 to FY 2007, the unit street cost of letters increased 5.6% and of flats increased 0.99%. It is not clear why these would be different, and both are lower than the factor price increase of 10.1%. By itself, this is a favorable outcome for Standard Flats. From FY 2007 to FY 2008, the unit street cost of letters increased 4.63% and of flats increased 3.31%. These are of similar magnitude and are near the factor price index of 3.5%.

From FY 2008 to FY 2009, the unit street cost of letters increased 17.03% and of flats increased 17.94%. These are appropriately similar, but are considerably higher than the factor price increase of 5.3%. Excess capacity is suggested. From FY 2009 to FY 2010, the unit street cost of letters increased 3.60% and of flats increased 11.35%. The factor price index increased 5.1%. If it were not for the inexplicably high result for flats, the result for letters would seem in order.¹²

C. Conclusion for City Carriers. The results reviewed above for city carriers are not satisfying, and they raise questions. They are inconsistent in many cases with what would be expected, being, among other things, significantly misaligned with factor price increases. They also suggest excess capacity. So long as questions

¹² One other comparison is of interest. The percentage increases reviewed in the text were calculated from the unit costs. In FY 2009, the unit cost of Standard Flats was 11.7% higher than that of Standard Letters. In FY 2010, it was 20.0% higher. Given the Bradley finding that an additional letter and an additional flat each require an additional 1.4 seconds of street time, based on the way the system behaves, it is unclear why the marginal cost of flats is higher than that for letters. Plus, it is unclear why it would be 11.7% higher in one year and 20.0% higher the next.

like this exist, the cost results cannot be viewed as valid, and reliance cannot be placed on them. Including the possibility that some of our results need adjustment or refinement, we would appreciate the Commission investigating further. The matters at issue are quite important.

CONCLUSION

As discussed herein, it is apparent that no valid revenue or cost is available for Standard Flats. There is no way to roll forward the costs of past periods, particularly given the cost reduction activities of the Postal Service in recent years. Also, serious questions concerning these past-period costs, both above and in previous comments submitted by ACMA, have been raised and not answered. These questions include evidence of excess capacity and low productivity, the costs of which should not be attributed. Under these circumstances, we can find no reason why the Postal Service's proposal should not be accepted. Beyond this, however, either now or later, we believe the Commission should review these matters further.

Respectfully submitted,

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