

BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

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Annual Compliance Report, 2012

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Docket No. ACR2012

**REPLY COMMENTS OF THE  
AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)**

(February 15, 2013)

Pursuant to Commission Order No. 1609 (January 2, 2013), ACMA is pleased to sponsor these reply comments, directed primarily to the initial comments of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (hereinafter "Valpak") (February 1, 2013), including Valpak's Appendix A, VP ACR2012 Appendix A.xls (containing Valpak's pricing model).

A significant portion of Valpak's comments relates to the harm it sees as having been caused by Congress's passage of the PAEA. We do not address these matters but rather focus on Valpak's position on pricing for the product designated "Standard Flats" and on the pricing model Valpak recommends to the Postal Service. Valpak's position on pricing and its recommended model are built on pillars of clay, specifically:

1. That the operating losses of the Postal Service have been caused in substantial degree by revenue shortfalls relative to reported costs on a limited number of products, including particularly Standard Flats, and that increasing the

rates on these products, within the law, would make the Postal Service somewhere near whole on an operations basis. In other words, that the operating losses of the Postal Service have been caused primarily by these products.<sup>1</sup>

2. That the costs being reported for flats, and specifically for Standard Flats, should be taken as meaningful costs based on accepted notions of causality and volume variability, and that it is reasonable to use them in pricing and in exercises to estimate the effects of changes in associated rates.<sup>2</sup>

3. That the categories now identified as products are meaningful foci for questions relating to cost coverage and pricing.

4. That the elasticities recently filed by the Postal Service for Standard Mail are applicable variously to the current list of Standard products and that since specific quantifications are not available for cross-elasticities and multiplier effects, it is acceptable to neglect them and proceed as though they are zero.

5. That the Postal Service should, within the law, within each class, set rates that maximize the contribution to fixed costs according to a simple model of changes in contribution that relies exclusively on the revenues, costs, and volumes being reported, the elasticities available, and the meaningfulness of the categories now designated as products. (Valpak presents such a model and applies it to Standard Flats.)

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<sup>1</sup> *Operating losses* are income statement losses before deduction of the required payment to the Retiree Health Benefits Fund, commonly RHBF. Valpak views operating losses as “the Postal Service’s core problem” (at 6).

<sup>2</sup> Consistent with the literature and postal practice, a cost that is meaningful and appropriately based on causality is one that is variable with volume. If the cost of a product is “C” and the unit cost is “c,” where  $c = C/\text{Volume}$ , the requirement is that if the volume changes by  $\Delta V$ , then  $\Delta C = c * \Delta V$ . In this case  $c = \text{marginal cost}$ .

**A. Valpak Should Know that Fixing the Cost Coverages on Underwater Products, Under the Law, by Adjusting Rates, Will Have a Small, and Possibly a Deleterious, Effect on the Operating Losses of the Postal Service, Not a Substantial or Redeeming Effect.**

Valpak states: “Had the Postal Service avoided all losses on underwater products during the last six years, it would have had a cumulative loss from operations of only 1/10 of what it was — around \$900 million, instead of \$9.0 billion” (at 8, emphasis removed). An apparent implication of this statement, in line with Valpak’s general development and a number of other statements,<sup>3</sup> is that fixing these losses by adjusting rates would all but eliminate the deficit on operations.

ACMA has explained before,<sup>4</sup> as has the Postal Service, that the bottom-line effect of adjusting rates within a class, under a price cap, depends on a number of factors (including own-price elasticities, cross-price elasticities, multiplier effects, and the responsiveness of costs to volume changes — matters discussed further *infra*) and would at best be a small portion of the losses at issue, and a much smaller portion, at least now, of the Postal Service’s deficit. This “small portion” nature, of course, is due to rate reductions that must accompany any increases, to stay within the cap.

In the instant docket, it turns out that tab “Max Contribution” of Valpak’s own model (discussed in Section D) can be used to quantify the small portion. To do this, simply select rate increases for Flats and Parcels that bring their coverages to 100

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<sup>3</sup> *As another example*, a section heading in Valpak’s comments (at 31) is: “THE POSTAL SERVICE’S FINANCIAL WOES ARE IN LARGE PART DUE TO SELF-INFLICTED LOSSES FROM UNDERWATER PRODUCTS” (bold omitted).

<sup>4</sup> See Comments of ACMA, Docket No. ACR 2010, February 2, 2011, at 8-9. See also ACMA’s Reply Comments in Docket No. ACR2010, February 17, 2011, at 3, 8.

percent (increases of 23.4% and 11.5% are needed, respectively, cells E42-43). Then return the cap space used (cell R45) back to the other 4 products, which requires a decrease for each of 3.98%. The increase in contribution is \$118.9 million, which is 21.4% of the loss on Flats and Parcels and 2.7% of the \$4.461 billion loss on operations (Valpak Comments at 5). Given the model's limitations, we believe this increase might be an overstatement, perhaps a large one, as discussed further *infra*. Nevertheless, in this situation, it is culpably misleading for Valpak to suggest that the increase in contribution available might be of a magnitude that approximates the level of the Postal Service's losses.<sup>5</sup>

A background matter here is the basic impossibility of laying blame for a residual, in this case for a deficit. A surplus can exist when some products are below cost. A deficit can exist when all products are above cost. When a deficit does exist and some products are below cost, there is no relation between the loss on those products and the size of the deficit. If they are of similar size, it is coincidental. An increase in *any* of the rates will reduce a deficit. Under these conditions, there is no link, causal or otherwise,

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<sup>5</sup> Particularly now that Valpak has prepared a model that can be used easily to confirm that adjusting rates within a class under a price cap would eliminate no more than a "small portion" of a deficit of the magnitude being experienced by the Postal Service, it is strange that Valpak goes to such pains to assert the contrary. And making matters worse, this is not the first time that Valpak has approached this issue and stood impervious to evidence. A Postal Service brief to the Court of Appeals for the District of Columbia Circuit (USCA Case #11-1117), filed on October 7, 2011, at 13, quoted ACMA as stating that the effect of rate adjustments "within the framework of a cap for a class of mail . . . would in all cases be no more than a small fraction of the shortfall at issue," remarking that ACMA's comment was "one of the most important comments offered [in the FY 2010 Compliance Review] regarding the impact on the Postal Service's overall revenue of implementing above-CPI changes on Standard Mail Flats." Then on December 7, 2011, in the same case, Valpak filed an intervenor brief, and stated: "ACMA asserts without any evidence or support that the net effect of rate changes would be no more than a 'small fraction of the shortfall,' *a point not mentioned by the Postal Service*" (at 32 [emphasis added]).

between the deficit and a specific product or group of products. And price cap regulation focuses attention on average rate increases, not on deficit responsibility.

**B. ACMA Has Explained that, Due in Large Part to the Attribution of the Costs of Excess Capacity in Inputs Often Viewed as Variable, an Unknown Proportion of the Costs Being Reported Are Neither Volume Variable Nor Efficient, and Thus the Costs Are Not Suitable for General Evaluation of Cost Coverages or for Use in Contribution Models Such as the One Presented by Valpak.**

For evaluation of cost coverages generally, and for use in contribution models, it is essential that the costs relied on be suitable for estimating the effects on costs of changes in volume.<sup>6</sup> ACMA has explained and provided evidence that the costs being reported do not satisfy this requirement and thus are invalid for such purposes. See ACMA's Initial Comments in the instant docket, ACMA's Comments in Docket No. R2013-1, and ACMA's Initial Comments in Docket No. ACR2011, these sometimes summarizing or referencing other submissions of record. It is not a matter of the costs being long-run instead of short-run but rather a matter of their being artificially high and of not being valid indicators of the behavior of overall costs in the face of volume changes, whether the volume changes are secular or rate induced. That is, the costs are not really volume variable.

It is possible that Valpak is not comfortable with ACMA's cost index (and the analysis surrounding it) or that it has not linked the cost index to the utility of the costs in its model. But Valpak does seem generally aware of the matter of excess capacity. It

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<sup>6</sup> For further discussion of the requirements on costing, see ACMA's Comments in Docket No. R2013-1, November 1, 2012, at 2-4. Contributions, of course, are defined as revenue minus cost. If rates are changed to change contributions, it is the volumes that change the costs. If the volume-cost relation is missing, no analysis can be done; if it is wrong, the analysis will be useless.

indicates that “the Postal Service has been unable to reduce expenses fast enough or far enough to keep pace with the decline in mail volume” (at 7). It notes that “the Postal Service’s labor contracts generally preclude layoffs” and that “its labor force is being downsized gradually through attrition” (at 8, n. 4). It concedes that the Postal Service might “continue having considerable excess capacity” (at 19). And it remarks that “management has recommitted to reduce excess capacity and fixed overhead costs” (confirming an understanding, apparently, that excess capacity can be separate from overhead costs) (at 22).

And it did note (with astonishment, incidentally) that the Postal Service itself explains that its costs, as reported by product, are not really as variable with volume as the cost analysis aimed for them to be and Valpak’s model presumes them to be (at 83, n. 65). But rather than think about what all this might mean, Valpak simply writes it off by saying that costing questions “should be raised by the Postal Service [or by an interested party, presumably] in a separate rulemaking docket ... [and that] [u]ntil this is done, attributable costs [as reported] should be expected to vary with volume.” When there is substantial evidence that the costs available are problematic and not fully variable with volume, it is difficult to understand why anyone, just because the costs have not been unblessed in a separate rulemaking, would *expect* them to vary with volume and *go on* to use them in models. “Expect” is a strong word.

It may be that the object of a separate docket could be to reach an agreement that costing weaknesses exist and that the costs should not be relied on, like a meeting of a council to reach agreement that a bridge has actually come down and that vehicles

should not use it. But, as ACMA has explained, it can be relatively easy to determine if a bridge is down, but much more difficult to build a new one.

ACMA has explained that by relying on a few simple tools, including a weighted cost index (which ACMA has provided and defended), particularly after the passage of some time, it is often possible to learn a lot about how costing systems are performing and about the usefulness of the resulting costs.<sup>7</sup> It is true that ACMA's analysis has been presented in cases of limited duration, but the work is not formidable and is no more difficult than the model presented by Valpak.<sup>8</sup> Further, once things have been learned about the costs, it is difficult to see how one could feel comfortable proceeding by pretending that nothing was learned. Some degree of pause is warranted.

**C. Valpak's Analysis Centers on the Groups of Categories Now Designated as Products. Because These Products Are Not Aligned with Markets or Users, Any Analysis Based on Them Is of Limited Value.**

Valpak's analysis centers predominantly on the Standard Flats product. It is composed of Commercial and Nonprofit categories, each with automation and non-automation categories, and each of these with four tiers of sortation, but it does not include the categories of Carrier Route or High-Density. ACMA has explained that catalog mailers use the Commercial categories of Standard Flats and the Commercial flats categories of Carrier Route and High-Density, variously,<sup>9</sup> just as do most

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<sup>7</sup> See *particularly* ACMA's Comments in Docket No. R2013-1, November 1, 2012, at 4.

<sup>8</sup> The basics of Valpak's model are presented on pages 80-107 of its comments.

<sup>9</sup> Catalogs may be the largest identifiable segment of flats in Standard Mail, but there are undoubtedly others, including segments in letters. ACMA supports identifying these segments

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Commercial flats mailers generally. So it is clear that there is no relation between Standard Flats as a product and catalogs as a market.<sup>10</sup>

To an extent that varies by mailer, Standard Flats is residual to Carrier Route, and High-Density is an extension of Carrier Route. The Postal Service links Standard Flats with Carrier Route in pricing.<sup>11</sup> Valpak alludes to this linkage and simply says that the Postal Service has not explained it (at 84, n. 66). But, as the PAEA recognized,<sup>12</sup> the Postal Service should be presumed to have some insight on such matters.

ACMA has also explained that grouping Nonprofit with Commercial adds to the non-coherence of the category and to the difficulty of interpreting results on it. It is much like saying that the average height of a population is five feet and six inches, when half of the people are four feet tall and the other half are seven feet tall. Valpak refers to the Nonprofit “discounts,” as part of the Universal Service Obligation (at 12). Valpak’s model is designed to maximize the contribution of the Nonprofit mail, along with that of Commercial mail. ACMA is not convinced this is how Nonprofit mail should

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and tailoring pricing, promotions, and service to them. We believe this would improve the effectiveness and viability of the Postal Service.

<sup>10</sup> According to the Preliminary RPW report for Quarter 1 of FY 2013, filed with the Commission on February 13, 2013, the volume of Carrier Route is about twice that of Standard Flats, even though the latter has four presort tiers and a greater proportion of Nonprofit. Also interesting is that, on a SPLY basis, Carrier Route grew 18.4 percent and Standard Flats declined 4.1 percent.

<sup>11</sup> See Postal Service Notice of Market-Dominant Price Adjustment, Docket No. R2013-1, October 11, 2012, at 24.

<sup>12</sup> See Dissent in Part of Commissioner Taub, Order No. 1541, Docket No. R2013-1, at 4 (“Within this spectrum [of lawful rates], the Postal Service is responsible for selecting the set of rates which, in its judgment, is most consistent with its statutory mission.”).

be viewed; it is more like minimizing the benefit than providing it according to Congressional intent. Changing product definitions would help.

**D. Valpak's Pricing Model Is Not Ready for Prime Time.**

Valpak advocates the use of, and relies heavily on results drawn from, a simple pricing model that juggles the six designated products in the Standard class, although the approach could be applied in any class with more than one product.

Basically, the model sets out a column of possible prices for each of the six products, and then, using own-price elasticities and the current values for price, cost, and volume, calculates a contribution for each possible price. As a way to maximize the class-wide contribution, it selects a set of marginal leakage fractions that corresponds to the level of the price cap, the same fraction for each product.<sup>13</sup> Persons familiar with the Ramsey analyses presented in earlier Commission proceedings will recognize the approach immediately.<sup>14</sup>

The Valpak model has a number of weaknesses and limitations. These are:

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<sup>13</sup> For immediate purposes, Valpak accepts a constraint of no rate decreases, so selects leakage fractions only for the two products whose revenues are below reported costs. It is a relatively simple matter, however, to extend the model to include rate decreases and to do a full maximization.

<sup>14</sup> See, for example, Testimony of Bernard Sobin, MOAA-T-3, Docket No. R87-1, September 14, 1987, at 9. The leakage fraction is the proportion of additional cap space used on a product that is not turned into additional contribution, because of volume loss. The fractions are usually expressed in percentage form and must be calculated at the margin. Valpak chooses to display the complement to the fraction, which might be called the realization fraction, to the same end. Valpak calls it the "Contrib./dollar of allowable revenue," appearing to give it units of dollars. One might say, for example, that \$100 of cap space was used to increase the price of a product further, and 69 percent of it was realized, meaning that the contribution increased \$69. Alternatively, the leakage fraction would be 31 percent.

1. Valpak applies elasticities using percentage changes based on the *current* price and volume, which implies linear demand curves.<sup>15</sup> It would be better to do arc calculations,<sup>16</sup> which imply a degree of non-linearity, and better still to move volume along a constant-elasticity curve. Doing the latter would be consistent with the way the Postal Service developed the elasticities Valpak uses.<sup>17</sup>

2. For the Standard class, the elasticities available leave much to be desired. The Postal Service develops four elasticities:

- (1) Regular Commercial,
- (2) Regular Nonprofit,
- (3) ECR Commercial, and
- (4) ECR Nonprofit.<sup>18</sup>

Valpak uses *only* the two Commercial elasticities, and links them to the six products.

All Standard Letters, Flats, and Parcels, Commercial and Nonprofit, excluding all ECR, are assumed to have the Regular Commercial elasticity.

All Carrier Route, High-Density, and Saturation, letters, flats, and parcels, Commercial and Nonprofit, are assumed to have the ECR Commercial elasticity.

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<sup>15</sup> Valpak notes that the elasticities may not apply to large rate changes (at 18-19). It does not discuss tipping points, although we believe they are possible. See the Postal Service saying that “above-average price increases ... could have the inadvertent effect of sending the Flats product into a tailspin” (Notice at 22, Docket No. R2013-1, October 11, 2012). In regard to First-Class, Valpak notes a downward trend and says demand may become “increasingly elastic” (at 15, n. 14). Valpak discusses downward spirals four places (at 7, 19).

<sup>16</sup> See “The Concept of Arc Elasticity of Demand,” R.G.D. Allen, *The Review of Economic Studies*, Vol. 1, No. 3, June, 1934, p. 226.

<sup>17</sup> Making things tenuous, the Public Representative notes that “own price elasticities are not known for Standard Mail Flats separately” and reasons that “the Standard Mail products might become more elastic in the near future” (Comments at 34-5).

<sup>18</sup> Some of these terms are now seldom used. “Regular” refers to non-ECR, including letters, flats, and parcels. “ECR” refers to a grouping of Carrier Route, High-Density, and Saturation, including letters, flats, and parcels.

ACMA has evidence that the elasticities of Commercial catalogs are higher, perhaps much higher, than those of letters and other flats. Valpak thinks the elasticity of Saturation and High-Density are higher than that of Carrier Route (at 80). It would be much better to redefine the products and have applicable elasticities for them.

3. Valpak's model does not recognize any effects from cross-elasticities to other Standard products or to non-Standard products, the latter often referred to as multiplier effects. ACMA understands that values for these elasticities are not available, but that does not mean that they are all zero or that their existence is not understood. In fact, ACMA believes some of them are significant. The Postal Service would be expected to consider such influences.

4. Valpak's model has no provision for recognizing the value, ECSI or otherwise, of the included products. When similar analyses were presented in earlier proceedings to implement Ramsey notions, there were proposals to adjust the leakage fractions in order to provide a systematic, quantifiable way to recognize statutory values not recognized automatically by the Ramsey model.

5. Perhaps the most important limitation of the Valpak model, indeed a fatal limitation, is that it relies strongly on the reported costs to quantify how the costs vary with volume. For example, if the reported cost is 10 cents per piece, Valpak takes it that a volume increase of 3 pieces will increase total costs by 30 cents. ACMA has explained that this behavior does not apply under conditions of excess capacity, because: additional volume can be handled without additional cost and a decline in volume does not allow cost reductions beyond those resulting from on-going tightening efforts. Under these conditions, the information provided by Valpak's model is useless. That the path to changing the costs involves a rulemaking docket does not ipso facto make the costs useful.

ACMA recognizes that the Commission must have a set of costs when it performs compliance reviews and that the Postal Service must have a set of costing steps that it knows it can use when preparing compliance reports. However, we believe

there may be times when there is good reason to believe that the costs available are seriously flawed, but alternative costs are not available. Under these conditions, which we believe exist now in considerable degree, it is difficult to see that highly questionable costs should be employed as if they were not questionable. Certainly this circumstance should be given weight in evaluating cost coverages.

Valpak advocates that the Postal Service be pressed into using its model, or perhaps a modified version of it, along with available costs, as the principal guide for establishing relative rates, much as advocates of Ramsey pricing once advocated relying on a quantification of Ramsey notions. We see the model and its inputs as much too rough and far too limited to play such a role.

#### **E. CONCLUSION.**

According to the CRA filed in this docket (USPS-FY12-1), the cost coverage of Standard Flats and Carrier Route combined is 99.81 percent. It would go higher if High-Density *were* included and higher still if Nonprofit *were not* included, at which point it would align reasonably well with the flats sent by catalog mailers. As a type of mail that accounts for a substantial and identifiable portion of the flats in the Standard class, catalogs cover their costs, even as reported now; they do not fall short. They are not being subsidized and the rates for them are fair. The Postal Service should be given some freedom to design rates for catalogs, an assignment for which the PAEA views it as well suited.

At great length, Valpak documents that the Postal Service's financial position is precarious. Then it explains that if the charges for the Retiree Health Benefits Fund are omitted, to obtain operating income, the cumulative net income for the last six years is

negative in the amount of only \$9 billion, and paints a picture that nearly all of this could have been avoided by increasing rates up to the level of reported costs for products whose rates are not that high. But, as ACMA explained in Section A and as Valpak's own model shows, this is decidedly untrue.

With the picture painted anyhow, Valpak proceeds to focus on a simple model based on existing product categories (even though they lack coherence and don't relate to markets), uses the costs as reported (which ACMA has explained are excessive and are not really volume variable), adopts elasticities that don't really apply and that likely do not represent reality, fails to make constant-elasticity volume adjustments (which would be consistent with the way the Postal Service developed the elasticities), neglects cross-elasticities and multiplier effects (which undoubtedly exist even if values for them have not been developed), fails to provide a way to recognize the relative values of the mail in the categories, and shows, based on all this, that the overall contribution might be increased somewhat by adjusting upward the rates of some low-coverage products and reducing the rates of some others, but only if the model is indicative. Valpak provides this model to the Postal Service for consideration. But there is more to pricing than a model.

Pricing models have been considered in a number of dockets. In regard to Ramsey analyses, the Commission: (a) expressed concern about "the broad confidence intervals of the price elasticities" in Docket No. R87-1 (Rec. Dec. at 373), a concern that exists here; (b) reasoned that the Ramsey models require efficient costs as inputs in Docket No. R97-1 (Rec. Dec. at 241ff.), another concern that exists here, but for somewhat different reasons; (c) explained that "[e]conomic efficiency is neither the

exclusive nor even the paramount ratemaking objective under the Act” in Docket No. R2000-1 (Rec. Dec. at 210), objectives we understand the PAEA has shifted essentially to the Postal Service; and (d) referred again to “price elasticity estimates of doubtful accuracy and robustness” in Docket No. R2006-1 (Rec. Dec. Appendix I at 11).

Other guidelines have been suggested as well. One is the Efficient Component Pricing Rule, commonly ECPR, which depends critically on movements caused by cross-elasticities. Another is that firms shouldn’t raise prices on their most profitable products. This one seems to sound nice and may be the outcome in some cases, but if one is trying to formulate a general rule, this may not be it. Still another is that relatively elastic products should always get relatively small rate increases, but that is not always true. A maximization theory might suggest this for some sets of cost coverages and elasticities, but not for others. Concern would always center on the meaningfulness of the inputs to the model.

All of this advice presents difficulties, and none of these matters are simple. The Postal Service should have leeway to develop rates for the various categories, just as it must manage other aspects of its operations.

Respectfully submitted,

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