

**BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001**

ANNUAL COMPLIANCE REVIEW 2016

Docket No. ACR2016

**RESPONSE OF POTPOURRI TO COMMISSION INQUIRY CONCERNING COMPLIANCE OF THE PHI NSA
WITH GOVERNING STANDARDS**

In its FY 2016 Annual Compliance Determination issued March 28, 2017 (the “ACD”), the Postal Regulatory Commission (the “PRC” or “Commission”) raised certain questions as to whether the Postal Service has “actively monitored” the Negotiated Service Agreement (“NSA”) it entered into with PHI Acquisitions, Inc. (“Potpourri” or “PHI”) and ordered the Postal Service to “report on its forecast for the remainder of the PHI NSA” with an “updated estimate of PHI volume” together with “any amendments” to the NSA. Since much of the data that the Postal Service needs to respond to this directive is within PHI’s possession, and since the issues raised by the Commission plainly are of great importance to Potpourri, these Comments are submitted to explain why, from Potpourri’s perspective, the conclusion that this NSA fails to meet the terms of Section 3622(c)(10) is erroneous.

In these Comments and related Library References, to be submitted under seal pursuant to Section 3007.10 of the PRC Rules, we show that:

- Far from producing a negative contribution to institutional costs, when a realistic and accurate measure of the firm-specific postal price elasticity of PHI eligible mail is used, this NSA not only has been but will continue to be beneficial to the Postal Service;

- The positive direct contribution made by PHI eligible volume is enhanced by the fact that this incremental volume yields “multiplier effects” of increased volume of profitable mail not only from PHI and its customers continuing for years after the incremental mailing but also from third party mailers who rent PHI mailing lists;
- The total overall positive contribution of this NSA to the Postal Service in the remaining years is plain despite the unfortunate history of the FSS rate category and its costs; this is because the mix of Potpourri’s volume has been and will continue to be such that more than 80% of total eligible volume is entirely unaffected by zeroing out the rate differential between Basic Carrier Route and FSS.
- The Commission is aware that the baselines are not being met in all quarters of Contract Year 3. The associated circumstances, detailed below, justify treating that NSA year as a nullity and moving the Year 3 thresholds from the NSA Year starting July 2016 to the Year starting July 2017. Such a change is the subject of an Amendment under discussion between PHI and the Postal Service.

I. THE POTPOURRI NSA HAS AND WILL CONTINUE TO FULLY MEET THE TERMS OF SECTION 3622(C)(10).

We set forth in these Comments and the Library References what we believe to be a full and detailed response to the Commission’s request for information concerning both PHI’s performance under the NSA during the past 3 years and projections of the remaining years under the Agreement. Much of this information was submitted by PHI and the Postal Service in the proceeding which resulted in approval of this NSA. *See*, Dockets No. MC2014-21 and R2014-6. Although Potpourri does not object to being required to update its projections for the remaining 3 years of the Agreement, we do wish to note that the Commission’s grounds for calling into question the bona fides of this NSA are seriously doubtful: As the Commission itself acknowledged in the Annual Compliance Determination, this NSA was

submitted as and approved by the Commission for a 5 year term; the Commission's assertion that the "PHI NSA did not meet the criteria of 39 U.S.C. § 3622(c)(10)(A) in Contract Year 2" is in essence a retroactive decision rejecting the 5 year term approved by the Commission and unilaterally – and retroactively – converting this NSA into a series of one year Agreements which are apparently subject to annual review. See ACD at 2 & 74. The Commission's authority to reach such a decision is seriously open to question. See, e.g. *Arizona Grocery Co. v. Atchison, T. & S. F. Ry. Co.*, 284 U.S. 370, (1932); *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956); *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956).

Moreover, the Commission's conclusion misreads Section 3622(c)(10) upon which it purports to be based. What the statute requires is that the special classification increases the "overall" contribution "to the institutional costs of the Postal Service." The statute does not require that the overall contribution be increased in each contract year (so long as there is no harm to the Postal Service) or for each piece of mail entered. The statute can only be read – as the Commission has consistently done until now – as requiring an overall aggregate positive contribution to institutional costs for the term of the arrangement as a whole.

We have chosen not to pursue these legal issues at this time because an examination of the facts in this case make plain that the Commission's conclusions are erroneous.

A. When firm-specific elasticities are used, it is clear that the NSA has and will make a positive contribution to institutional costs.

The conclusion that the Potpourri NSA yielded a net loss to the Postal Service in Contract Year 2 rests almost entirely on the estimation of before rates volumes based on the Commission's "preferred methodology." With all due respect, we maintain that the analysis is incorrect for the simple reason that the firm-specific elasticity is materially different from the Postal Service's product elasticity. The proper

use of the Panzar analysis requires the use of the firm-specific elasticities if available, but defaults to Postal Service product elasticities when not available. The Postal Service used a product elasticity for Carrier Route of -0.846 and for Standard Regular of -0.484. As Library Reference 1 submitted by PHI makes clear, the actual elasticity of all of the volume – which includes a significant percentage of High Density as well as Basic Carrier Route and small amount of FSS Carrier Route – entered by Potpourri was -1.410.

The difference between the actual firm-specific elasticity of Potpourri mail and the far more generalized Postal Service product elasticities used in the “preferred methodology” is manifestly of profound importance to the assessment of whether this NSA does or does not meet the statutory criteria. In a separate pleading to be filed within the next several days, PHI intends to offer to the Commission to convene a technical conference, if it is deemed to be necessary, in order for PHI to explain how the firm-specific elasticity was developed. This firm-specific elasticity yields results that far more realistically reflect the realities of Potpourri’s mailing decisions than do the general, Postal Service product elasticities upon which the ACD conclusion is based. The PHI firm-specific elasticity of -1.410 should be used to calculate the Postal Service value using the “preferred methodology” for all years of the agreement.

Potpourri’s reliance on the -1.410 measure of elasticity is entirely consistent with, and in fact based upon, the elasticity computations that it made during the course of the negotiations with the Postal Service in the formation of the NSA. Indeed, a firm-specific elasticity is embedded in the Agreement itself. There is a provision which is designed to protect the integrity of the agreement in the event that rate increases during the term of the Agreement make it uneconomic for PHI to meet the annual thresholds and therefore unable to mail incremental volume under the NSA. Section D at page 5 of the Agreement provides that if rates applicable to covered mail are increased by greater than 20 basis points over the January CPI-U preceding the rate increase, then the Quarterly and Annual Volume

Thresholds are adjusted in accordance with an Adjustment Percentage that is spelled out in the Agreement. To remove any possible doubt as to the objectivity of the adjustment, the Agreement sets forth a hypothetical rate increase that triggers the adjustment and shows exactly how the adjustment is computed. NSA at 5-7. This methodology uses the firm-specific elasticity, rounded to -1.4, to calculate the revised baseline caused by rate increases outside those anticipated by CPI increases.

The Baseline Adjustment methodology due to unforeseen rate increases was not arbitrarily or randomly selected. It was based on PHI's analysis of the elasticity of its mail at the time the NSA was being negotiated. The adjustment was based on the conclusion that the elasticity of PHI's eligible mail was -1.4, essentially the same elasticity independently developed on a more recent time period as set forth in Library Reference 1. The Baseline Adjustment and the elasticity computation on which it was based was accepted by the Postal Service and was an essential part of the NSA. The methodology that PHI used in developing the baseline adjustments is identical to the methodology set forth in the Library Reference. There is nothing in the Commission's decision approving this NSA that suggested that the baseline adjustment formulae was inadequate to the task of assuring year over year realization of the 3622(c)(10) factor. In short, the Agreement was just and reasonable when it was entered into and it remains so now.

B. The Multiplier Effects of the Agreement cannot be ignored.

The "overall" contribution to the institutional costs of the Postal Service cannot be fairly and rationally measured by looking only at the additional volume in the NSA tiers, even if the firm-specific elasticity is acknowledged. As the Commission is aware, Potpourri is a catalog mailer. Eligible mail is, by the terms of the NSA, limited to mail entered by Potpourri at ECR rates. Some consumers place orders with the company by First-Class Mail, using the order forms in the catalogs. In other cases, communications, also conducted by mail occur from PHI to the consumer; and, because of the nature of

its business and its customer base, PHI's lists are frequently rented by other entities engaged in mail order businesses. In short, the incremental volume of eligible mail for which PHI earns a rebate generates significant volumes of undiscounted PHI catalog mailings, First-Class Mail sent by consumers and by PHI, and by third party renters of PHI mailing lists. All of that mail generates additional operating revenues. See USPS Notice of PHI NSA, Filing ID 89305, Dockets No. MC2014-21 and R2014-6 (March 5, 2014).

Because PHI's business model is specifically direct-mail centric, it keeps track of the incremental volume (and the associated costs and revenues) resulting from these activities that are not directly covered by the NSA but cannot be ignored in an assessment of the overall value of the NSA to the Postal Service. Library Reference 2 shows this incremental multiplier effect.

II. THE FACT THAT VOLUME DID NOT MEET THE THRESHOLDS IN CONTRACT YEAR 3 WARRANTS TREATING THAT YEAR AS A NULLITY.

In its analysis the Commission suggests that the difficulties it identified with respect to the NSA could perhaps be addressed through an "amendment" to the Agreement. See, ACD at 74. It is unclear what sort of amendment the Commission may have had in mind but given the fact that there is no basis for concluding that the Agreement fails to meet the terms and purposes of the statute, the suggestion is perhaps moot.

What is not moot are the reasons why Potpourri failed to meet the thresholds for rebate eligibility in the first two quarters of Contract Year 3, which just ended. The reasons were provided in the Response to Question 8 of CHIR No. 8, submitted by the Postal Service on February 6, 2017. See Docket No. ACR2016. The fact is that PHI opened a new warehouse utilizing new warehouse management software for product fulfillment in the first quarter of that Contract Year; it became quickly evident that start up and technical difficulties would complicate the shipment of product during the late

fall and Holiday season; in order to avoid selling products that it could not deliver in a timely fashion, PHI elected to curtail its mailings of catalogs during that period and until the production and technical issues at the plant had been resolved. Resolution of the issues involved has taken time and is expected to slightly curtail incremental volume for the NSA year beginning July 1, 2017.

In these circumstances, and given the profitability of the NSA, including its multiplier effects, PHI has requested that the Postal Service agree to an amendment that treats Contract Year 3 as a nullity; and sets the thresholds for contract Year 3 as if it began in July 2017; the contract would thus remain in effect until June 30, 2020 subject to renewal in accordance with its terms. The Postal Service has not rejected this request, which is under discussion between the parties.

June 26, 2017

Respectfully submitted,

/s/ Ian Volner

Ian D. Volner
Matthew Field
Chris Boone

Venable LLP
600 Massachusetts Ave., N.W.
Washington, D.C. 20001

Counsel for Potpourri Group, Inc.