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WASHINGTON, DC 20268-0001

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Annual Compliance Report, 2013	)	Docket No. ACR2013
	)	

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
REPLY COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2013 ANNUAL COMPLIANCE REPORT
(February 18, 2014)

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INTRODUCTION

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. ("Valpak") submitted Initial Comments on January 31, 2014, and submit the following Reply Comments with respect to the Initial Comments filed by certain other commenters, as well as the Postal Service Responses to Chairman's Information Requests filed after the deadline for filing Initial Comments.

This docket again demonstrates that fewer and fewer parties are filing comments in Annual Compliance Reviews. The Commission should consider whether the Annual Compliance Reviews are serving the purpose for which they were intended by Congress.[1]

Valpak has participated actively in Commission dockets for nearly 19 years. Valpak has submitted comments in each annual compliance review under the Postal Accountability and Enhancement Act ("PAEA"). As the Commission well knows, Valpak is a heavy user of Standard Mail, primarily the High Density/Saturation Letters product, which had one of the highest cost coverages of any product in FY 2013 — 235.8 percent. Valpak Dealers' Association, Inc. is an association of about 175 independently owned franchises across North America, assisting more than 50,000 small business advertisers in promoting their products and services. Valpak's annual volume has declined in recent years, to 466.0 million pieces in 2012, of which approximately 93 percent is at the saturation rate, and over 99 percent of which is SCF-entered. Valpak has continued its involvement in this annual review process in the hope and belief that the Commission will act aggressively to do its job to require the Postal Service to follow the pricing mandates of Title 39.

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[1] United Parcel Service ("UPS") notes that lack of transparency has made it difficult for parties to comment on competitive products. UPS Initial Comments, pp. 8-14.

I. American Catalog Mailers Association

A. Advertising Matter in Catalogs Has No Special Value in Comparison to Other Standard Mail Advertising Matter.

In an effort to urge the Commission to sanction of continued underwater pricing of Standard Flats, American Catalog Mailers Association ("ACMA") again contends that catalogs are positively magical — they represent something special, something unique, something different from and better than other forms of hard copy advertising. *See* ACMA Initial Comments, p. 1. This argument flies in the face of the reality that almost all Standard Mail is advertising, of one sort or another, regardless of the specific method of advertising used. No form of advertising entered as Standard Mail has more, or less, value than other forms of advertising mail. No type of Standard Mail should be lavished with cross-subsidies extracted from some advertisers to benefit other commercial firms using other forms of hard-copy advertising. And no type of Standard Mail should be penalized by being required to pay such cross-subsidies. At times, some companies choose to use catalogs, some use coupons, some use fliers, some use product samples, and some use multiple forms of hard copy advertising media.

What the Commission recognized in its FY 2010 ACD, and must remember again now, is that Title 39 is intended to prevent Postal Service pricing from establishing postal rates that are not "**fair and equitable**." 39 U.S.C. § 101(d) (emphasis added). Moreover, the Postal Service may not give "**undue or unreasonable preferences**" to one type of Standard Mail advertising and impose "**undue or unreasonable discrimination**" against another type of Standard Mail. 39 U.S.C. § 403(c) (emphasis added). (Valpak's Initial Comments address numerous provisions in Title 39. *See* n.23, *infra*.) Yet this is exactly this type of unlawful pricing that ACMA is asking the Commission to sanction.

That having been said, and at the risk of following ACMA down a rabbit hole, these reply comments address a few of the arguments raised by ACMA, lest silence be mistaken for acquiescence.

1. ACMA asserts:

> Catalogs make a wide range of goods and services available, many of which are difficult to find. [ACMA Initial Comments, p. 1.]

Many if not most catalogs, especially those that are widely distributed, offer for sale a wide range of common, relatively easy-to-find items for which there exists a mass market. As to locating "difficult to find" products, ACMA may have been correct about catalogs 10-15 years ago. However, today, if one were searching for such an obscure product, few would conduct a search by locating and thumbing through a pile of catalogs that might have been saved in a pile in the corner for a moment such as that. Obscure and difficult-to-locate goods and services are both easier and far faster to find by Internet search.

2. ACMA continues with the statement that:

> [Catalogs] provide information, are valued by recipients, and often serve as resource documents. [*Id.*, p. 1.]

Those who respond to a catalog presumably find value in the "information" provided by the catalog, just as many people find value from discounts enabled by the coupons enclosed in Valpak envelopes. (If there must be a comparison, coupons also "make a wide range of goods and services available," and they generally do so at a reduced rate — arguably providing greater "value" to the recipient than does a catalog.) ACMA's claim that "[catalogs] often serve as resource documents" is both unexplained and unsupported by any data. Of course, even if true, this does not justify forcing competitors to cross-subsidize ACMA's mailings. Congress certainly has not authorized this type of undue preference.

In truth, catalogs are just another form of hard copy advertising — nothing more, nothing less. For some merchants, catalogs are preferred. Other merchants prefer coupons distributed by Valpak (as well as others), or other forms of hard copy advertising. Despite ACMA efforts to persuade the Commission that its catalogs are the cat's meow, nothing in ACMA's comments override Title 39 to justify the failure to cover attributable costs plus contribute to institutional costs.[2]

B. Linkage to Other Mail Categories Is Both Unproven and Irrelevant to Pricing Decisions for Postal Products.

ACMA states that:

> Catalogs are a major component of the Standard Mail class, and they are linked to other mail categories. [*Id.*, p. 1.]

Beginning with the second part of this claim, this asserted "linkage" to other mail categories is unexplained.[3] From time to time, ACMA has alluded to some use of First-Class Mail for

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[2] For further elaboration concerning this aspect of ACMA's argument, *see* Docket No. ACR2012, Valpak Reply Comments, Section II-F, pp. 33-35.

[3] Subsequently, ACMA discusses what it calls "repercussions," and explains "[i]n Postal proceedings, these repercussions have been called, for the most part, multiplier effects." *Id.*, p. 7. Multiplier effects generally refer to usage of one product generating revenue for other products, often products in other classes.

placing orders, bill payments, complaints, etc., but ACMA fails to address pertinent questions raised by this assertion, such as:

- What percentage of catalog orders is placed by mail, compared with the Internet or telephone?

- What percentage of catalogers' sales is on credit, with an invoice subsequently mailed to the purchaser, as opposed to payment by credit card or debit card at the time the order is placed?

- Of those sales that are shipped on credit and followed by an invoice, what percentage is paid through the mail (*i.e.*, by check)?

- With respect to order fulfillment, ACMA ignores how many catalogers ship goods via FedEx or UPS rather than the Postal Service.

A footnote (n.1) says that ACMA possesses an unpublished "Survey of Member Mail Use, 2012." ACMA makes speculative assertions based on oblique references to an undocumented and unpublished survey. ACMA does not say if that survey included basic questions concerning mail usage, such as those raised above, and does not proffer any pertinent information about catalogers' "linkage" to other mail categories.

However, it would not matter even if ACMA offered proof rather than speculation to revive its multiplier argument. The Commission has ruled that profitability and pricing of each postal product must be evaluated independently — *i.e.*, profits from a portion of some products cannot be deducted from that product and included in another product nor, of course, can such profits be double-counted. In rejecting the ACMA multiplier effect, the Commission analyzed the claims and ruled definitively: "Each product must be evaluated using its own revenues and attributable costs." FY 2010 ACD, p. 93. ACMA has offered no legal or factual reasons for the Commission to reconsider this ruling.

With respect to that part of ACMA's statement which says "Catalogs are a major component of the Standard Mail class," Valpak would not disagree. But it is also true that, because of unlawful pricing practices, catalogs entered as Standard Flats are a major component of Postal Service losses each and every year. *See* Valpak Initial Comments, p. 46. Moreover, all catalogs constitute a share of Standard Mail that is far too large and far too important to be exempted from the requirement that they make a significant contribution to pay the Postal Service's large pool of non-attributed costs. Ever dollar forcibly given to catalogs as a cross-subsidy is extracted from another mailer, such as those that send coupons. Every dollar that catalogs do not contribute toward institutional costs must be extracted from another mailer. And, as UPS notes in its Initial Comments (p. 2), this pool of non-attributed costs has grown to 46 percent of total costs, and now amounts to some $33 billion each year.

C. ACMA's Renewed Assault on the Definition of Standard Mail Products Is Unavailing.

For the past several years, ACMA has been highly critical of the way products in Standard Mail are defined. In each docket, ACMA suggests various floating, chameleon-like definitions that can be adapted to whatever argument suits its immediate purpose. ACMA's Initial Comments in Docket No. ACR2013 continue ACMA's perennial assault on Postal Service-recommended, and Commission-approved, product definitions, as follows:

> Except for small mailers, Standard Flats is **a declining category of residual mail** … As defined, then, Standard Flats is an **odd concoction**. It is composed of mail that, due to volume limitations, cannot be presorted more finely than a 5-digit area,

> **as though the notion of a 5-digit area were pertinent. The notion is not. Five-digit areas vary significantly in terms of geographic size, population, demographics, and affluence,** the latter factor being an important volume determinant. Viewed another way, Standard Flats is composed of mail that simply cannot reach the 10-piece threshold for Carrier Route. In short, **the definition of the Standard Flats product is not particularly meaningful.** [*Id.*, pp. 3-4 (emphasis added).]

Every class of mail has what could be called a "residual" category, with a higher unit cost.[4] For example, in First-Class Mail ("FCM"), single-piece stamped mail is the residual category. Like Standard Flats, the volume in that FCM residual category also happens to be declining. Applying ACMA's analysis to FCM, one would conclude that FCM single-piece stamped mail is an "odd concoction." However, this does not mean that FCM single-piece stamped mail is not a legitimate, separate product with its own separate price — indeed, unlike Standard Flats, it is one that comfortably exceeds its unit cost.

ACMA questions the significance of "the notion of a 5-digit area." The "notion of a 5-digit area" is highly relevant to the Postal Service's mail processing and transportation schemes. And it is highly relevant to all those advertisers who engage in and rely on ZIP Code marketing strategies, including vast numbers of mailers who use the various products in Standard Mail.

ACMA's statement that "the definition of the Standard Flats product is not particularly meaningful" implies that "catalogs are catalogs" regardless of the condition in which they are

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[4] ACMA appears particularly disdainful of the notion that "residual mail" is meaningful to the Postal Service, but the Postal Service must accept relatively unpresorted residual mail from point of entry and provide it additional intermediate sortation, as well as transportation, including delivery to addressees, all of which are expensive.

entered into the mail, and any distinction between otherwise identical catalogs is nonsensical. Actually, it would be more accurate to say that "Standard Flats are Standard Flats," regardless of whether they are catalogs or not, and treating catalogs entered as Standard Flats differently from other Standard Flats prepared and entered in the same manner would be nonsensical.

ACMA fails to acknowledge that the existing product definitions facilitate achievement of "lowest combined cost," as between catalogers and the Postal Service. As is its custom, ACMA swings wildly, but offers no proposal, constructive or otherwise, for what it considers a better definition for all products within Standard Mail.[5]

ACMA's fulminations about the Standard Flats product presumably are designed to lay a foundation for the following statement:

> ACMA's position … is that special **concern about the level of the rates** for Standard Flats **is not warranted by the cost coverage.** … This schedule includes Standard Flats, Carrier Route, and High-Density, **whose differences are not based on meaningful criteria,** have been **eroded by DPS processing**, and are now being eroded further by FSS processing. [ACMA Initial Comments, p. 4 (emphasis added).]

ACMA asserts that differences between various products used by catalogers (in terms of sortation, transportation, and other costs the various products impose on the Postal Service) "are not based on meaningful criteria." However, ACMA makes no effort to explain why the established criteria, which distinguish the different products, are not meaningful to postal operations. Nor does ACMA suggest even one criterion that would be more meaningful for all Standard Mail.

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5 For further discussion of ACMA's earlier attack on the definition of Standard Mail products, *see* Docket No. ACR2012, Valpak Reply Comments, Section II-A, pp. 9-13.

ACMA's statement that "DPS processing [is] now being further eroded by FSS processing" (*id.*) is incomprehensible, for FSS processing is basically DPS processing for flats.

Finally, ACMA lands on something that is correct. It states:

> Despite all the discussion on the FSS and its implications, it is important to remember that **the vast majority of flat mail for the foreseeable future is not destined to be DPS'ed on the FSS.** [*Id.*, p. 4, n.6 (emphasis added).]

This statement reveals ACMA's belief that, for the foreseeable future, manual processing by carriers will continue. This is a highly significant statement, as it is ACMA's admission that there would be no legitimate basis for the Commission to anticipate any significant cost reduction in handling Standard Flats into the future. In the past, the Commission has eschewed exclusive reliance on price increases to bring Standard Flats up to full cost coverage, anticipating that cost savings were just around the corner. But now ACMA freely admits that any such hopes are unrealistic. Valpak agrees. **The only logical conclusion of ACMA's position is that the problem of underwater Standard Flats can only be solved by a large price increase ordered by the Commission, which should do so without further delay**.

D. ACMA's Arguments Illustrate just how Little Catalogs Contribute to the Postal Service's Huge and Growing Overhead Costs.

After rejecting existing distinctions between Standard Mail **products** as meaningless, ACMA selects what it terms "**categories**" that better suit its immediate purposes to defend its subsidy:

> Nevertheless, **Commercial** flats as a category is "above water." The cost coverage for Standard Flats and Carrier Route **combined**, without Nonprofit, is 114.0 percent, and even with pull-down from **Nonprofit** is 105.0 percent. [*Id.*, pp. 4-5 (emphasis added).]

ACMA continues to blame its problems in large part on the existence of **nonprofit mail**. However, by law, nonprofits are allowed to use any product in Standard Mail, and every product in Standard Mail includes some volume of nonprofit mail. 39 U.S.C. § 3626. And despite this legal burden, revenue earned from other products in Standard Mail (including Carrier Route) not only makes up for the low nonprofit rate, but also makes a significant contribution. That is, revenue from what ACMA refers to as the "commercial" portion within each product always exceeds the nonprofit portion by a substantial margin. The law requires that nonprofit rates be lower than the commercial rate, which means that, within every Standard Mail product, coverage on the commercial mail portion necessarily will be higher than coverage for the entire product. ACMA does not explain, either here or elsewhere, why its artificial "commercial" flats "category" would be legal, or why it represents a distinction worthy of special recognition by the Commission. ACMA never explains any legal or other basis for preferential pricing for Standard Flats.

ACMA postulates that a "category," consisting of (i) Commercial and Nonprofit *Carrier Route* flats, and (ii) Commercial and Nonprofit *Standard* flats, would pay a combined positive coverage of 105 percent.[6] This hypothesis is designed to support the ACMA demand for continued, massive cross-subsidizing by arguing that catalogs are not truly underwater. The volume in this "category" is sizeable (15.1 billion pieces in FY 2013), and constitutes a major share of the entire Standard Mail class. Even looking at this artificial "category," it begs the question how long the Postal Service could survive with such a low coverage on such

[6] Compare this low cost coverage to the systemwide average for FY 2013 of 166 percent.

a large volume of Standard Mail. This, of course, is of no concern to ACMA, which simply wants to keep its subsidy. However, it should be a highly pertinent consideration to the Postal Service, the Commission, and indeed any party interested in forestalling another liquidity crisis and another exigent rate increase on profitable mailers. The first way to improve that 105 percent "average" is to increase coverage of the bottom tier — Standard Flats.

ACMA states "special concern about the level of rates for Standard Flats is not warranted by the cost coverage." ACMA Initial Comments, p. 4. However, ensuring that institutional costs are paid, fairly and equitably, in FY 2013, total attributable costs amounted to $39.2 billion, while total costs (excluding the $5.6 billion for RHBF) amounted to $66.7 billion. To help put ACMA's desired "category" coverage of 105 percent in perspective, **if the Postal Service imposed a 5 percent coverage on its total attributable costs of $39.2 billion, it would suffer an annual shortfall of $25.6 billion**. The specter of such a prospect should help explain why the Postal Service needs an immediate and substantial increase in the coverage on Standard Flats so as to eliminate the annual drain on contribution from that source. Moreover, such an increase would be fully consistent with representations made by the Postal Service to the federal circuit court in the appeal from Docket No. ACR2010 with respect to Standard Flats rates:

> The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it. [Brief of the United States Postal Service at 34, U.S. Postal Service v. Postal Regulatory Commission, No. 11-1117 (D.C. Cir. Oct. 7, 2012).]

E. Even Revenue from "Commercial" Flats Fails to Cover Attributable Costs.

ACMA does acknowledge that:

> Even without bringing in Carrier Route, the cost coverage for Standard Flats is 84.9 percent.... [*Id.*, p. 5 (emphasis added].]

Here, ACMA acknowledges that revenue from the Standard Flats clearly does not cover its attributable costs, using percentages, but **it never even once in its comments mentions** the existence of or consequence to the Postal Service of its pricing being underwater — **a $380 million loss** in FY 2013.

If the Commission allows pricing that generates such a loss, it must address who would pay that subsidy. The Postal Service has no surplus on its balance sheet, and no longer has any borrowing capacity. Therefore, the shortfall on Standard Flats inevitably must be paid from some other source. That means payment by users of other mail products. In the short run, especially for pricing adjustments limited by the price cap applied at the class level, it generally means other Standard Mail products. Over the longer run, of course, the almost inevitable cumulative effect of losses on underwater products is a liquidity shortfall. At that point, the short run catches up with the long run. Then, as recent history so well illustrates, after the Postal Service obtains an exigent rate increase applicable to all products in all classes, users of mail products in other classes also will be forced to contribute to the cumulative shortfall.[7] As recent experience has proven, **the price cap does not protect other mailers**

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[7] The result of a cumulative shortfall in contribution and the resulting liquidity crisis that forces other mailers using profitable products to cross-subsidize Standard Flats could be said to represent a "multiplier effect" which perversely links catalogs and Standard Flats to all other products in all classes.

from the long-run cumulative effect of bad Postal Service pricing decisions, a fact which Valpak has repeatedly pointed out. *See* Valpak Initial Comments, p. 48.

F. A Coverage of 84.9 Percent Should Not, under Any Circumstances, Be Described as a Favorable Outcome.

In its desperate effort to put a good face on what only can be regarded as a deplorable situation, ACMA introduces rank speculation that:

> The **coverage of 84.9 percent** is an average for the year. If the **trend during the year** was upward, as we believe it was, the coverage at year end was in all likelihood higher than the average. **This is a favorable outcome**. [ACMA Initial Comments, p. 5 (emphasis added).]

A coverage of 84.9 percent is **not** a favorable outcome, and statements such as that of ACMA above go beyond complacency. Giving deference to ACMA's pure unsupported speculation that "the trend during the year was upward" would be irresponsible. Under Title 39, and acting as fiduciaries for mailers, neither the Postal Service nor the Commission can continue to allow coverage for the Standard Flats product to continue at such an abysmally low level.

G. After Railing Against Nonprofit Mail in the Standard Flats Product, ACMA Asks for Lower Rates Because of It.

In an interesting twist, after pointing to nonprofit mail as a principal source of the low coverage of Standard Flats, ACMA uses the presence of nonprofit mail to argue that the price and coverage of the Standard Flats product should not be increased. ACMA states that since the Standard Flats product includes both commercial and nonprofit mail, increasing the coverage of all Standard Flats would result in an increase in the rate for nonprofit Flats.

> Note also that focusing on the cost coverage of Standard Flats, including Nonprofit, puts nonprofit organizations in an unfavorable and disadvantaged position. Specifically, … if there

> is **any interest in keeping the cost coverage up, the greater the increase in rates they experience.** In a sense, success brings about a penalty. It seems doubtful that Congress intended this kind of dynamic. [*Id.*, p. 5 (emphasis added).]

What ACMA fails to point out is that restraining the coverage on Standard Flats to less than 100 percent, as the Postal Service persists in doing, forces an increase in the coverage on other Standard Mail products — including the rate paid by nonprofit mail within those other products. ACMA never even argues that Congress cares only about the rate for only one particular Standard Mail product used by nonprofit mailers.

H. ACMA's Arguments about Abolishing Mail Categories Obscures the Fact that Best Pricing Strategy Requires Increasing the Price of Flats.

ACMA rhetorically poses the hypothetical question:

> So, if the subsidy question is to be asked, and a product offering is to be removed to see the effect on profits, exactly what product offering should be removed? [*Id.*, p. 7.]

In response to its own hypothetical question, and through a strained chain of reasoning, ACMA decides that the profitable Carrier Route product must be abolished along with Standard Flats, and replaced with a combined "category" with a coverage of 105 percent. Consistent with its predilection to rearrange product definitions to suit its immediate purpose, ACMA postulates "therefore, no subsidy exists." *Id.*, p. 8. By framing the issue this way, ACMA implicitly claims that the subsidy to Standard Flats is being paid directly and only by the Carrier Route product. That reasoning suits ACMA because it would give Standard Flats a free ride — which is ACMA's sole desired end. ACMA concludes with the statement:

> Where does this leave the question of the cost coverage for Standard Flats, 93.9 percent and gaining, without Nonprofit? It

> is left [that] … there is no subsidy that needs to be fixed. [*Id.*, p. 9.]

Although fundamental problems arise from ACMA's redefinition of products to suit its immediate end, none is addressed. First, its combined "category" is not a recognized product and is antithetical to the Commission's determination that "Each product must be evaluated using its own revenues and attributable costs." FY 2010 ACD, p. 93. Second, it totally ignores what the Postal Service recently represented in federal court:

> The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it. [Brief of the United States Postal Service at 34, U.S. Postal Service v. Postal Regulatory Commission, No. 11-1117 (D.C. Cir. Oct. 7, 2012).]

The need to increase contribution, not reduce it, should be obvious to anyone who is even remotely familiar with Postal Service finances, but the Postal Service has a blind spot in applying this goal when it comes to Standard Flats, and ACMA urges the Commission to embrace the same blind spot.

ACMA seems to enjoy framing issues in the form of rhetorical hypothetical questions posed to itself. However, its discussion about eliminating all flats, including profitable Carrier Route, seems designed to avoid the rather obvious question: Instead of **eliminating** all mail in this huge "category," why not significantly **increase the price** of Standard Flats to improve contribution? The answer, which ACMA does not care to entertain, is that increasing the price and reducing some of the money-losing volume in the Standard Flats product would do the most to increase contribution, which is exactly what the Postal Service needs to do at this time in its history. If the Postal Service has a blind spot and does not understand this, the responsibility to protect Postal Service finances from illegal and irresponsible pricing must be borne by the Commission.

I. ACMA's Criticism of the Cost of Flats Again Presumes Unproven Excess Capacity.

ACMA renews its perennial challenge to the validity of Standard Flats costs. The following statement contains the essence of its arguments regarding costs:

> Following a **volume decrease,** it is likely that **resources are not yet adjusted, resulting in excess capacity,** even in inputs that are normally viewed as variable. The algorithms then attribute the **costs of this excess capacity**. Again, the costs are inefficiently high and not causal in the desired sense. Here, however, as opposed to the case of a volume increase, the inefficiency may exist for some time, and it could be added to the next year. [*Id.*, p. 10 (emphasis added).]

ACMA's statement that there exists a decrease in the total volume of flats needing to be processed is not supported by RPW data.

Table I-1
Volume Trends, Selected Standard Mail Products

	FY 2012	FY 2013	Change
Carrier Route	9,119,946	9,507,247	387,301
Standard Flats	5,939,635	5,568,019	-371,616
Total	15,059,581	15,072,266	15,685

Source: RPW data

Although the volume of Standard Flats decreased during FY 2013, Carrier Route volume increased by an amount that was slightly more than the decrease in Standard Flats volume. Thus, ACMA bases its argument on an error relating to volume changes. Consequently, contrary to ACMA's implications, there is no reason to perceive upward pressure on costs because of some lag in resources "not yet adjusted." The above data demonstrate that the volume of flat-shaped Standard Mail was relatively healthy in FY 2013. The data also indicate that in FY 2013 the volume of profitable Carrier Route increased while the volume of underwater Flats decreased — which is precisely the sort of trend that price adjustments should do more to encourage.

ACMA does not stipulate whether claimed excess capacity applies to labor, or plant and equipment, or both.

1. Labor Excess Capacity. ACMA may want to imply the existence of a large, inflexible labor force that for some unexplained reason is sent off to work Standard Flats, as a way to keep unnecessary workers occupied. ACMA ignores the fact that size and composition of the postal labor force have undergone significant change during the last two years.

Table I-2

USPS Workforce Breakdown

	2013		**2012**		**2011**	
	Employees	% of Total	Employees	% of Total	Employees	% of Total
Career	491,000	79%	528,000	84%	557,000	86%
Non-career	127,000	21%	101,000	16%	89,000	14%
Total	618,000		629,000		646,000	

Source: 2013 Report on Form 10-K, p. 29.

As shown in Table I-2, the Postal Service added 26,000 non-career employees during FY 2013, after adding 12,000 in FY 2012, while the number of career employees diminished by 66,000 over this same period. In years past, the Postal Service may have had too many career employees who could not be laid off, but the reduction in career employees alone goes a long way towards elimination of any possible excess labor capacity. Moreover, if the Postal Service still had any excess labor capacity in its career workforce in FY 2013, it would have had no reason to add so many non-career employees — *i.e.*, hiring all these non-career employees is a strong indication that allegations of excess labor capacity as a contributor to high unit flats costs is simply a red herring, designed to divert attention from the fact that revenues from Standard Flats are still a long way from covering their attributable costs. The statement that "The algorithms then attribute the costs of this excess capacity" (*id.*, p. 10) is unsupported by any factual analysis pointing to the existence of excess capacity.[8]

[8] Reasons why manual flats processing does not reflect excess capacity was discussed in Valpak's Initial Comments, pp. 71-72.

2. Mail Processing Excess Capacity. ACMA's allegation of excess capacity may be intended to imply an inflexible network of mail processing facilities. However, between 2012 and 2013 Postal Service consolidation efforts resulted in reducing the number of plants and mail processing facilities in its network by 78, from 312 to 234 — a 25 percent reduction. 2013 Report on Form 10-K, p. 15. To the extent that those 78 facilities may have represented some excess mail processing capacity prior to being consolidated, ACMA fails to explain why those costs were disproportionately included in the unit cost of Standard Flats and not other products as well.

As a final note, ACMA again includes its cost index. That index indicates that the attributable unit cost of flat-shaped mail (as reported in the CRA) not only has increased disproportionately over the last 10 years, but also has not come down by any appreciable amount. This index confirms what is generally known about the unit cost of Standard Flats. Regrettably, the index offers no useful insight that might help explain and better understand the persistence of high unit cost for every category of flat-shaped mail that requires processing.[9] The only suggestion proffered by ACMA is "excess capacity," which is unsupported by any empirical evidence.

ACMA's final defense for continued underpricing of Standard Flats does not derive from any reason relating to costs, products, elasticities, capacity, or any economic principle. It simply concludes with the recommendation that:

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[9] *See* Valpak's Initial Comments, Table V-2, p. 65.

> the **Postal Service** should be accorded **flexibility** to select the various rate elements in the schedule of rates presented to flats mailers. [*Id.*, p. 10 (emphasis added).]

ACMA's recommendation to the Commission is to ignore the facts and the law and simply accede to "Postal Service flexibility to select the … schedule of rates." ACMA, like the Postal Service, asks the Commission to ignore all of the statutes violated by continued underwater pricing of Standard Flats because the Postal Service apparently likes to lose money on Standard Flats.[10]

Valpak urges the Commission to again reject the baseless claims of ACMA, and then take the next step required by its statutory responsibility to ensure lawful rates to the Postal Service, and order a remedy consistent with the decision of the U.S. Court of Appeals for the District of Columbia Circuit in Gamefly v. Postal Regulatory Commission,[11] that completely solves the unlawful Standard Mail rates the Commission itself has repeatedly found to exist.

II. Newspaper Association of America

Initial Comments filed by the Newspaper Association of America ("NAA") address the absence of Postal Service required reporting regarding the Valassis negotiated service agreement ("NSA"). NAA identified the seven categories of data that the Commission, in Order No. 1448, ordered the Postal Service to submit within 60 days of the end of each contract year. *See* Order No. 1448, p. 41.

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[10] The Commission designed the "modern rate making system" now in effect. Allowing unbridled pricing flexibility has led to the losses shown in Valpak's Initial Comments, Tables III-1 and III-2 (pp. 44-45).

[11] 704 F.3d 145, 149 (D.C. Cir. 2013).

Remarkably, the FY 2013 ACR contained virtually none of the information the Commission ordered to be reported, confining its entire discussion about that NSA to two sentences which almost completely disregard Order No. 1448:

> Valassis did not send enough NSA-eligible volume to qualify for volume discounts, and paid published rates during FY 2013. Therefore, there are **no further data to report**. [FY 2013 ACR, p. 38 (emphasis added).]

NAA's Initial Comments discussed that "The Commission is unable to fulfill its oversight responsibilities if the Postal Service fails to provide data required by Commission orders, including Order No. 1448." NAA Initial Comments, p. 4. NAA urged the Commission to require the Postal Service to submit the required data collection report as soon as possible.

The Commission should not accept in stride the Postal Service's failure to provide required information in disregard of Commission Order No. 1448. That failure certainly should demonstrate to the Commission that the Postal Service does not take the Commission's statutory role and regulatory authority seriously. The Commission should order the Postal Service to file the required data collection report immediately.

III. Pitney Bowes

A. The Disparity of Cost Coverage and Unit Contribution within First-Class Mail Amplifies the Even Greater Disparities with Standard Mail.

Pitney Bowes' Initial Comments focused on certain differences between two First-Class Mail products:

- First-Class Mail Single-Piece Letters/Cards, and
- First-Class Mail Presort Letters/Cards.

Pitney Bowes notes that a large **cost coverage gap** between the two products has existed every year since 2008 — but has now grown to **140.8 percentage points** (169.7 percent and 310.5 percent, respectively). PB Initial Comments, p. 2.

Pitney Bowes also described the significant disparity in **unit contribution** between the two First-Class products (24.6 cents and 19.1 cents, respectively) — a difference of 5.5 cents. Pitney Bowes contends that the "disparity in unit contribution and cost coverage cannot be justified." *Id.*

The problem in First-Class Mail issues raised by Pitney Bowes is not dissimilar to a problem that exists with respect to Standard Mail under current Postal Service pricing. In fact, the problem in Standard Mail is even more shocking, where a serious and unjust disparity also exists in the cost coverage between Standard Flats and High Density/Saturation Letters in the face of repeated Commission findings of illegal rates. *See* Valpak Initial Comments, pp. 5-6.

While the Postal Service's ACR touted a 4.0 percentage point increase in coverage for Standard Flats as constituting a significant improvement for Standard Mail pricing, it never admitted that the problem of intra-class disparity is actually worsening. In FY 2013, the cost coverage gap within Standard Mail between High Density/Saturation Letters and Standard Flats increased further — by 13.6 percentage points to **150.9 percentage points** — even higher than the difference between the First-Class Mail Single-Piece and Presort products pointed out by Pitney Bowes. Furthermore, the cost coverage for the High Density/Saturation Letters product is the **highest it has ever been under PAEA**. Fully 5 percentage points higher than its previous high in FY 2008, the cost coverage for Standard Flats has been reduced to 9.5 percentage points **lower** than it was in FY 2008.

With respect to unit contribution, Pitney Bowes complained of a difference of **5.5 cents** between the two First-Class products. However, the difference between the unit contribution between High Density/Saturation Letters and Standard Flats was an amazing **14.9 cents** in FY 2013 (positive 8.1 cents and negative 6.8 cents, respectively).

Also, Pitney Bowes' Initial Comments compared two profitable products within First-Class Mail. Within Standard Mail, by contrast, Standard Flats has perennially lost vast amounts of money, helping to bring on the liquidity crunch for the Postal Service which created the "necessity" by which the Commission determined that the price cap could be pierced. These losses have forced other profitable products to cross-subsidize Standard Flats, as perpetuated by the exigent price increase. As such, the problem that exists within Standard Mail is far more serious a violation of several provisions of Title 39 (identified in Valpak's Initial Comments, pp. 50-51, 75), including 39 U.S.C. § 101(d), because it allows the apportionment of institutional costs on an unfair and inequitable basis. The Commission must intervene and use its regulatory authority in this docket to completely remedy this pricing inequity quickly.

B. The Solution to Intra-Class Pricing Disparities.

Pitney Bowes explained that it is in the Postal Service's power and best interests to correct the unjustifiable disparity within First-Class Mail:

> Under the CPI price cap, the overall amount of revenue that the Postal Service can collect from First-Class Mail is limited, but the Postal Service can use its pricing authority to **increase the contribution** that revenue produces.... It should **lower prices on more profitable** Presort letters. Doing so would **increase the total contribution** from First-Class Mail by helping

> to retain and grow Presort letters. Recent elasticity data confirm this. [*Id.* (emphasis added).]

Here, Pitney Bowes presents a succinct summary of how rational and lawful pricing principles would be, as applied to First-Class Mail. Pitney Bowes is certainly correct that, by using more economically rational rates, the Postal Service could increase the total amount of contribution that is generated by revenue adjustments allowed under the price cap.

Pitney Bowes concludes: "A prudent response to the financial challenges currently facing the Postal Service would be to preserve and encourage the growth of its most profitable products." *Id.*, p. 2. Pitney Bowes could not be more correct. However, despite the Postal Service's representation to a federal court that its "goal at this time in its history must be **to maximize contribution**, not reduce it,"[12] the Postal Service continues to act at variance with that representation by underpricing Standard Flats at the expense of its bottom line — purportedly justifying unnecessary losses as part of some undefined "long-run approach." Indeed, the Valpak Standard Mail contribution maximization model (submitted Jan. 31, 2014) easily could be modified to apply to First-Class Mail, so as to identify rates which increase, even maximize, the contribution obtainable under a price cap regime.

As urged by Pitney Bowes, the Commission, as designer and keeper of the modern rate making system now in place, must reconsider its responsibility and role with respect to the survival of the Postal Service. That regulatory role cannot be limited to a "light-handed approach" that allows the Postal Service virtually unfettered "flexibility" with respect to

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[12] Brief of the United States Postal Service at 34, U.S. Postal Service v. Postal Regulatory Commission, No. 11-1117 (D.C. Cir. Oct. 7, 2012).

whether it will send correct price signals, seek economic efficiency, and become financially self-sustaining. The Postal Service must be compelled to follow the mandates of Title 39 or the Commission will not serve the function for which it was established.

IV. Public Representative

A. The Need for Improved Financial Reporting in the ACR.

The Public Representative's ("PR") Initial Comments begin with a discussion of the financial condition of the Postal Service. The PR notes that none of the financial information is found in the ACR, but rather: "One must look beyond the ACR for this information. The Integrated Financial Plan (FY2014 IFP) filed with the Commission on November 25, 2013 and the Form 10-K file November 15, 2013 contain that financial information." PR Initial Comments, p. 4. Although the PR questions the sufficiency of the Postal Service's reporting of financial information, it makes no recommendations.

Valpak agrees with the PR's analysis of the problem. Financial reporting is required by PAEA, but it is not expressly required in the 39 U.S.C. § 3652 Annual Compliance Report. *Compare* 39 C.F.R. § 3050.21 *with* §§ 3050.35, 3050.40. However, the Postal Service's financial health always should be a factor in the Commission's determination of compliance with the requirements being reviewed under 39 U.S.C. § 3653.

Furthermore, the way the basic annual financial information is presented by the Postal Service is not clear. It presents its revenues and costs in different ways in the Form 10-K, but in no way does it present a straight-forward table. For example, in the Postal Service's recent reporting of the results for the first quarter of FY 2014, the Postal Service claims it lost $354 million. *See* FY 2014, Q.1 Form 10-Q, p. 2. One must dig into the Form 10-Q to determine that the $354 million loss "includes $1.4 billion of expense accrued for the legally-mandated prefunding payment for retiree health benefits." *Id.*, p. 7. Of course, the Postal Service has no intention of making the annual RHBF payment of $5.7 required at the end of FY 2014: "the Postal Service anticipates that it will be unable to make its next $5.7 billion payment due by September 30, 2014…." *Id.*[13]

Valpak would take the PR's comments a step further and urge the Commission to establish a docket to revise its annual compliance and financial reporting rules to require the Postal Service to clearly report its financial results and also to include a summary of those results in the annual compliance report itself.

B. Standard Flats: Need Significant Improvements.

The PR states that in FY 2013 "the overall Standard Flats contribution to the **institutional burden** of the Postal Service **decreased** from $528 million [in FY 2012] to $380 million [in FY 2013], or more than 28 percent." PR Initial Comments, p. 27 (emphasis added). The phrasing of Public Representative's comment is both interesting and revealing.

For a profitable product, one speaks of a product making a contribution to the **institutional costs** of the Postal Service. The PR describes unprofitable Standard Flats product as making a "contribution to the **institutional burden**." While the use of the term "contribution" could be misleading at first glance — the PR's phrasing actually highlights that

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[13] The Postal Service's presentation of its financial data may lead to confusion on Capitol Hill, such as where the purported "loss" was used to justify a postal reform bill (S. 1486, reported out of the Senate Committee on Homeland Security and Governmental Affairs on February 6, 2014) which would give the Postal Service unprecedented monopoly pricing power, at the expense of participation by mailers, transparency, and accountability.

the continued losses from Standard Flats have a serious consequence — **Standard Flats continue to impose an enormous burden on the Postal Service, as well as other mailers**.

Thus, in FY 2013, Standard Flats:

(i) failed to cover their **attributable costs**, as required by Title 39, and

(ii) failed to make a **contribution** to cover an equitable portion of institutional costs of the Postal Service, as required by Title 39, and

(iii) imposed an enormous **burden** on Postal Service finances, impairing liquidity, and

(iv) forced the Postal Service to charge **profitable** Standard Mail users **artificially high rates** (*e.g.,* Docket No. R2013-11), and

(v) helped establish the Postal Service's "necessity" (39 U.S.C. § 3622(d)(2)(E)) of above-cap **exigent rates** (*e.g.,* Docket No. R2011-13) due to the liquidity crisis they help create, imposing additional burdens on all mailers in all classes of mail.

(If other products made a "contribution" of the sort made by Standard Flats, the Postal Service would not just be illiquid — it would be out of business.)

Although the PR correctly indicates that the "contribution to the institutional burden" **decreased** in FY 2013, there should have been little reason for the PR to view this as a particularly favorable sign. Indeed, that decrease was **not** primarily due to **cost savings** resulting from **increased productivity** in handling Standard Flats which the Commission had hoped for and expected in allowing the Postal Service to give Standard Flats (i) only *de minimis* "CPI x 1.05" price increases on this product in annual price increases,[14] and (ii) only an average increase in Docket No. R2013-11.[15]

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[14] *See, e.g.,* FY 2012 ACD, p. 116.

[15] The Commission apparently had also hoped that improved costing might affect Standard Flats costs, but the Postal Service explained that all three **costing methodology**

Indeed, contrary to the implication of the PR's implication of improvement, the record in this docket demonstrates that the primary drivers of cost savings for Standard Flats were:

(i) **reduced labor rates** resulting in slightly lower unit costs — but are in no way unique to Standard Flats; and

(ii) **reduced volume** of Standard Flats.

(These facts are confirmed by Postal Service responses to ChIR No. 4, addressed further in Section VI, *infra*.)

The Commission had to ask the Postal Service to provide the information "required by the FY 2010 Annual Compliance Determination (at 107) … regarding the Standard Mail Flats product" — the information which it failed to provide in its filing. Among this missing information was "all operational changes designed to reduce flat costs in FY 2013 [with an] estimate [of] the financial effects of such changes." The Postal Service's response to ChIR No. 2, Question 1 identified a few operational changes that affected processing of flats generally, but it was not able to "isolate the cost savings resulting from these initiatives…." USPS Response to ChIR No. 2, Question 1a. Indeed, despite efforts to increase processing of Standard Flats on automated equipment, the percentage of Standard Flats processed manually increased slightly. Only tiny changes in processing occurred: AFSM100 processing decreased from 71.5 percent to 70.9 percent, and FSS processing increased from 18.0 percent to 18.3

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changes in FY 2013 had only a "minimal" (actually *de minimis* would be a better word) effect on Standard Flats costs — $771,000 — or "only **0.03 percent** of the FY 2012 total attributable costs for Standard Mail Flats ($2.76 billion)." USPS Response to ChIR No. 2, question 1b (emphasis added). Certainly, there is no predicate for cost cutting or cost methodology changes in this docket for the PR's seemingly optimistic comment that "the Postal Service continues to undertake multiple operational changes in order to reduce Standard Mail Flats costs…." PR Initial Comments, p. 28.

percent. As demonstrated in Valpak's Initial Comments, Section V, there is no reason whatsoever for the Commission to rely on any hope that Standard Flats costs will decrease slightly as labor rates decrease. Indeed, even the Postal Service declined to provide the Commission with anything at all on which it could rely, limiting its observations to aspirational generalities such as "we expect to see" improvements in the future.

Indeed, the only meaningful comment explaining changes in Standard Mail Flats costs was with respect to "Cost Per Work Hour" where the Postal Service explained: "Generally, the Postal Service also realized savings across most operations as a result of a lower average costs per work hour" which were significant. USPS Response to ChIR No. 2, Question 1a (especially Table entitled Productive Hourly Rates for FY 2012 vs. FY 2013).

In Docket No. ACR2010, the Commission ordered the Postal Service to provide in each ACR "a statement summarizing the historical and current fiscal year subsidy of the Standard Mail Flats product, and the estimated timeline for phasing out this subsidy." Again, the Postal Service violated this order. And again, the Commission had to ask this question through a ChIR. And again, the Postal Service demurred — providing no meaningful answer to the question. The Postal Service's non-answer could be summarized as: "it is very difficult to predict," but assuming "increasing Standard Mail Flats prices" on the present schedule of "at least CPI x 1.05 during the next two market dominant price changes," it is "unlikely that the shortfall will be eliminated by the end of 2016 when the Commission will commence a comprehensive review of the present regulatory system."[16]

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[16] Of course, the Commission's question does not allow for the Postal Service to refuse to respond beyond FY 2016, but that is what the Postal Service has done before, and the

The PR concludes with its observation that the "improvement in cost coverage for Standard Flats proves the effectiveness of a 'special remedy,' *i.e.*, above-CPI price increases for Standard Mail Flats." PR Initial Comments, p. 29. While Valpak appreciates the PR's endorsement of above-CPI price increases, the PR's apparent conclusion that increasing Standard Flats rates by CPI x 1.05 has achieved anything is neither supported nor supportable. If the CPI cap applicable to the next price increase is 2.0 percent, under the Postal Service's formula of CPI x 1.05, the increase in Standard Flats would be 2.1 percent — a paltry 0.1 percentage points more than if there were no such requirement. Assuming FY 2013 volumes are unchanged, compare the two difference in FY 2013 revenues under a 2.0 percent increase and a 2.1 percent price increase:

Standard Flats Increase at CPI x 1.06:	
$2,134 billion x 2.10 percent =	$44.814 million price increase
Standard Flats Increase at CPI:	
$2,134 billion x 2.00 percent =	$42.688 million price increase
Difference	$ 2.126 million extra price increase

In a product that lost $380 million in FY 2013, supposedly above-average price increases netting an extra $2.126 million in revenue is an obviously inadequate remedy, assuming costs increase at the rate of inflation. The Commission must order a complete and rapid remedy to comply with the mandate associated with Commission remedies to address illegalities, as required by the U.S. Court of Appeals for the District of Columbia in Gamefly v. U.S. Postal Service. *See* discussion in Valpak Initial Comments, pp. 28-29.

Commission has not insisted upon any better answer.

Lastly, in apparent satisfaction with "CPI x 1.05," the magnitude of a **$380 million annual loss** appears to escape the imagination of the PR. Putting aside the fact that the Postal Service has chosen to incur, and the Commission has allowed, Standard Flats losses which were $2.995 billion through FY 2013, and which no doubt have gone **over the $3 billion mark in losses** since then. A few illustrations drawn from the Postal Service's ACR, as to how much money $380 million truly is, should suffice:

- It is more than twice the Postal Service's **net interest expense** of $167 million. USPS Annual Report to Congress, "The year in review."
- It is more than twice the Postal Service's savings on having **transitioned 7,985 post offices** to 2-hour, 4-hour, and 6-hour service. *Id.*, p. 19.
- It is almost half of the total revenue earned from the **Priority Mail Express** product. *Id.*, p. 32.
- It is almost half of the total revenue earned from **Package Services**. *Id.*

And, the total $3 billion loss from Standard Flats since PAEA:

- was more than the total amount of contribution which the Commission has allowed the Postal Service from its **exigent price increases** in Docket No. R2013-11. Docket No. R2013-11, Order No. 1926, p. 106.

It is submitted that the Commission, consistent with a law that requires the Postal Service maintain liquidity, cannot allow such a financial hemorrhage to continue any longer.

C. Standard Flats: Reliance on Projected Cost Reductions.

The PR addressed various of the underwater market dominant products. In addition to looking back at the year under review, FY 2013, the PR points out that "[i]n FY 2014, as projected in R2013-11, the cost coverage shortfalls would decline to $607.389 million." PR Initial Comments, p. 22. The PR then presents a chart comparing the FY 2012 ACD, the FY 2013 ACR, and the Postal Service projections in Docket No. R2013-11, showing Standard Flats cost coverage improving to 92.22 percent in FY 2014.

Valpak pointed out in its Initial Comments that the Postal Service's projections in Docket No. R2013-11 were faulty, with the projected cost coverage for Standard Flats being 2 percentage points lower than what was projected. Although the projected cost coverage of Standard Flats for FY 2014 is even less accurate, assuming that it is only 2 percentage points off, the projection would be closer to 90 percent coverage in FY 2014. Again, the Postal Service rarely explains its projections. *See* FY 2012 ACD, p. 116.

If the Commission does rely on the projected cost coverage for FY 2014 for any guidance, it should focus on the Postal Service's projected cost coverage for High Density/Saturation Letters for FY 2014 (after rates) being 251.4 percent, thus increasing the coverage gap with Standard Flats to **159.2 percent**. *See* Docket No. R2013-11, Statement of Stephen Nickerson, Attachment 25. This is an unlawful disparity of coverage within Standard Flats that must be rectified if the Commission is to serve its role in protecting mailers from abusive exercises of monopoly pricing power.

D. Separate Elasticities for Standard Mail Products.

The PR discussed the Commission's recommendation in FY 2012 ACD "that the Postal Service derive elasticity estimates to provide for a more realistic assessment of the impact of price changes on contribution," and the Postal Service's failure to make any mention of this in its FY 2013 ACR. *See* PR Initial Comments, p. 30, citing FY 2012 ACD, p. 116. The PR concludes: "The Postal Service's failure to provide elasticities for products is a strong disadvantage." *Id.*

In response to ChIR No. 4, Question 13, the Postal Service explained that, despite the claimed unusability of the aggregated elasticity estimates that it files with the Commission annually, "the disaggregated shaped-based equations have still not yielded results which would suggest that substituting the disaggregated elasticity estimates for the aggregate estimates would generate better forecasts or otherwise improve the assessment of the impact of price changes on contribution." Although this response could have been written in clearer English, the Postal Service's response seems to say, in essence, that the aggregated, or "joint," elasticities last reported in January 2014, and incorporated in the Valpak Multi-Period model, have **not** been improved upon by recent efforts to estimate disaggregated elasticities for individual products. Hence, the Valpak Standard Mail contribution maximization model uses the latest and best information available.

The PR is correct that the lack of separate elasticity estimates is a disadvantage — to mailers and the Commission. As long as the Postal Service fails to develop and report reliable product elasticities, it will continue to make pricing decisions that cannot be as easily evaluated by the Commission. However, the Commission must work with what it has, now aided by the

Valpak Standard Mail contribution model, which shows contribution of Standard Mail is nowhere near being maximized.

E. Unfair Workshare Discounts.

The PR mentions the five workshare discounts for Standard Flats that exceed the costs avoided. *See* PR Initial Comments, pp. 41-42. The PR notes that one passthrough — Automation, Mixed AADC Flats — increased from 239 percent in FY 2012 to 305.6 percent in FY 2013. The Postal Service justifies all five passthroughs using the "rate shock" exemption "because it would require a significant reduction in the discounts in order to bring passthroughs equal to 100 percent," and the PR notes the entire lack of evidence in support of this claimed exemption.[17] *Id.* Valpak agrees with the PR that the "Postal Service should provide this evidence [of why this level of discount is needed] in order for this discount to qualify for an exemption pursuant to 3622(e)(2)(D)." PR Initial Comments, p. 42. Further, Valpak questions providing such large workshare discounts to certain mailers using a product that is causing large financial losses to the Postal Service. High Density/Saturation Letters has an excessively high cost coverage, but no workshare discounts that exceed their costs avoided.[18]

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[17] Remarkably, the Postal Service claims the rate shock exemption right after it imposed an exigent price increase which the Commission determined was "unlikely to cause rate shock." *See* Docket No. R2013-11, Order No. 1926, p. 157.

[18] The High Density/Saturation Letters workshare discount with the highest passthrough is DSCF-entered letters, with a passthrough of 52.9 percent.

V. United Parcel Service

UPS' Initial Comments focus on whether the competitive products with which they compete are paying their fair share of Postal Service institutional costs. UPS addresses the issue of dramatically falling attributable costs, reporting an 11 percent drop in levels of attribution over a 15-year period (UPS Initial Comments, pp. 2-3):

FY 1998 (Docket No. R97-1) — 65.1 percent

FY 2013 (Docket No. ACR2013) — 54.2 percent (including RHBF payment)

UPS discusses how lower levels of attribution result in competitive products (which are statutorily required to pay attributable costs plus an appropriate share of institutional costs) being relieved from paying their fair share of Postal Service costs.[19]

The consequence of this reduction in levels of attribution, of course, is not limited to competitive products — it also has a profound effect on prices of market dominant products. For market dominant products, fewer costs being attributed also necessarily means more costs being treated as institutional, with two simultaneous effects:

> (i) allowing the Postal Service to charge even lower prices to its favored underwater market dominant products, such as Standard Flats; and
>
> (ii) loading extra burdens onto mailers using market dominant products through a high coverage from which it must recover ever increasing levels of institutional costs.

Attributing fewer costs lowers the bar that products must reach to be said to be covering their costs. For example, since attributable costs is the standard against which Standard Flats is

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[19] UPS questions why market dominant product prices have increased an average of 5.9 percent in 2014, while competitive products have increased only 2.4 percent. *Id.*, p. 7.

being judged, and since the level of attributable costs is declining, it takes less and less each year for Standard Flats to be said to covering its costs. Of course, Standard Flats has not covered its costs since PAEA was enacted, but it demonstrates why the Postal Service plan to increase Standard Flats prices by CPI x 1.05 is now seen to be even more inadequate than it had been previously.

VI. Postal Service Responses to ChIR NO. 4

On January 21, 2014, Valpak asked the Commission to submit to the Postal Service a number of questions, most of which were contained in ChIR No. 4 (issued Jan. 27, 2014). Postal Service responses to these questions were filed on February 6, 2014, after the deadline to file Initial Comments on January 31, 2014, and therefore these responses are addressed here.

A. Market Dominant Negotiated Service Agreements.

ChIR No. 4, Questions 14-16 involved Market Dominant negotiated service agreements. The Postal Service's response to ChIR No. 4, Question 15 admitted that, using Docket No. MC2004-3 methodology — the current Commission-accepted methodology — the second year of the Discover NSA resulted in a **net loss of $6,861,160** to the Postal Service.[20] This is in direct contradiction to the Postal Service's claimed **net benefit being in the range of $26.5 million to $31.9 million** in its FY 2013 ACR (revised Feb. 6, 2014).

[20] The Postal Service response to ChIR No. 4, Q. 15 reveals that its own results imply a remarkable First-Class Mail elasticity of -3.33 and Standard Mail elasticity between -8.27 and -6.20 for Discover's mail. *See* responses to Question 15.b-d.

Similarly, in its FY 2012 ACR, the Postal Service claimed a **net benefit** of the first year of the Discover NSA of **$24.8 million-$26.8 million**. The Commission again used the accepted methodology to calculate that the first year resulted in a **net loss of $4.3 million**. *See* FY 2012 ACD, pp. 156-58. One year ago, the Commission concluded:

> *If the Postal Service is not realizing a net benefit due to the agreement or the insights gained by its implementation by that time, the Commission recommends that the Postal Service re-evaluate the benefits and costs of continuing the NSA.* [*Id.*]

The Postal Service has demonstrated that it has not yet learned to use its much vaunted "pricing flexibility" to fashion profitable Market Dominant negotiated service agreements, as demonstrated by a summary of the money lost on prior NSAs.

Table VI-1
Summary of Market Dominant NSAs
Net Effect on Postal Service Contribution
($ Thousands)

	2009	2010	2011	2012	2013	Total
Bookspan						20
Lifeline	25	104	0			129
Bradford Group	93	(72)	(37)			(16)
Bank of America	(23,514)					(23,514)
Discover				(4,338)	(6,861)	(11,199)
Valassis						
Total	**(23,396)**	**32**	**(37)**	**(4,338)**	**(6,861)**	**(34,580)**

The Postal Service still denies it is losing money on the Discover NSA, but it has lost substantial money over multiple years. The time has come for the Commission to order the Discover NSA be terminated forthwith.[21] *See* 39 U.S.C. § 3622(c).

B. Standard Flats.

The Commission ordered the Postal Service to solve the problem of underwater Standard Flats through above-CPI price increases, "to increase the cost coverage of the Standard Mail Flats product … until such time that the revenues for this product exceed attributable costs" — but it also had two hopes for Standard Mail that related to costs.[22] FY 2010 ACD, p. 106.

First, the Commission apparently had hoped that **significant costing methodology refinements** would result in a lower attribution of costs to Standard Flats. *See* FY 2010 ACD, p. 107 ("In subsequent ACRs, the Postal Service shall report the following information … describe all costing methodology or measurement improvements made in the previous fiscal year and estimate the financial effects of such changes.") The Postal Service Response to ChIR No. 2, Q. 1b, demonstrates that this has not been, and is not likely to be, the case. (This issue was addressed in Section IV.B, n.16, *supra*.) If UPS is correct, it may be that the level of attribution for all products should be higher than they are (*see* UPS Initial Comments, pp. 2-

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[21] In part, the Commission approved the Discover NSA using an extra-statutory criterion for approval: "allowing this negotiated service agreement to proceed will allow management to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume." Order No. 694, p. 15. Certainly, this initial rationale no longer applies.

[22] Measured costs provide the underlying basis, or backbone, of the pricing system, and it is critical to begin with reliable information about the costs.

8), but suffice it to say that the Postal Service has not demonstrated, or even contended, that Standard Flats costs are overstated, and there is certainly no reason for the Commission to decline to act on that basis.

Second, in its FY 2010 ACD, the Commission had expected that the Postal Service would achieve **significant cost cutting for Standard Flats** (by "streamlin[ing] operations to capture efficiency and reduce costs"). FY 2010 ACD, p. 107. Generally, such cost savings have not materialized. The question again in this docket is whether the Commission has any basis to anticipate future cost savings. The Postal Service's responses to ChIR No. 4 gives the Commission no such basis. Valpak's Initial Comments (Section V) explained why no significant future cost reductions in processing Standard Flats could be relied upon. Nothing contained in the Postal Service responses to ChIR No. 4 contradicts Valpak's position. Accordingly, the only way for Standard Flats to achieve breakeven and become profitable is via significant rate increases, imposed without delay, as discussed in Section VI.C., *infra*.

Each of the Postal Service responses addressing cost cutting for Standard Flats is addressed separately.

1. ChIR No. 4, Question 7.

Question 7 asked the Postal Service:

> Please discuss all modifications made to the AFSM 100 machines during FY 2013, and **explain the extent to which those modifications increased productivity** (*e.g.*, throughput) of the AFSM 100 machines. [Emphasis added.]

The Postal Service response provides a detailed listing of modifications to the AFSM 100, but the entirety of the somewhat ambiguous (essentially non-responsive) discussion pertaining to productivity was:

> These modifications focus on two areas: software updates and hardware modifications. Depending on the modification, the AFSM 100 improvement **might** involve **improved mail processing performance (i.e. throughput or accept rate)** or reducing maintenance activities associated with machine downtime. [Emphasis added.]

The only inference that can be drawn from this response is that during FY 2013 there was little or no measurable increase in the productivity of the AFSM 100 machines.

2. ChIR No. 4, Questions 9 and 10.

The Postal Service responded to Questions 9 and 10 as follows:

> Confirmed [that all 100 FSS machines were deployed and operational throughout both FY 2012 and FY 2013]. However, it is important to note that one of the FSS machines is used by engineering for software and hardware evaluations. Accordingly, only 99 FSS machines are used for mail. In addition, during FY 2013 two machines were relocated and out of service for 12 weeks each.
>
> The measured productivity in FSS operations in FY 2012 was 816 pieces per hour. In FY 2013 the FSS productivity was 798 pieces per hour. The small FSS productivity decline is the net result of a modest increase in distribution productivity being offset by lower prep productivity.

The first response says that essentially all FSS machines were fully deployed and operational during FY 2012 and FY 2013 — *i.e.*, one should **not** expect any increase in the number of FSS machines in operation. The second response indicates that there has been no significant increase in productivity during two full years of operation. Together, these two responses support what Valpak said in its Initial Comments, namely, there is no reason to expect a meaningful reduction in the unit cost of handling flats as a result of deploying all 100 FSS machines.

Those 100 FSS machines are DPSing 25 to 30 percent of all Standard Flats volume, and the unit cost of that portion is not likely to decline much, if at all. Thus, without a substantial increase in the current price of Standard Flats, there is no reason to expect any future increase in profitability, much less profits, at any level that would justify the continued "investment" in subsidizing Standard Flats in hopes of what Docket No. R2013-11 pricing witness Altaf Taufique referred to as "future profits." It may be too early to describe the FSS machine as a "mature" technology (like the AFSM 100), but it appears to be approaching maturity.[23]

3. ChIR No. 4, Question 11.

Question 11 had two parts pertaining to return on investment ("ROI"). The response to **Part a** states that all capital investment projects are prioritized because of the capital freeze, and the one exception that might be applicable to Standard Flats is:

> 3) those projects that have a high return on investment and a positive net cash flow within a very short period.

This response shows that if the Postal Service were to subject "investments" in the form of subsidies of underwater products to the same standards it uses for a hardware investment such

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[23] A working definition of "maturity" would be where productivity (*e.g.*, throughput) and unit cost level off. A principal benefit of the FSS is that it now is a proven technology capable of DPSing flats. Processing is not very fast: between 800 and 900 pieces per hour, compared to a more simple sortation (not DPS) on the AFSM 100 of 16,000 pieces per hour. What the FSS does do is send a message to both rural and city carriers that the Postal Service now possesses automation technology that can eliminate the need for most, if not all, of their in-office time.

as the FSS, the subsidy to Standard Flats would never have even been presented to the Postal Service Governors for approval. The multi-year prospect for Standard Flats is shown in Valpak's Initial Comments, Table II-2.

The response to **Part b** states that:

> The time period for computing the ROI on capital investments is based on the expected service life of the equipment. In the case of FSS, since it is automated processing equipment, the service life is ten years. The cash flow period would be ten full operating years after full deployment.

If the Postal Service uses a 10-year horizon to evaluate a major capital investment such as the FSS, that should be an ample (or more than ample) time horizon for evaluating subsidies to underwater products. The statement pertaining to cash flow means a **net** cash inflow, or benefits (*e.g.*, cash savings) that exceed the investment. As applied to an "investment" in supporting any underwater product that is expected to become profitable — *i.e.*, a "temporary" subsidy — the expected future profits would be discounted against the full subsidy this year, and discounted subsidies for as many intervening future years as are necessary to get to the point when profits materialize.

In truth, the Postal Service has two entirely different approaches to evaluating "investments." When the Postal Service is spending its own money, it takes a very hard-nosed "show-me" approach. For approval when using the Postal Service's own capital, investment projects must "have a **high return** on investment and a **positive net cash flow** within a **very short period.**" For approving underwater pricing requiring cross-subsidies, using mailers' money, the Postal Service allows those in charge of pricing to take an extraordinarily loose, laid-back approach, as though neither the amount of the losses nor the time horizon matter.

The Postal Service's complete lack of discipline with respect to "investing" mailers' money is truly appalling.

4. ChIR No. 4, Question 12.

The Postal Service's response to ChIR No. 4, Q. 12 discusses the slight decline of $0.013 in the unit cost of Standard Flats, from $0.465 to $0.452. In essence, the response says that about half of this slight reduction can be attributed to productivity gains, and the other half to the reduction in wage rates of new employees as allowed by union contracts. Unless and until the unions or arbitrators again relent, this latter reduction is likely to be a one-time occurrence. The bottom line here is that nothing is in the offing to give the Commission any reason to believe that in the foreseeable future there will be productivity increases and cost decreases sufficient to result in meaningful profitability of Standard Flats. The prospect of obtaining future profits from Standard Flats sufficient to repay the current "investment," made via subsidy to offset losses, is essentially non-existent.

5. ChIR No. 4, Question 8.

The Postal Service response to ChIR No. 4, Question 8 states:

> The Postal Service does not have separate end-to-end cost estimates for pieces processed on the AFSM 100 machines and then cased manually by carriers; versus flats that are DPS'd on the FSS machines.

The cost of sorting flats on the AFSM 100 and then having carriers DPS them manually is well established, as reflected in CRA unit cost data for the last five or more years. In the absence of separate end-to-end cost estimates, the Postal Service simply cannot claim that speculative future increased FSS utilization would achieve a significantly lower unit cost for Standard Flats.

6. Conclusion from ChIR Responses.

The Postal Service's lack of proof of cost savings for Standard Flats was considered a problem in the last ACD. There, the Commission stated that it was "concerned that the Postal Service has not quantified the cost savings from operational changes designed to reduce Flats costs. Consequently, the Commission cannot properly assess the likely rate of improvement in the cost coverage shortfall." FY 2012 ACD, p. 116 (citation omitted).

In the instant docket, not only has the Postal Service "not quantified the cost savings from operational changes," it has given the Commission no reason to believe that such operational changes exist.

C. Standard Mail Remedial Prices.

Now that it has been demonstrated that the Commission has no basis to believe Standard Flats costs are overstated, and no basis to believe Standard Flats costs will be reduced in the next few years, Valpak respectfully requests that the Commission order the Postal Service to increase pricing immediately to ensure that the Standard Flats product covers its costs and makes a reasonable contribution to institutional costs, based solely on such pricing changes which it orders the Postal Service to put into effect.

Standard Flats pricing continues to violate 39 U.S.C. section 403(b) as the Commission found in its FY 2010 ACD. FY 2010 ACD, pp. 106-107. Standard Flats and High

Density/Saturation Letter rates also continues to violate that statute and many other sections of Title 39, as discussed in Valpak's Initial Comments.[24]

Valpak has made this request to the Commission on many occasions, and little has been accomplished except that the Postal Service has not given Standard Flats below average rate increases as it had done in the past. With the decision of the U.S. Court of Appeals for the District of Columbia in the Gamefly case, it is now clear that a Commission remedy must not only address an unlawful circumstance, but must truly remedy it. 39 U.S.C. section 3662(c) requires that the Commission:

> shall order that the Postal Service take such action as the Commission considers appropriate in order **to achieve compliance** with the applicable requirements and to remedy the effects of any noncompliance (such as ordering **unlawful rates to be adjusted to lawful levels** … ordering the Postal Service to discontinue providing loss-making products…. [Emphasis added.]

The truth is that the Commission knows much more in February 2014 than it knew in March 2011 when it issued its FY 2010 ACD, first found Standard Flats rates to be unlawful, and issued its order that the subsidy be phased out promptly. Indeed, since the Commission approved the price adjustment in Docket Nos. R2013-10 and R2013-11, the Commission has learned many things.

- It is clear that the Commission's Order originally entered in its FY 2010 ACD did not result in Standard Flats prices covering costs in FY 2011, FY 2012, FY 2013, and will not be complied with in FY 2014 or FY 2015 or FY 2016 — more likely decades — to come, at the turtle-like pace of "CPI x 1.05."

[24] Valpak's Initial Comments address how Postal Service pricing for Standard Mail violates: 39 U.S.C. § 3622(c)(2), (3), (7), (12); 39 U.S.C. § 101(a) and (d); 39 U.S.C. § 403(b)(1) and (c); 39 U.S.C. § 404(b); 39 U.S.C. § 3622(b)(1), (b)(2), (b)(5), (c)(7), and (c)(12).

- It is also a virtual certainty that changes in costing methodology will continue to have no meaningful effect on Standard Flats costing.

- It is a virtual certainty that costs of handling Standard Flats will not decrease any faster than reduced labor rates across-the-board.

- As the level of cost attribution has decreased over the years, an average **coverage of 176 percent** for market dominant products is now necessary for the Postal Service to pay its institutional costs, and the goal of having a major product like Standard Flats merely cover its costs with a **100 percent cost coverage is much too low a target** to either achieve compliance with Title 39, or to have the Postal Service have the money to pay its institutional costs.

- The cross-subsidy that is being extracted from mailers, like Valpak, who use the highly profitable High Density/Saturation Letter Product has increased, and the spread between that coverage and the coverage for Standard Flats has exceeded 150 percentage points — providing unfair and inequitable rates, and an "undue preference" for Standard Flats together with an "undue burden" imposed on High Density/Saturation Letters.

- The Commission now has the Valpak Standard Mail Contribution Model to use to test various rates, which undermines the Postal Service's excuses for preferential pricing for Standard Flats.

In a pricing docket, the Commission's finding that a pricing adjustment is in compliance with the rate cap, worksharing limitations, and nonprofit rates is conclusive, but, as to compliance with other aspects of Title 39 it is only "provisional" and "subject to subsequent review" and modification during an Annual Compliance Review. *See* 39 CFR § 3010.11(k)

Accordingly, Valpak urges the Commission to re-examine that "provisional" approval to pricing it granted in Docket Nos. R2013-10 and R2013-11, find that pricing unlawful, and issue a new remedial order replacing that originally issued in its FY 2010 ACD. In a new remedial order, the Commission would rescind its recent approval of increased prices for Standard Mail approved previously, and order the Postal Service to establish lawful rates for all Standard Mail products as soon as possible. These rates would increase prices for Standard Flats to well above-breakeven, and to make corresponding decreases in rates for High Density/Saturation products to maximize contribution as demonstrated by the Valpak Standard Mail contribution maximizing model. Such an enhanced Commission remedial order would be fully consistent with the Postal Service's representation to the Federal Appeals Court:

> The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it. [Brief of the United States Postal Service at 34, U.S. Postal Service v. Postal Regulatory Commission, No. 11-1117 (D.C. Cir. Oct. 7, 2012).]

Achieving the Postal Service's goal of maximizing contribution begins with the elimination of losses, and there is no better time to begin eliminating such losses than now, before more money is lost on this one product, and the Postal Service again finds itself in a worsened liquidity crunch that could lead to another exigent rate increase. **Three billion dollars in losses on one product is enough.**

Respectfully submitted,

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