Postal Regulatory Commission
Submitted 2/1/2013 1:48:02 PM
Filing ID: 86390
Accepted 2/1/2013

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2012	)	Docket No. ACR2012

INITIAL COMMENTS OF THE

AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)

(February 1, 2013)

Pursuant to Commission Order No. 1609 (January 2, 2013), ACMA is pleased to sponsor these comments, along with ACMA_ACR2012_Workbook.xlsx, a separate file that documents Graphs 1 through 3.

Through catalogs distributed mostly through the mail, ACMA members make a wide range of goods and services available, many of which are difficult to find or otherwise unavailable. Catalogs are a major component of the mailstream and a significant portion of the economy.[1] They are valued by recipients. Catalogers typically spend 40 to 60 percent of their marketing budget on postage. The rates for catalogs, then, are critically important to the Postal Service, recipients, and catalogers.

[1] The soon to be published 2012 EMA Mailing Industry Jobs Study indicates catalog sales in 2011 was $126 billion. Adding half again to represent total upstream and downstream economic activity (purchases, employment, etc.) equates to $190 billion of economic value or 1.3% of total US GDP.

Catalogers' Use of the Mail. Most catalogs are sent via the flats categories of Commercial (as opposed to Nonprofit) Standard Mail. Category use is determined by the automation and density characteristics of the mailings. If 125 or more pieces are available for a carrier route, those pieces use the High-Density category.[2] Then comes Carrier Route, the largest category, requiring 10 or more pieces per route. Short of that, automation and non-automation categories are available for pieces prepared for a 5-digit category, a 3-digit category, an ADC category, or a Mixed ADC category. Within each category are three entry points (Origin, DNDC, and DSCF). For reporting and breakdown purposes, these categories are parts of three products.[3] As a practical matter, the law allows considerable leeway in product designations.[4]

---

[2] Use of the Saturation category by catalogers is considered uncommon, representing about 3.8 percent of total catalogs mailed. Beginning January 27, 2013, the High-Density category was split into High-Density and High-Density Plus, the latter requiring 300 or more pieces per route.

[3] Excluding Saturation and the dropship options (which *are* categories for workshare constraints), there are 10 categories for Commercial flats and 10 more for Nonprofit flats [10= 2 (auto & non-auto) * 4 sortation (Mx ADC, ADC, 3-digit, & 5-digit) + 2 sortation (Carrier Route & High-Density)].

These 20 categories are parts of three products: 1—<u>Standard Flats</u> {a collection of 16 categories [2 (Commercial & Nonprofit) * 2 (auto & non-auto) * 4 sortation (Mx ADC, ADC, 3-digit, & 5-digit)]}; 2—<u>Carrier Route</u> {a collection of 6 categories [2 (Commercial & Nonprofit) * 3 shapes (letter, flat, & parcel)]}; and 3—<u>High-Density and Saturation Flats and Parcels</u> {a collection of 8 categories [2 (Commercial & Nonprofit) * 2 sortation (High-Density & Saturation) * 2 shapes (flat & parcel)]}. Due to the recent creation of High-Density Plus and Simple Samples, this breakout has changed somewhat.

The 10 categories used by catalogers, then, or by Commercial flats mailers generally, fall into 3 products, but the products house other categories as well, some disparate.

[4] Section 102(6) of 39 U.S.C. indicates that when the term "product" is used, it means a "postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied"; so it is clear that the law countenances almost any product breakdown. Indeed the Commission has indicated that "the term 'product' in section 102(6) is so general …
*** footnote continued next page

I. Background that Frames this Compliance Review

In its Annual Compliance Determination for Fiscal Year 2010 (Docket No. ACR2010, March 29, 2011), the Commission drew on § 101(d) to find the cost coverage for Standard Flats (a collection of 16 categories, as outlined above, 8 of which are among the 10 categories used by catalog mailers) to be below 100 percent, unacceptably. It ordered steps to move the cost coverage toward 100 percent.

On April 27, 2011, the Postal Service filed for review of the Commission's order in the Court of Appeals for the DC Circuit (USCA Case #11-1117). The Commission argued that the situation surrounding Standard Flats was an "extreme case" (court Opinion at 5, *citing* Respondent's Brief at 29), warranting invoking §101(d). The court agreed that §101(d) could be invoked, "at least in extreme circumstances," but remanded the case to the Commission "for a definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed [ ] is appropriate to ameliorate that extremity." It asked: "Why might not Standard Flats cease to be an extreme case at some slightly-less-than-complete cost coverage number (Would 95% suffice? What about 99%)" (Opinion at 6-7).

The Commission responded to the remand in Order No. 1427 (August 9, 2012), saying that to decide if the situation is "extreme," the "totality of circumstances presented" must be considered (at 4).

This, then, is the setting. The Standard Flats category has been found in violation of § 101(d), though it is defined in a way that is not aligned with markets or

---

that almost any category of mail nominated would qualify" (Order No. 536 at 22, September 14, 2010, Docket No. RM2009-3).

users, as discussed above. Catalogs are a significant component of it, but they use Carrier Route and High-Density as well. It is composed of both Commercial and Nonprofit, the latter virtually designated by Congress to have below-cost rates. Further, to the extent that a large portion of many mailings is sent via Carrier Route,[5] it stands as a residual category with, as the Postal Service has explained, rates linked to Carrier Route.[6] It would seem that if such a category is to receive scrutiny, including under § 101(d), its meaningfulness should be established. Consider the following questions.

> 1. In terms of its homogeneity, its use by mailers, its relation to markets, its scope, the ease of interpreting results on it, its alignment with mail processing and delivery operations, or some other characteristics, what is it about the Standard Flats grouping that makes its cost coverage particularly meaningful?
>
> 2. Why is the Standard Flats grouping of categories more deserving of attention than other candidate categories or groupings of categories?
>
> 3. Since, in effect, the Nonprofit grouping is designated by Congress to have below-cost rates, why are the Nonprofit categories included in the Standard Flats category that receives attention? [7]

---

[5] The 2012 Catalog Mail Use Survey conducted by ACMA indicates that 70.5% of catalogs mailed are submitted under Carrier Route. This study included a sample size of 1.9 billion pieces across all flats mail categories.

[6] *See* Notice of Market-Dominant Price Adjustment, Docket No. R2013-1, October 11, 2012, at 24 (Postal Service referring to "the need to *manage* the price gap between Standard 5-Digit automation flats and Carrier Route flats" (italics added)).

[7] A general question relates to whether Congress intended that the benefit given to Nonprofit mailers, at least to the extent it is a subsidy, be paid in a certain way by corresponding Commercial mailers. Suppose a Commercial category is suitably priced, but when linked with a Nonprofit category, the combined revenue falls below the combined cost. Should this outcome be taken to require an increase in both the Commercial and Nonprofit rates? In the current categorization, it works that way. Or, suppose the Commercial volume declines secularly relative to the Nonprofit volume (as it did in 2012 — Commercial was 80.48 percent of non-ECR
*** footnote continued next page

> 4. If conclusions are to be reached concerning the level of the rates paid by catalog mailings, why shouldn't a grouping be selected that houses the categories used by catalog mailers?
>
> 5. Why shouldn't the selection of rate elements used by catalogers, or by Commercial flats mailers generally, be a matter of Postal Service selection, according to ratesetting principles and market realities, instead of a matter of the fairness of the average level of rates of a category that houses part of this mail plus a string of Nonprofit categories?

In short, it is unclear why the Standard Flats category, selected for what may be reporting purposes, is a logical one for review. But whatever categories are reviewed, the Commission has stated that to decide if an associated cost coverage is an extremity, it will consider the "totality of circumstances presented."

On its face, considering the totality of circumstances seems like a straightforward exercise, one independent of category selection. But deeper down, the steps are not independent. That is, if a category selected lacks the constitution that would be preferred, then that lack would seem to be a circumstance that weighs in considering the result. Accordingly, we believe the above considerations, as well as several we discuss below, should be given weight as elements of the totality of circumstances.

---

flats in 2011 and 79.64 percent in 2012), which causes the joint cost coverage to fall below 100 percent. Is this cause to increase the Nonprofit rate?

A development similar to this is now occurring in Standard Mail Parcels. A large block of Commercial volume has been transferred to the competitive category. The cost coverage of the remainder will certainly decline, probably by a lot. Without quantifying the drop, the Postal Service simply says: "Because a higher proportion of the product is now Nonprofit, the product is likely to continue to have a cost coverage below attributable costs in FY 2013" (2012 Compliance Report at 15).

A. What Does a Cost index Tell Us about the Costs Reported for Standard Flats in FY 2012?

Being identical in structure to the familiar price index, the concept of a cost index is not a difficult one. Price indexes weight elemental prices by base-period volumes, and cost indexes weight elemental unit costs similarly. Both correct for the effects of changes in the volume mix, due to such things as volume trends and changes in the degrees of worksharing. Price indexes have been estimated regularly for various categories of mail; cost indexes have not been estimated, probably due in part to non-trivial data requirements. Arguably, they should be estimated.[8] They support analyses of behaviors and outcomes that can be intractable.

An alternative way to estimate a cost index (alternative to a straightforward weighting of unit costs by volumes) is to divide a total-cost index by a weighted quantity index. A total-cost index is simple and easy to construct. A weighted quantity index may be easier to develop than a weighted unit-cost index.[9]

---

8 In reply comments in Docket No. ACR2011 (February 17, 2012), addressing the notion of a cost index, the Public Representative said (at 11):

> Such a measure would provide the Commission, the Postal Service, and interested parties with a better understanding of the evolution of the costs of processing mail for the different products over time, and the Public Representative appreciates ACMA's effort to develop this measure.

9 To develop a weighted unit-cost index, operations would be disaggregated into a number of cost centers, possibly a very large number. Then a cost and corresponding volume for each would be needed. A question would have to be raised about whether each piece going through a center caused the same cost. For example, light and heavy, or rigid and floppy, pieces going through the same sorting operation could take different amounts of time and have different costs. The Postal Service's systems are not set up for this. For the alternative of a price- or cost-weighted quantity index, overall volume would be disaggregated into volume elements, perhaps along the lines of the billing determinants. Then a price or cost for each would be needed. The systems available allow a reasonable cut at this.

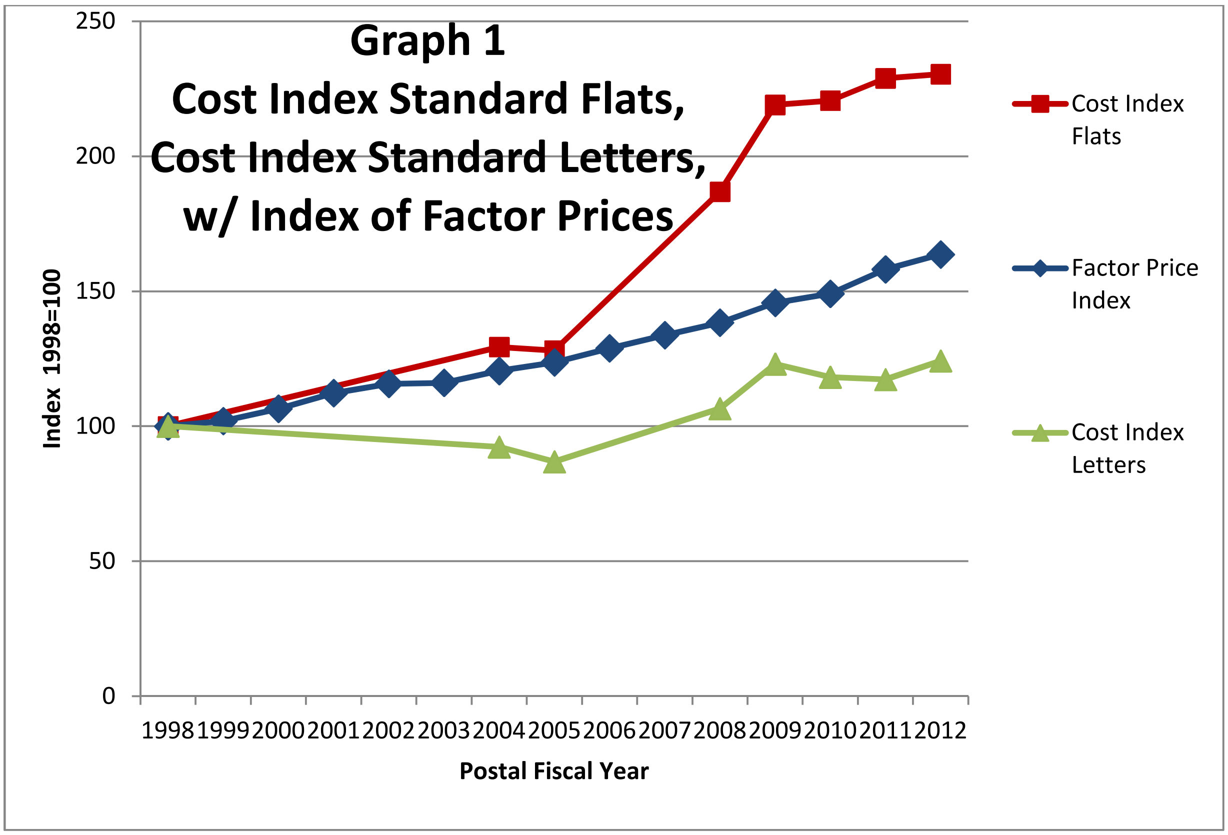
If a weighted quantity index is used, it must be decided which weights to use, usually either prices or unit costs. In its comments in Docket No. R2013-1 (November 1, 2012), ACMA discussed the merits of each approach[10] and showed (at an intermediate level of detail) that the results of the two are approximately the same, but that, if anything, the ACMA cost index might be an understatement of the cost increases that have occurred (*see particularly* Graph 2 at 8 and Graph 3 at 9; these graphs are updated on tabs 8 and 9, respectively, of ACMA_ACR2012_Workbook.xlsx).

In its initial comments in the 2011 Compliance Review (Docket No. ACR2011, February 3, 2012, Appendix A), ACMA showed that a rate index divided by an index of the cost coverage — both indexes that are either available or easy to construct — is identically equal to a total-cost index divided by a price-weighted quantity index, and thus is a cost index. Intuitively, this can be understood by thinking that the cost coverage has prices weighted by volumes in the numerator <u>and</u> unit costs weighted by volumes in the denominator. Note also that the numerator and denominator are each developed from the ground up in a very detailed way.

The only reservations on the record to ACMA's cost index were expressed by the Public Representative in reply comments in the same docket (February 17, 2012). Subsequently, ACMA explained that the Representative's reservations were misguided or wrong (*see* comments in Docket No. R2013-1, Appendix II). The Public Representative has made no response to that explanation. Thus, ACMA's cost index stands unrebutted as a valid, legitimate cost index.

[10] See Appendix II, pp. 10-11 of 18, including footnotes.

ACMA's cost index was introduced and its implications were discussed in initial comments in the last Compliance Review (Docket No. ACR2011). The instant question becomes: what does the cost index tell us about the 2012 outcome? Graph 1 shows the cost index for Standard Flats and Standard Letters, along with the factor price index.



Since the 2012 factor price index is not yet available,[11] it has been assumed for all graphs herein to be an increase of 3.5 percent over 2011.[12] The increase in 2010 was

---

[11] The 2011 index was filed with the Commission on April 27, 2012 (Table_Annual_2011 (2011 CRA).xls). The factor price index is shown in column K of tab Tfp-49.

[12] Interested parties can change this assumption easily on tab 1 of the spreadsheet being filed with these comments, and see the effect on the graphs. A substantial part of what determines the factor price index is the agreements the Postal Service reaches with its unions.

2.3 percent (restated in 2011 from an originally filed 5.1 percent), and the increase in 2011 was 6.1 percent, unusually high.

Before considering the 2012 result, note two things. First, there is Commission precedent for reasoning that, absent changes in technology and costing method, the default expectation would be for unit costs, corrected for changes in product mix, to move upward with factor prices. This was the basis for the primary conclusion on costs of the Periodicals Mail Study of the Commission and the Postal Service (September 2011).[13]

Second, based partly on recognizing factor prices and partly on other evidence (most of which is summarized in ACMA's comments in Docket No. R2013-1, November 1, 2012), ACMA believes it is clear that the rise in the cost index for Standard Flats from 2005 to 2009 (top line in the graph) is due to costs of excess capacity being attributed.[14] The issue of excess capacity will be discussed further below.

---

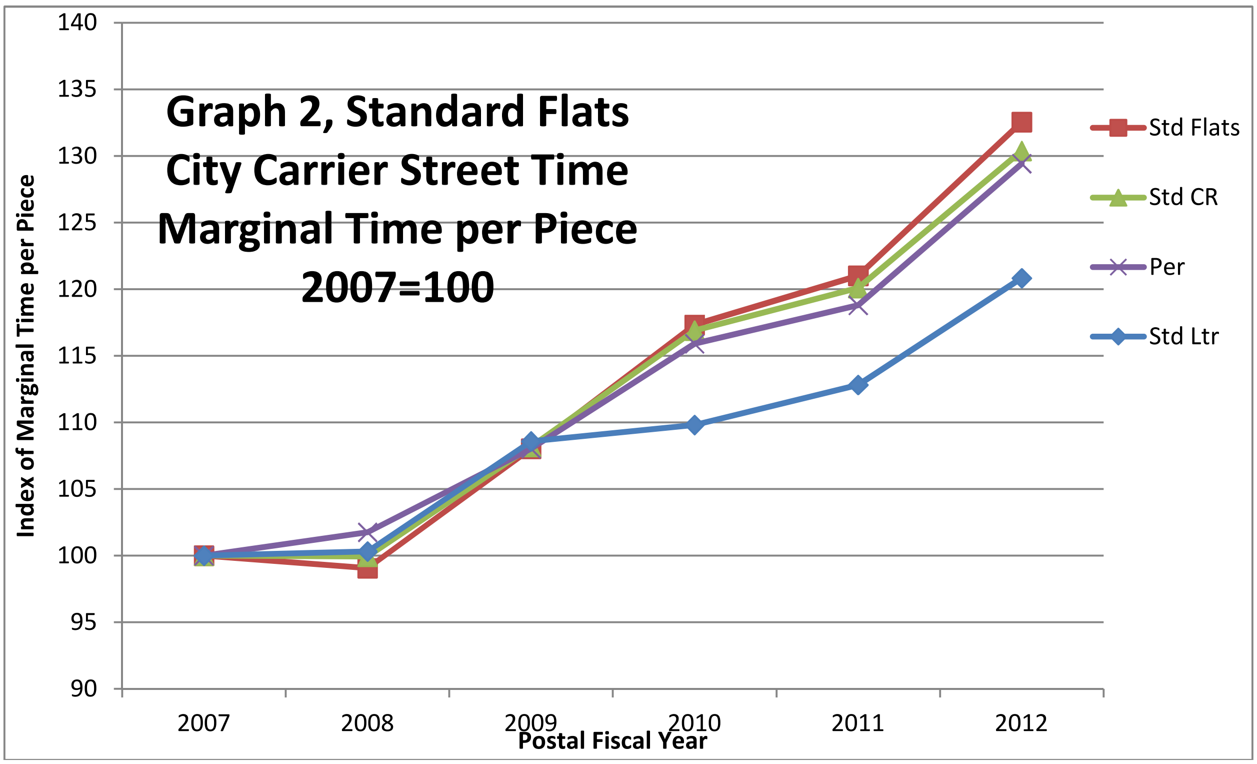
13 *See* Study, Appendix O, at 3-5, which reasons that the effects of technical advance on Periodicals costs would be approximately equal to the difference between an applicable factor price increase and the unit-cost increase, the latter corrected properly for changes in costing method and product mix (i.e., worksharing). The difference between the piece volume and the weighted quantity index implicit in the ACMA cost index (a difference that quantifies the effects of changes in worksharing) is actually much greater than the Study presumed, meaning that the Study's conclusion should have pointed to excessive cost growth for Periodicals (as Graph 4 in ACMA's initial comments in Docket No. ACR2011 showed, at 11). But the failure of the Study to estimate the magnitude of the effects of the changes in worksharing does not change the fact that it relied heavily on an understanding that unit costs should increase with factor prices, absent technological advance, changes in costing method, and changes in product mix.

14 One piece of evidence suggesting excess capacity, that took a disturbing upward tick in 2012, is the marginal street time for flats, shown in index form in Graph 2, following. Note that by focusing on marginal times, this graph corrects automatically for changes in wage rates.
*** footnote continued next page

What, then, happened in 2012?

Letters. Letter volumes were 9.0 percent below 2011 levels. On a unit basis, letter costs continued to increase approximately with factor prices, as they have since 2005. The resulting cost coverage was 177.9 percent, 7.0 percentage points below the 2011 level. The indication is a reasonably controlled operation. The reduction in cost

---



Before indexing, the 2007 marginal time for Standard Flats is 2.2 seconds. In Docket No. R2005-1, at the start of the new street analysis, the marginal time began, apparently, at 1.4 seconds (Rec. Dec. at 68, Table 4-3). If the 2005 figure were set equal to 100 and used in an index, the 2012 index would be 247.8, *much* higher than shown on the graph.

The argument that these increases are all due to the natural effects of volume declines does not seem a good one. *Bulk handling* should be linear with volume. Capturing route *coverage* effects would seem to require new regressions. *Fingering* fewer pieces should be linear with volume. ACMA would appreciate the Commission giving further consideration to this matter. The effects of street time are inflated by a piggyback factor of 1.304, so small changes get magnified. Also, any effect on attributed support activities should be recognized.

coverage is due in significant degree to the factor price increase being larger than the rate increase, the latter being 1.87 percent.

Flats. The volume of flats decreased 12.4 percent, somewhat more than the decrease for letters. The costs have been reduced with volume and then a little more, allowing an increase in unit costs that is notably under the increase in factor prices. Some tightening of operations is apparent. The resulting cost coverage was 80.7 percent, 1.2 percentage points *above* the 2011 level. In the face of excess capacity, undoubtedly made worse by the on-going transition to the FSS, this represents progress, and it would have been even higher if the Commercial proportion of non-ECR flats had not decreased from 80.48 to 79.64 percent (comparing 2012 with 2011 billing determinants). Normally, the limitation on reducing excess capacity, particularly in variable inputs, is exogenous, such as a labor agreement.[15] The reduction in cost that can be achieved is sometimes independent of volume. It is likely, then, that the reduction in unit cost would have been greater if the volume had not declined.

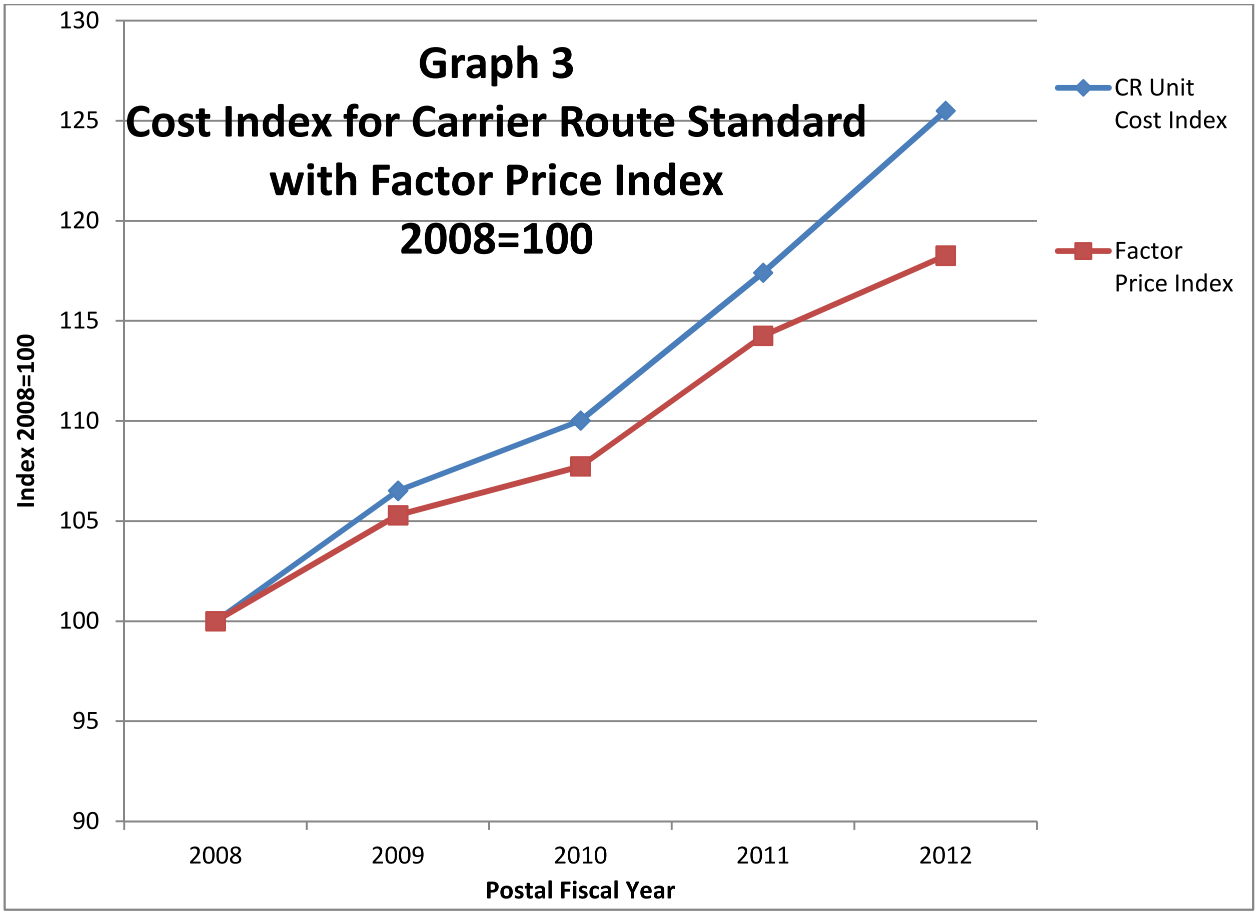
B. What Happened to the Costs of Carrier Route in FY 2012?

Carrier Route (including Commercial and Nonprofit categories, mainly flats but including a small quantity of letters and parcels) is a product. It is complementary to Standard Flats. In the case of FSS preparation, it is indistinguishable from Standard Flats. Mailers using Carrier Route usually use Standard Flats as well, according to the density characteristics of the mailing. Co-mail pools are denser than the included

[15] See USPS OIG Report Number MS-AR-11-001 (Audit Report – Workshare Discounts Exceeding Avoided Costs, December 23, 2010) saying (at 7): "The Postal Service faces constraints in responding to reduced volume, such as no-layoff provisions in labor contracts."

components, and thus would use Carrier Route in greater degree than if the components were mailed separately.

The earliest year for which we have a cost coverage for Carrier Route is FY 2008. Graph 3 shows the cost index for Carrier Route, along with the factor price index, 2008=100.



These results are disturbing. Since 2008, the unit cost of Carrier Route, corrected for the effects of changes in the mix of its categories, has increased 25.5 percent while the factor price index has increased 18.3 percent. Over the same period, the CPI increased 7.4 percent (March 2008 to March 2012, not seasonally adjusted).

From 2011, the cost index increased 8.1 percentage points while the factor price index increased only 4.0 percentage points.[16] The 2012 rate increase was 2.9 percent. As a result of the unit-cost increase being greater than the rate increase, the reported 2012 cost coverage at 130.4 percent is 5.3 percentage points below the 2011 level. The cost coverage of Carrier Route in 2008 was 151.2%—it has been declining since.

Partly because data are available for a shorter period, and partly because the mail processing component of Carrier Route is relatively small, the evidence on excess capacity for it is more limited than for Standard Flats. However, the results displayed in Graph 2 (in a footnote above) for city carrier street time show excess capacity clearly, and Graph 3 shows cost increases that are very difficult to accept.[17]

The volume of Carrier Route is down 5.7 percent, less than the declines in Standard Letters (9.0 percent) and Standard Flats (12.4 percent). In Standard Flats, though, despite its larger decline, there is some evidence of progress. Carrier Route is profitable for the Postal Service. Its rates, along with the rates for Standard Flats, are key determinants of the volume sent. ACMA is deeply concerned that Carrier Route is moving in an adverse direction. The Commission took a first step at inquiry in question 5 of CHIR No. 3. We believe further steps should be taken.

The behavior of Carrier Route relative to Standard Flats highlights a phenomenon that is beginning to play out and that suggests difficulties. Consider a

---

16 Recall that factor prices have been assumed to be 3.5 percent higher in 2012 than in 2011. The 4.0 percentage point increase is in an index based on 2008.

17 In question 5 of CHIR No. 3, the Chairman asked the Postal Service to explain a cost increase in FY 2012 for Carrier Route of 6.8 percent. Corrected for changes in volume mix, this increase would be 8.1 percent, as shown by the cost index in Graph 3.

hypothetical. Suppose the rates for products A, B, and C are set based on ratesetting principles and market realities. And suppose the cost coverages of them, in order, are 110 percent, 120 percent, and 130 percent. Now suppose a period passes, the rates increase with a cap, and, due to factor prices and the costs of excess capacity being attributed, the coverages change to be 100 percent, 110 percent, and 120 percent. Next suppose yet another period passes, the same thing happens, and the coverages change to 90 percent, 100 percent, and 110 percent. Is it helpful to observe that product A is below cost and to require that its rate be increased? Does its below-cost status indicate that it is now misaligned with markets? What is it about cap increases for all three products that made product A underpriced? If its rate is increased and product B's rate is decreased, will product B become a below-cost product? There appears to be the possibility of some tension between effective rates and a focus on cost coverages, under a price cap.

Aspects of this scenario are being played out in Standard Mail, with Standard Flats and Carrier Route being key players. The indication is that excess capacity and large factor price increases have caused reductions in cost coverage, and that increasing rates to solve a perceived "problem" might lead to ineffective rate relationships. Some restraint is needed. The relationship between Standard Flats rates and Carrier Route rates is becoming a difficult one. The Postal Service should be allowed to manage it.

C. Recognizing the Effects of Excess Capacity on Costing

The presence of excess capacity in the postal system has been recognized widely.[18] Most recently, a study of short-run costing prepared by the USPS Office of Inspector General discussed excess capacity at some length. Report Number: RARC-WP-13-004, January 9, 2013 ("OIG Study"). As one contribution, the Study makes it clear that excess capacity can involve inputs normally viewed as variable, such as labor. Another contribution is the Study's clarification that the "[s]hort-run total cost for a firm is generally greater and never less than [the] long-run total cost" and that "[u]nder certain conditions, a firm's short-run marginal cost can be less than its long-run marginal cost" (at 2, footnote omitted). Principally, these "conditions" involve excess capacity in a variable input. These are important matters.

For purposes of estimating the effects of volume changes on variable inputs that are in excess, the OIG Study provides an algorithm (Figure 1: Algorithm to Estimate Short-Run Costs, at 15). It recognizes that the Postal Service may be doing all it can to tighten its operations and that the situation may be that an increase in volume causes the need for little or no addition of the input in question, and similarly that a decrease in volume might allow little or no further reduction in it. This situation can in some cases

---

18 For example: OIG Report RARC-WP-008 (A Primer on Postal Costing Issues, March 20, 2012) asked (at i): "How should the system be adapted to reflect the excess capacity currently present in the postal network (short-run versus long-run marginal costs)?" and GAO report GAO-12-470 (Mail Processing Network Exceeds What Is Needed for Declining Mail Volume, April 2012) says (at 2): "Over the past decade, USPS has taken steps to reduce its excess capacity to move toward optimizing its mail processing network … Since 2006, the gap between USPS expenses and revenues has grown significantly …."

be characterized validly by assuming it to have a low volume-elasticity of cost.[19] The Study suggests using such an elasticity to obtain a low marginal cost for an input in excess, and then, to include the costs of inputs not in excess, adding "the remaining long-run variable cost by component to calculate the short-run volume variable cost by product" (at 15). If the "long-run variable cost[s]" added are in fact variable with volume (as the input in question is not), this procedure should lead to a legitimate "short-run variable cost."

Presuming price stability to be a virtue, and it may be, the Study reasons that price stability can be achieved by tying rates to *long-run* attributable cost, as usually developed (section beginning at 6). It fails to point out that the excess capacity at issue will elevate artificially that long-run attributable cost, making it both too high and on that account in-fact *unstable*. As appears to be happening, the costs of the excess capacity get attributed and distributed to products in an ordinary long-run costing exercise. The long-run attributable cost that results turns out to be too high. It will not be causal or based on volume variability. It will not be an efficient cost. *It will be an excessive cost.*

The conclusion that the long-run attributable cost just described is excessive is important. One of the characteristics of this cost is that as the Postal Service succeeds

---

[19] The Study explains (at 41):

> If only one input is used and it is in excess capacity in all applications across the entire postal network, then the short-run cost elasticity is zero because the amount of the input remains the same regardless of what happens to volume. However, if multiple inputs are used or if the degree of excess capacity varies across the network the computation of the effect on the short-run cost elasticity is more difficult and econometric estimation, functional analysis, or operational assumptions must be applied.

in steps to remove its excess capacity and align its costs with the volume levels, this long-run attributable cost will decline and the cost coverage will increase. In other words, a low cost coverage *is caused by the excess capacity*. The OIG Study is correct that a short-run cost that recognizes excess capacity in a variable input will move upward toward the long-run cost as operations are tightened, but it does not point out that the long-run is too high and will itself decline, but indeed it will.

Another effect of an elevated long-run cost needs to be recognized, an effect that could be viewed as pernicious. Suppose such a long-run cost is taken as a reason to increase the rate of the product in question, and applicable ratesetting considerations suggest reducing that same rate when the excess capacity is eliminated. Volume will be lost when the rate is increased and may not come back when the rate is decreased. A negative effect on demand can be permanent. This is especially the case when mailers re-orient their businesses or are forced out of business

Further supporting the conclusion that the long-run attributable costs currently being reported may be too high is the fact that bills before both houses of the 112th Congress (H.R. 2309 and S 1789) specified that the costs of excess capacity should be estimated, and, presumably, should be removed from the attributable costs. This is both logical and good business practice. It is true that the costs of excess capacity must be paid by the Postal Service overall, but it is not true that they are properly attributed to specific products.

D. Estimating the Effects of Changes

When rates change, volumes and revenues change. When volumes change, costs change, though not necessarily. If revenues and costs change, the profitability of the organization changes. When deciding on one rate instead of another, a primary reason for estimating costs is to estimate the associated change in profitability. Indeed one of the reasons for changing the rates is to affect that profitability. Clearly, then, the estimation of costs *that do in fact vary with volume* is important.

The OIG Study explained that when excess capacity is present, the short-run marginal cost might be much lower than an associated long-run level. We have explained above that it is also true when excess capacity is present that the associated long-run costs would be expected to be excessively high, meaning that they are not causal, not efficient, and not indicative of the changes that would occur in a long-run equilibrium. Moreover, we have explained that these long-run costs would be expected to decline as the organization tightens its operations and moves toward efficient levels. Said another way, traditional long-run costs, developed during a period of excess capacity, are excessive and are not a valid measure of the resources that are absorbed by the products in question.

In order to be helpful in estimating the effects on the profitability of the organization of rate adjustments under a price cap, the Postal Service has provided a study by Christensen Associates, Scenario Analysis for Standard Mail Contribution, December 27, 2012, filed with accompanying spreadsheets as USPS-FY12-43 in the instant docket ("Christensen Study"). This Study shows that increasing the rates for the Standard Flats product could have a negative effect on Postal Service finances, or that any positive effect might be small. For the reasons below, we believe it might understate the magnitude of any negative effects, or might overstate the magnitude of any positive effects.

> 1. Although the <u>price-elasticities of demand</u> in the Christensen spreadsheets can be adjusted by the user, the scenarios shown assume that Standard Flats has an elasticity of -0.6. We believe the elasticity for many catalogers is much higher than this (in absolute value). Some of our members make mailing decisions using business planning and circulation models that have elasticities in the neighborhood of 1.35. These models are not unique to one or two catalogers. They recognize market behaviors that we believe are common to many catalogers. Also, the elasticities estimated for the Commercial categories have always been higher than those for the Nonprofit categories.
>
> 2. The Study provides a capability to assume a <u>volume-elasticity of attributable cost</u> of less than 1.0, as could be the case in the presence of excess capacity, consistent with the algorithm presented independently in the OIG Study. A scenario in the Study applies a cost elasticity of 0.9. Based on the behavior of the costs for letters and flats ACMA has presented, we believe that this elasticity could be significantly below 0.9 and that the figure for flats might well be lower than that for letters.[20]

---

[20] A volume-elasticity of cost that is below 1.0, and a volume-elasticity of cost for flats that is lower than the elasticity for letters, are consistent with arguments made by Time Inc. that the presence of automation refugees has elevated the costs of Periodicals. The Commission has noted that the refugee issue "warrants systematic investigation" (Docket No. R97-1, Op. & Rec. Dec. at ¶ 3148, May 11, 1998).

In its initial comments in Docket No. ACR2011 (February 3, 2012), ACMA showed that the cost index for Periodicals outpaces the factor price index by a considerable margin, and explained that this should not occur in the presence of technological advance (*see* Graph 4, at 11). ACMA also explained that the cost index for letters is *below* the factor price index (*see* Graph 1, at 5), perhaps further below than can be explained by the changes in technology that have occurred. These findings support the presence of excess capacity for flats and of automation refugees.

3. The Christensen Study does not discuss the possibility of a multiplier. But an increase in catalog volume would be expected to cause an increase in parcels and First-Class letters. We believe such a multiplier is a reality for catalogs and that it has financial effects on the Postal Service that should not be neglected. Further, considering a multiplier effect, although difficult to quantify precisely, would be consistent with the Burden Test for cross-subsidy, which is accepted as the most advanced (and only thorough) assessment of the value to an organization of a product.[21]

4. A particular part of the multiplier effect, also neglected by the Christensen Study, is the relation between Standard Flats and Carrier Route. To a considerable extent, catalog mailers make mailing decisions on the basis of the profitability of the entire mailing, part of which would ultimately use a group of Commercial categories in Standard Flats and another part of which would ultimately use the Commercial flats category of Carrier Route. If the rates increase for Standard Flats, and the associated volume is reduced, the volume would also be reduced in Carrier Route. This would have a negative effect on the profitability of the Postal Service.

5. Another phenomenon needs to be noted. If a rate is reduced and the volume increases, catalog prospecting will expand and new customers are established. These customers will be included in mailings over the next year, at least. So, even if the reduced rate does not apply in the next mailing, the volume of it will be higher than it would have been otherwise.[22] The reverse is also true: a rate increase could have greater negative effects than might be apparent.

6. The Christensen Study forecasts volume on a trend and a simple elasticity relationship on real price. The forecasts recognize changes in two variables. One is the CPI and the other is postal rates. If the CPI increases 3% and the cap is 3%, then if the rates increase 3%, the increase in the real rate would be taken to be zero and the change in volume

---

[21] Further discussion of the Burden Test, with references to the literature, was provided by ACMA in its initial comments in Docket No. ACR2011, February 3, 2012, at 31-32.

[22] ACMA members who took advantage of the Summer Sales report a continuing circulation impact from incremental prospecting enabled by the sales.

> due to rates would be projected to be zero. If the prices of catalog products also increased 3%, and if all of the non-postal inputs purchased by catalogers increased 3% as well, the forecast of "no change" would be understandable, although technical improvements are a constant thing and the range of products made available is far from static. In general, however, catalogers do not think in terms of catalog prices changing with the CPI, partly because the CPI is wide and catalogs are narrow. Also, the products made available in the catalogs change. When facing a future year, we find that catalogers make adjustments for factors that are known, and think in terms of their sensitivity to *nominal* postal rates. Our guess is that our sensitivity to rates is greater than the Christensen scenarios suggest. Models need to be made of the specific situations at hand, not of economy-wide generalities.
>
> 7. Finally, the Christensen Study contains an internal inconsistency that causes it to lowball the profitability of the flats it analyzes. Specifically, it assumes the excess capacity is of a kind that can be modeled with a below 1.0 volume-elasticity of cost but fails to see that the presence of this excess capacity implies that the costs it uses are too high. Automatically reducing the cost to recognize the excess capacity would make the scenarios more complex, but also more realistic, and it would increase the negative effects on the Postal Service of above-cap rate increases for Standard Flats, that is, the effects would be more highly negative.

In short, we believe there is ample reason to give weight to the possibility that above-cap increases in the rates for Standard Flats will have a negative financial effect on the Postal Service that is notably greater than the Christensen scenarios suggest.[23]

[23] An example of an apparently permanent effect is the volume reductions that occurred after the large rate increases of Docket No. R2006-1.

E. Catalogs Are a Category of Mail with Considerable Value

Section 3622(c) requires the Commission to

> take into account – (1) the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery.

This direction is reasonably broad and cannot be summarized in a single measure. Commercial catalogs are certainly a "type of mail service" and they are valued. They are a profitable mailstream component to the Postal Service. They also have value to recipients and to the nation.

Appendix I of ACMA's comments in Docket No. R2013-1 (November 1, 2012) contained the results of a random survey of 817 consumers' behavior toward catalogs. Of unsolicited mail, 46 percent found catalogs useful while 5 percent found non-catalogs useful. The number one reason for buying was to get hard-to-find items. The next reasons were ease of shopping and greater assortment. Sixty-six percent would request the catalogs and 15 percent would pay to receive them.

Many catalogs serve as resources to recipients. The Eastbay catalog has hundreds of shoes, mostly athletic. Having a resource like that is much different from an advertisement that says "buy this special shoe." The Northern Safety catalog helps meet safety requirements in situations that arise and provides information from their technical support group. Cataloger Fun and Function shows developmental toys for autistic children, among others. Renovator's Supply helps in restoration ventures. The Patagonia catalog helps consumers understand and prepare for harsh outdoor environments. A good deal of information in catalogs qualifies as educational, cultural, or scientific, factors mentioned in § 3622(c)(11). Some persons buying from catalogs are in remote areas, are infirm, or are otherwise shut-in and without the content catalogs provide, they would not have access to this information. Some value the privacy and security that catalogs allow.

Deservedly, catalogs are part of American culture. They play an important role and are of considerable value. They deserve recognition in postal rates.

II. Conclusion

The situation surrounding consideration of the cost coverage of Standard Flats is in need of review, for the health of the Postal Service and the mailing industry.

Under the PAEA, the Postal Service early on grouped 16 relatively elemental categories of Standard Mail, each familiar to one mailer or another, to form Standard Flats, a collective product. Eight of these categories are used variously by Commercial mailers, including catalogers; the other 8 are used variously by Nonprofit mailers. A particular mailing, however, would in most cases use a limited number of these categories plus it would use categories included in Carrier Route and maybe High-Density.

The outcome of this product designation has been that (1) Standard Flats is a line item in the CRA (a summary financial report) and (2) the Commission has focused on its cost coverage and found it to be unacceptably low. Further, the Commission has explained that in deciding if any shortfall is an extremity, it will consider the "totality of circumstances presented." [24]

---

[24] Order No. 1427 at 4, August 9, 2010, Docket No. ACR2010-R.

We have explained that Standard Flats is a non-homogeneous grouping that does not relate well to mailings or markets. Therefore, it being axiomatic that the mere availability of a cost coverage figure is not a good reason for attaching importance to it, some justification is needed for any attention accorded its cost coverage.

We list above several questions that should be addressed. One is: Why shouldn't the selection of rate elements used by catalogers, or by Commercial flats mailers generally, be a matter of Postal Service selection, according to ratesetting principles and market realities, instead of a matter of the fairness of the average level of rates of a category that houses part of this mail plus a string of Nonprofit categories?

The lack of desirable attributes in the constitution of the Standard Flats category makes shaky ground for evaluating the level of its cost coverage. It starts, therefore, with limitations that make it difficult to know what is being fixed if the associated rates are increased, and that raise the possibility that something might be made worse. Compounding this situation are other circumstances that should be given weight in any assessment or any response.

> 1. Substantial evidence has been presented that costs of excess capacity exist for variable inputs, and that these costs are being attributed. This situation exists for all flats categories, and in no apparent degree for letters.
>
> 2. Consistent with a study on short-run costing done recently by the OIG, we have explained that the presence of excess capacity not only makes the short-run costs low, but also makes the traditional long-run costs too high. Such traditional long-run costs are not causal, not volume variable, and not efficient. Congress too has expressed concern about the costs of excess capacity.
>
> 3. The Christensen Study shows the likelihood of negative long-term financial effects on the Postal Service of relatively large rate increases for Standard Flats. We provide seven

> reasons above why the effects might be more negative than Christensen suggests. The Study is a good start, and provides a framework for thought and analysis, but it needs a few tweaks, some not minor.
>
> 4. The value and cultural significance of catalogs should be recognized. We have explained that catalogs are important, relevant, and valued by the consumer. Catalogs make a substantial contribution to the health of our economy.

Together these circumstances and the weaknesses in the category definition support a conclusion that great care should be taken in using the cost coverage as a basis for remedial action. The costs available, which have been shown to lack the robustness that should be required for them to be viewed as a solid platform, are only one of the circumstances. The increase in FY 2012 of the reported cost coverage for Standard Flats should also be recognized, and the Postal Service should be encouraged to continue tightening its operations. Taken together, we believe there is insufficient basis for finding the rates for Standard Flats to be out of compliance with the law.

In response to a call for remedial steps, nevertheless, the Postal Service has suggested that the rates for Standard Flats, both Commercial and Nonprofit, be increased at 105 percent of the applicable price cap. This is a measured response that we believe might not cause undue harm.

Beyond Standard Flats, but related, ACMA is deeply concerned about the rising costs of Carrier Route and its declining cost coverage. Although its volume is down somewhat, it has been a growth category for many of our members. Its health is as important as that of Standard Flats, even more so.

Part of the importance of Carrier Route is its role in fostering an efficient mailstream. Partly because of their ability to plan and coordinate, and partly because they can do work before the mail is printed instead of just after, mailers and printers have options that the Postal Service does not have. They can sort and integrate mail before it is printed. They can select the printing location. They can arrange to have full trucks. They have room to compete and be creative. Of Commercial Carrier Route, 87.4 percent is entered in the destination SCF and another 9.0 percent is entered at a destination NDC. The mail is thus prepared and entered so that the Postal Service can do an additional step and send it out with the carrier. If this can be done at a low cost, mail will work. Volume is necessary to make this happen. We believe catalogs should be part of that volume.

Respectfully submitted,

The American Catalog Mailers Association, Inc.

Hamilton Davison
President & Executive Director
PO Box 11173
Hauppauge, NY 11788-0941
Ph: 800-509-9514
hdavison@catalogmailers.org

Robert W. Mitchell
Consultant to ACMA
13 Turnham Court
Gaithersburg, MD 20878-2619
Ph: 301-340-1254
rmitxx@gmail.com