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ANNUAL COMPLIANCE REPORT, 2017	Docket No. ACR2017

**COMMENTS OF THE
NATIONAL POSTAL POLICY COUNCIL,
THE NATIONAL ASSOCIATION OF PRESORT MAILERS, AND
THE MAJOR MAILERS ASSOCIATION**
(November 1, 2018)

The National Postal Policy Council ("NPPC"), the National Association of Presort Mailers ("NAPM"), and the Major Mailers Association ("MMA") ("First-Class Business Mailers") respectfully submit these comments on the Postal Service's Annual Compliance Report for Fiscal Year 2017 ("*ACR*"), filed December 29, 2017.[1] These comments will address the persistently excessive rates that the Postal Service charges First-Class Presort Letters and Cards, and the apparent absence of any explanation by the Postal Service of the 4.1 percent volume decline in First-Class Mail.[2] Both concerns should be fully addressed before the Postal Service seeks to raise Presort rates in the future.

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[1] Order No. 4323 (Jan. 2, 2018) (*Notice of Postal Service's Filing of Annual Compliance Report*).

[2] NPPC lacks the resources to produce a thorough study of why First-Class Mail volumes, including those of its members, is declining. Given the Postal Service's size, marketing department, statistical resources, and clear self-interest in understanding the causes of the decline, it really is up to the Postal Service to conduct the analysis, draw defensible conclusions, and form a remedial plan.

I. RATES FOR FIRST-CLASS PRESORT LETTERS AND CARDS ARE UNJUST

Section 3622(b)(8) requires that the schedule for market-dominant postal products be "just and reasonable." In Order No. 4257, the Commission ruled that whether rates are "just" or not is defined by whether the rates are "excessive to the mailer." *Id*. at 116. The Commission also stated that "whether a rate is unjust is a highly fact and situation specific inquiry intended to be undertaken on a case-by-case basis." *Id*. at 121. The Commission did not specifically evaluate First-Class Presort rates in Order No. 4257; it should do so now.

In evaluating the justness of rates in Order No. 4257, the Commission applied several analytical tools. First, the Commission examined the changes in cost coverages by class. *Id*. at 124. Notably, it observed that "[w]ith the exception of First-Class Mail, each class had an average cost coverage less than the average cost coverage of all market dominant products." *Id*. at 126. That "exception" alone raises eyebrows, as it means that First-Class Mail had an above-average cost coverage despite steadily declining volume.

Second, it reviewed cost coverage indices. In Table II-4 of Order No. 4257 (at 126), the Commission presented the market-dominant coverage indices by class and selected products. Without explanation, the Commission failed to note that the coverage index for First-Class Mail rose from 2008 to 2016 by more than that of any other product on the list, that at 1.88 in FY 2016 it far exceeded any other product (1.22 for High Density and Saturation Letters is the only other product whose coverage index exceeded 1.00), and that it exceeded the average by more than twice the standard deviation.

Third, Order No. 4257 also compared changes in cost coverage to estimates of demand elasticity. *Id*. at 127-130 & Table II-5. Table II-5 presented cost coverages and price elasticity by class and selected products, by years since FY 2008. It showed that First-Class Presort Letters and Cards had a cost coverage of 338 in FY 2016 and a price elasticity of (0.193). That cost coverage exceeded all others on the chart by more than 100 percentage points (the next highest product – High Density and Saturation Letters – was at 219 percent), and only two of the 14 products listed on Table II-5 had a lower price elasticity.

In contrast, in FY 2006, the last year before the Postal Service assumed greater control over pricing, the cost coverage of Presort letters was 298 percent, meaning that the cost coverage rose by 40 percent over ten years. No other product experienced an increase remotely close to that amount. Despite these numbers appearing on Table II-5, Order No. 4257 seemed to ignore them in concluding that "extreme cost coverage increases were not imposed on products with the lowest elasticities." *Id*. at 129.

Given that the Commission applied these analytical tools only last December, it would be reasonable to apply them now, only a brief time later, to assess the justness of the rates in this review. And when applied to First-Class Presorted Letters/Cards, there is ample reason to find that the rates were unjust.

The *ACR* reports that First-Class Presorted Letters/Cards once again contributed a grossly disproportionate share of institutional costs, regardless of whether measured by cost coverage (318.74 percent) or unit contribution ($0.257 in FY 2017). Applying Order No. 4257's first test, the cost coverage of 318.74 percent borne by Presort Letters and Cards in FY 2017 was so large that every other First-Class product enjoyed a cost coverage below 200 percent, well below the class average of 210.12 percent. *ACR*, Table 1. This also means that Presort mailers were charged more than *triple* their cost, a punitive rate to the highly efficient mailers who must use First-Class Mail because the Postal Service's own mailing standards require them to do so.

Similarly, the cost coverage index for Presort Letters and Cards in FY 2107 was 1.85 (using total Market Dominant mail). While a marginal decline from FY 2016, that figure is still higher than the cost coverage index for Presort Letters and Cards in any other year under the PAEA.[3] The next highest was Every Door Direct Mail, at 1.56. By comparison, that of High Density and Saturation Letters was 1.23. First-Class Single-Piece was, at 0.95, below the average for Market-Dominant mail.

The *ACR* does not report price elasticities, so one must refer to the elasticity estimates contained in the Postal Service's volume forecasting models. Using the same price elasticities as in Table II-5 of Order No. 4257, it is again clear that the

3 *See* Order No. 4257, at 126 Table II-4.

listed elasticity for Presort Letters and Cards is one of the lowest, and the cost coverage the highest, of any market-dominant product.[4]

The cost coverage and unit contributions of Presort Mail remained exceptionally high in FY 2017 despite two important changes in FY 2017. One was the rate adjustment in Docket No. R2017-1, which ameliorated the cost coverage slightly, as was expected.[5] Another was the revised definition of attributable costs resulted, as the Postal Service observes (*ACR* at 4) in attributing more costs to the various products than under the previous methodology. These had the effect of causing Presort Mail's cost coverage index for FY 2017 to decline slightly to 1.85, trivially lower than in FY2016, but still far above that of other mail products.

That the high cost coverage persisted despite these two ameliorating factors indicates that the fundamental problem -- a failure to reflect the low cost characteristics of Presort Mail in rates -- is deep and persistent. Indeed, the continued high cost coverage and unit contribution is partly explained by the fact that many low-cost characteristics of First-Class Presort Letters and Cards (such as local entry, traying and facing, entry near the destination, and a lower cost sales channel) have not, to date, been found to be within the definition of worksharing in Section 3622(e).

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[4] Although using the Postal Service's elasticity estimate for the purpose of this discussion, NPPC strongly believes, based on its members' experience, that the true price elasticity of Presort Mail is much higher. The updated volume forecasting models filed with the Commission on January 19, 2018, suggest that this belief may be correct, because the Service revised the specifications in its models and the new estimate is comparatively less inelastic (at -0.411). *Econometric Demand Equation Tables for Market Dominant Products as of January, 2018* (filed Jan. 19, 2018).

[5] *See Comments of the Major Mailers Association, National Association of Presort Mailers, and the National Postal Policy Council*, Docket No. ACR2016, at 17 (Feb. 2, 2017).

Consequently, those lower costs are ignored in the workshare discount calculations. Yet these low costs are real, which is why First-Class Automation and Presort mail have significantly lower attributable costs than other mail even before taking worksharing into account.

The FY 2017 CRA confirms this yet again. It reports a unit attributable cost for Presort Letters of 12.0 cents, compared to a unit attributable cost of Single-Piece letters of 29.8 cents.[6] Only 8.7 cents of this 17.8-cent per piece cost difference are explained by the worksharing costs avoided. *See* USPS-FY16-3 (Worksharing Discount Tables, Tab FCM Bulk Letters, Cards). The remaining 9.1 cents of the cost differential arises from the many low-cost characteristics of Presort Mail that are not included in the worksharing discount calculations, and thus are not recognized in Presort prices.

The exceptionally high cost coverage of Presort Mail recurred in FY 2017 despite an improved pass-through (93.8 percent) of the worksharing costs avoided at the heavily used 5-Digit Automation Letter tier. Set in Docket No. R2017-1, this passthrough was a welcome recognition by the Postal Service of the need for efficient pricing of the all-important 5-Digit tier.[7] The total 5-Digit rate was nonetheless less efficient than it could have been because its pass-through was substantially offset by

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6 *See* USPS-FY17-1 Public-FY17CRA.xls (Tab FCM Bulk Letters, Cards).

7 Unfortunately, the Postal Service designed the recently implemented rates in Docket No. R2018-1 to pass through only 88.2 percent at the 5-Digit Automation Letter tier, a step in the wrong direction. *See* USPS-LR-R2018-1-1 (FCM Workpapers Tab FCM Bulk Letters, Cards). Using the avoided costs in the current ACR, however, the passthrough returns to 93.75 percent. *See* USPS-FY17-3, WorksharingTables_Final.xls Tab FCM Bulk Letters, Cards)

the miserly 54.4 percent pass-through to the Presort tier from the Metered Letters benchmark. That low passthrough kept Presort rates artificially and inefficiently high. Both passthroughs should be set at efficient levels. If the Postal Service rebalanced the cost coverage and unit contributions within First-Class Mail Letters, all of the Presort passthroughs should be set at efficient levels.

FY 2017 marked the fifth consecutive year, and sixth in the last seven, in which the cost coverage of First-Class Presort Letters and Cards exceeded 300 percent – that is, the price was more than triple the cost of this efficiently-prepared mail. And each annual compliance review proceeding under the PAEA has shown that First-Class Presort Mail consistently has been forced to pay substantially above-average cost coverages and the highest per-piece contributions to institutional costs.

The excessive and inefficient pricing of First-Class Mail Presort Letters and Cards has persisted for too long. The Commission should find that Presort Letters and Cards prices in FY 2017 were unjust.

II. THE POSTAL SERVICE OFFERS NO EXPLANATION FOR THE PRECIPITOUS DECLINE IN FIRST-CLASS MAIL VOLUME OR PLAN TO REVERSE THE TREND

First-Class Mail volume fell by 4.1 percent in FY 2017. Presort Mail volumes fell by 2.87 percent, and Single Piece volumes by 6.1 percent. Given that the Postal Service continues to rely upon First-Class Mail for the largest contribution to institutional costs of any mail in the system, it would have been reasonable to expect that it would attempt to explain the reasons for this decline in the *ACR* and, perhaps more importantly, begin to propose a plan for turning the decline around.

Instead, the Postal Service says merely:

> Unfortunately, whereas the year-over-year decline in First-Class Mail volume had been slowing in recent ears, it accelerated in FY 2017, with the class losing 4.1 percent, or 2.5 billion pieces.

ACR at 8. It then turns to other issues. The Postal Service's *Annual Report to Congress and Comprehensive Statement*, filed as a Library Reference in this proceeding, offers only barely more:

> First-Class Mail primarily consists of single-piece and presort letters and cards Revenue from First-Class Mail was $25.6 billion, $0.4 billion below plan, due to continued and accelerated migration of consumers to electronic communication and transactional alternatives.

USPS-FY17-17, at 22.

The First-Class Business Mailers understand that the Commission's rules regarding the contents of ACRs do not explicitly direct the Postal Service to discuss significant volume declines, nor do they require the Postal Service to address plans to stem or reverse such losses. Nonetheless, when such an unexpected decline in volume occurs in a product that pays so much of the overhead, is it not reasonable to ask the Service what it plans to do?

In its recently filed volume forecasting models, the Postal Service uses econometric forecasting that employs factors such as Gross National Product and employment to "explain" volume changes.[8] Unfortunately, these models also rely

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[8] It is worth noting that the Postal Service volume forecasting models, despite the extensive effort put into developing them, utterly failed to predict the plummeting volumes in FY 2017. Of course, the models do not really "forecast" future volumes; instead, they are, in effect, retrofit to "forecast" the known volume in the most recent past year.

significantly on intervention variables and time trends that themselves contain no inherent economic content. Indeed, trend factors starting in 2008Q1 and 2016Q3 had the largest (alas, negative) effects on volume of *any* factors, only partially offset by yet another trend factor beginning in 2014Q1. But the trend factors so prevalent in the First-Class equations can neither explain what is happening nor offer a solution.

What is missing is a thoughtful narrative discussion of *how* these factors and trends affect First-Class Mail volumes. An important element of that discussion would be how the Postal Service might use these factors to its benefit to stem or reverse the tide.

Unfortunately, in the absence of a clear plan, matters surely will get worse. Indeed, the Postal Service's Integrated Financial Plan for FY 2018 anticipates a decline of *yet another 2.5 billion pieces of First-Class Mail* – about 4.2 percent. It attributes that anticipated loss to "ongoing migration of communications and transactions out of First-Class Mail."[9] With distressing pessimism, the Service says "the resilience of First-Class bill and statement presentment in the mail is waning, as customers are becoming more amenable to accepting bills and statements on their mobile devices, often in response to incentives by companies for making the switch."[10] Again, however, nary a word as to what the Postal Service intends to do about it.

It is true that electronic diversion has flourished, now going far beyond merely email to include websites, mobile communications, and social media. It also must be

[9] United States Postal Service, *Fiscal Year 2018 Integrated Financial Plan*, at 5-6.

[10] *Id*.

acknowledged that the pricing of First-Class Mail products, particularly Presort mail, gives companies a strong incentive to encourage electronic diversion. Many business mailers believe that the accelerated diversion is a direct result of the rate shock of the exigency surcharge, coupled with the stark possibility of even higher rates emerging from the 10-year review process in Docket No. RM2017-3.

Postage today already can account for nearly two-thirds of the cost of a Presort mailing. Prices so removed from unit costs cannot be considered efficient or just in any economic or legal sense. The high cost of postage, however, is only part of the charges mailers incur from the Postal Service. Using the Postal Service can be quite costly for mailers even when postage is not taken into account. Mailers incur expense when the Postal Service shifts costs on to mailers or mailing services providers in order to comply with changing entry requirements. Adding to the costs is a plethora of assessments that the Postal Service imposes, which soon inevitably will include assessments arising from the new Move Update requirements. It is quite reasonable to think that mailers concerned about the direction of future rates are taking action now to reduce their potential exposure.

The Postal Service needs to examine this problem with some urgency. To that end, the Commission should direct the Postal Service to address why volume is falling, why its models failed to forecast that decline, and what remedies it proposes to slow or reverse the decline. At a minimum, the Postal Service should refrain from raising First-Class Presort rates any more until it can understand and explain the reasons for the continuing volume loss and has a clear plan what to do.

III. CONCLUSION

For the foregoing reasons, the National Postal Policy Council, the National Association of Presort Mailers, and the Major Mailers Association respectfully urge the Commission to consider these comments when making its determination pursuant to 39 U.S.C. §3653, and also to take these comments into account in its review of the ratemaking system pending in Docket No. RM2017-3.

Respectfully submitted,

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