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

Annual Compliance Review, 2018	)))	Docket No. ACR2018

COMMENTS OF THE ASSOCIATION FOR POSTAL COMMERCE
(February 19, 2019)

Pursuant to Order Nos. 4960, 4988, and 4998, the Association for Postal Commerce ("PostCom") submits these comments on the Annual Compliance Report ("ACR") for Fiscal Year 2018 filed by the United States Postal Service ("Postal Service") on December 28, 2018.[1] As noted in comments filed in past annual compliance dockets, the information presented in the ACR illustrates several ongoing and recurring concerns of which the Commission is well aware. In short, the concerns PostCom has expressed in its comments on previous ACRs remain largely unaddressed—the Postal Service continues to make decisions that impose additional costs on mailers without creating corresponding efficiencies in the postal network, causing costs to both the Postal Service and the industry to continue to rise. Moreover, the Postal Service has once again failed to meet its own service standards for any market dominant product, meaning that mailers continue to pay more for less. PostCom urges the Commission to remain cognizant of this dynamic as it evaluates and makes recommendations regarding cost coverage and workshare discounts reported in the ACR.

I. <u>WORKSHARE DISCOUNTS</u>

As PostCom indicated in its comments in Docket No. R2019-1, the Postal Service

[1] In Order No. 4998, the Commission granted PostCom access to certain nonpublic library references filed by the Postal Service and extended the deadline for PostCom to file comments on the ACR to February 19, 2019. PostCom has reviewed these nonpublic files, and they have informed these comments. PostCom is not commenting directly on any of this nonpublic information, however, and is therefore filing these comments publicly.

continues to reduce workshare passthroughs, squeezing its customers as it does so. The current ACR indicates that the Postal Service reduced numerous passthroughs such that, with the price changes in R2019-1, it now expects them to pass through less than 100% of avoided costs. *See, e.g.,* ACR at 23-24. The ACR suggests that the Postal Service has made these changes at least in part to protect against a finding by the Commission that the discounts are not in compliance with 39 U.S.C. § 3622(e)(2). This rationale is both legally and logically flawed. Moreover, these changes raise the question of whether the Commission and the Postal Service are so focused on limiting passthroughs to 100% of avoided costs that they are ignoring the practical realities of both the calculation of avoided costs and the processing and entry of mail and driving discounts to less efficient levels. The problems with this approach manifest elsewhere in the ACR, where USPS uses mail mix changes resulting in entry farther from destination to explain a loss in efficiency. *See, e.g.* ACR at 15.

Given the considerable leeway that the Postal Accountability and Enhancement Act provides with respect to the 100 percent passthrough requirement, the rigid and crude enforcement of this particular feature stands in stark contrast to the tremendous latitude the Commission grants the Postal Service with respect to other features of PAEA (see comments on service performance to follow). In fact, throughout the ACR it is impossible to find any specific example where the Postal Service attempts to remediate non-compliant passthroughs except through the imposition of higher than average price increases. Thus, despite estimated passthroughs that exhibit considerable volatility due to methodological changes, postal inefficiency, and normal variation, the Postal Service and the Commission continue to use only one technique – higher prices – to attempt to achieve compliance with one specific component of PAEA while perennial failure on efficiency and service performance is met with a finger wag.

As we have noted in previous ACR proceedings, the calculation of avoided costs and the setting of workshare discounts is, to a degree, an inexact science, and PostCom does not contend that avoidable costs must be measured with absolute precision before the Commission can make a finding of compliance or non-compliance. But PostCom does contend that the Commission has not adequately accounted for this uncertainty in its past rulings.

A. Treatment of Workshare Discounts Does Not Adequately Reflect Customer Choice

In R2019-1, the Postal Service reduced destination entry discounts for USPS Marketing Mail Letters by almost ten percent. As PostCom explained in its comments in that docket, the expected result of these changes would be for more mail to be entered either at origin or at a DNDC rather than at a DSCF. Docket No. R2019-1, Comments of the Association for Postal Commerce at 3 (Oct. 30, 2018). To the extent that mailers are responding only to the difference in price, one could argue that a more efficient price signal is being sent if the discounts are more closely aligned with the Postal Service's estimates of avoided costs. This reasoning is sound so long as the service provided by the Postal Service is equal across all entry points. In that case, a mailer could evaluate the entry point that provides the lowest combined cost of mailing, identify the service standard for that entry point, enter mail accordingly, and be confident that the mail will be delivered on time. But unfortunately, not all things are equal. As has long been understood, the farther mail is entered from its destination, the worse the Postal Service's service performance.

Thus, more than a simple calculation of costs and available discounts goes into a mailer's decision as to where to enter its mail. Some customers, for example a retailer sending advertising content relating to a specific time-limited offer, may enter mail closer to destination ensure timely delivery even if an avoided costs analysis would suggest the Postal Service can transport the mail to that destination for less. As entry discounts decrease, theses mailers will need to decide whether to move volume upstream and risk worse service performance, or to pay more for destination entry. Conversely, other users, less concerned about delivery timing, may evaluate where to enter mail solely by comparing entry discounts to the cost of delivering mail to an entry point.

USPS Marketing Mail is used for a wide variety of purposes by thousands of different mailers, yet the mechanistic approach heretofore favored by the Commission presumes that all customers can make the same cost versus service tradeoffs. In reality, customers choosing destination entry may be buying something different – greater service reliability – than those choosing origin entry. An unnecessarily oversimplified approach to setting worksharing discounts does not properly recognize that reality. Further, as pricing signals incent more mail to be entered upstream or sorted to less fine sortation, overall efficiency (and service performance) may be reduced further as the Postal Service struggles to handle the additional volume entered at upstream points and mail that requires more processing and sortation.

Because Section 3622(e) does not establish an absolute requirement that workshare discounts never exceed 100 percent of avoided costs, the Commission should stop acting as if it does. Its decisions are discouraging efficient mail preparation, entry, and processing. This impact is even more adverse when one considers how many workshare discounts still pass through less than 100% of avoided costs. PAEA specifically allows workshare discounts to exceed avoided costs where “reduction or elimination of the discount would impede the efficient operation of the Postal Service.” 39 U.S.C. §3622(e)(2)(D). This provision was included in the statute precisely to prevent the situation described above.

B. Passthroughs Less Than 100% Must Be Considered and Balanced With Those That Exceed 100% of Avoided Costs

The Commission's rules require the Postal Service to "identify and explain discounts that are set substantially below avoided costs, and explain any relationship between discounts that are above and those that are below avoided costs" in its notice of price changes. Order No. 4215 at 11 (citing 39 C.F.R. § 3010.12(b)(6)). Yet in the ACR dockets, the Postal Service and Commission focus almost entirely on those discounts that pass through more than 100 percent of avoided costs. The FY 2018 ACR has no discussion of discounts set below avoided costs. This imbalance adds to the risk that the Postal Service will continually reduce passthroughs in ways that lead to less efficient mail entry and processing.

For example, dropship passthroughs for Commercial and Nonprofit Basic Carrier Route Flats (DNDC) are only 57.4%. Dropship passthroughs for Nonprofit Machinable and Irregular Parcels (DNDC) are only 46.4%. Presorting passthroughs for Commercial and Nonprofit Marketing Mail Flats—Automation range from 42.5% to 83.8%. *See* USPS-FY18-3 Worksharing Tables. And the passthrough for First-Class Mail Letters—Automation 5-digit, the most efficient mail for USPS to handle, is only 88.2%. These discounts are not discussed at all in the ACR even though they are just as, and in some cases significantly more, inefficient than the discounts the Postal Service justifies in the ACR.

Postal prices should encourage mailers to participate in worksharing and ensure that mail is delivered at the lowest total combined cost. Those incentives fail when the discount is insufficient to drive a change in behavior, a result that is inevitable when workshare discount passthroughs are consistently below 100%.

The Commission's requirement that the Postal Service analyze, report on, and provide detailed justifications for every passthrough that exceeds 100% causes the Postal Service to err on the side of reducing passthroughs below 100%. This reduces the flexibility of the Postal Service to price efficiently in response to market forces while simultaneously undermining the purpose for providing workshare discounts. For instance, in our 2016 and 2017 comments we noted that:

> Through its price signals and operational decisions, the Postal Service has been driving mail upstream to less efficient operations. This has caused costs, through no fault to the mailing industry, to continue to increase as the USPS chases efficiencies that either do not exist or no longer exist due to decreased economies of scale and lost volumes.

See Initial Comments of the Association for Postal Commerce, Docket No. ACR2017, at 2. Our comments in ACR2017 also identified instances in which the Postal Service reduced a passthrough so far below 100% that the change resulted in less efficient pricing than when the passthrough exceeded 100%. *See id.* at 4. The Postal Service reports the same phenomenon in the current ACR, explaining that the price changes in R2019-1 will reduce the Nonautomation 5-Digit Nonmachinable Letters passthrough from 101.4% to 97.1%. ACR at 20-21. So long as the Commission continues to focus on passthroughs that exceed 100% of avoided costs to the exclusion of those that pass through less than 100% of avoided costs, it will continue to discourage efficient pricing.

C. The Commission's Position on Passthroughs Is Neither Logically nor Legally Supported

As demonstrated in the previous section, the Commission's intense focus on ensuring workshare discounts never pass through more than 100% of their avoided costs has resulted in inefficient pricing and handling of mail. These consequences are particularly regrettable because the Commission's dictates are contrary to PAEA and the logic that underpins it.

PAEA states that the "Commission shall ensure that [workshare] discounts do not exceed the cost that the Postal Service avoids as a result of workshare activity, unless" the discount falls within certain exceptions. 39 U.S.C. § 3622(e)(2) (emphasis added). This "unless" is key. It means that if one of the exceptions applies, the workshare discount is lawful even if it exceeds the avoided costs associated with that activity.

It is also important to look at the parameters of the exceptions themselves. The exceptions in 3622(e)(2)(A) and (B) require that the excessive discount be "phased out" over some period of time. That is, those exceptions are designed to apply when certain conditions temporarily require a discount to exceed avoided costs. The exceptions in 3622(e)(2)(C) and (D), by contrast, are not so limited. If a discount meets the requirements of these exceptions, it is lawful no matter how long the discrepancy between the discount and the avoided costs has persisted or will persist.

With respect to 3622(e)(2)(D), the logic behind not requiring the reduction of the discount over time is clear. This exception permits a discount to pass through more than 100 percent of avoided costs when reducing the discount "would impede the efficient operation of the Postal Service." 39 U.S.C. § 3622(e)(2)(D). By definition, reducing this discount would result in less efficient operations. If the exception were time-limited, the statute would be requiring the Postal Service to become less efficient over time. Such a result would seem absurd.

Yet that is exactly the result the Commission has pursued. The Commission has stated that even when a discount is lawfully set above avoided costs because it promotes operational efficiency, it will nevertheless encourage the Postal Service to reduce the discount "to promote pricing efficiency." See Docket No. ACR2017, Annual Compliance Determination Report, Fiscal Year 2017, at 15. This position is irreconcilable with the statute and purpose of this exception. First, the statute makes no distinction between "pricing efficiency" and "operational efficiency" when evaluating workshare discounts. It simply permits workshare discounts to be set above avoided costs if reducing the discount "would impede the efficient operation of the Postal Service." 39 U.S.C. §3622(e)(2)(D). "Pricing efficiency," though not defined in the statute, presumably simply refers to the practice of setting workshare discounts as close as possible to avoided costs. To claim that "pricing efficiency" supports reducing a discount justified by this exception is to engage in circular reasoning. Section 3622(e)(2)(D) is an exception to the general rule that pricing efficiency should be pursued. Thus, it applies even if reducing the discount would increase pricing efficiency, however defined.

Moreover, the exception is specifically designed to promote operational efficiency, and reducing the discount would subvert this purpose. To the extent the statute requires pricing efficiency, it does so on the assumption that better aligning discounts with avoided costs will result in more efficient entry and processing of mail—*i.e.*, operational efficiency. The statutory exceptions recognize that this assumption might not always hold. The Commission has not explained how the benefits of "pricing efficiency" alone, assuming they exist, are distinct from those of operational efficiency, nor why they outweigh the harm that would come from impeding the efficient operation of the Postal Service by reducing the discount.

In an attempt to circumvent this conundrum, the Commission has further stated that "[i]f the operational efficiency results in cost savings to the Postal Service, the Postal Service should quantify the impact of the operational efficiency in its cost avoidance models." Annual Compliance Determination Report, Fiscal Year 2017, at 15. Here, too, the Commission's position finds no support in PAEA. The importance of the "operational efficiency" exception lies in its availability in situations where the Postal Service's cost avoidance models cannot quantify the impact on operational efficiency reducing the discount would have. For instance, in its response to CHIR No. 3, Question 7 regarding the passthrough for Automation Mixed AADC

Letters, the Postal Service explained that its "cost avoidance models do not capture the operational efficiencies that flow from information obtain from Full-Service IMb" because "[c]ost models address the direct measurable cost differences associated with barcoded pieces and non-barcoded pieces." The Full-Service IMb, however, provides significant cost savings by enhancing the Postal Service's ability to investigate processing failures, aiding with internal service measurement, enabling automated entry of mail, and providing insight into mail quality to mailers. USPS Response to CHIR No. 3, Question 7 a-b. These benefits are unquestionably real, but it is difficult to conceive of a cost avoidance model that would capture them. Section 3622(e)(2)(D) allows the Postal Service to set discounts that will allow it to realize these benefits, even if the benefits are not precisely measurable avoided costs.

The Postal Service's response to CHIR No. 3 also illustrates the deleterious impact the Commission's position has had on Postal Service decisionmaking. In response to Question 7.c., the Postal Service states that it "is committed to bring this passthrough into compliance with the statute" by gradually reducing it. The discount, however, is already in compliance with the statute because it is justified by 39 U.S.C. § 3622(e)(2)(D). The discount can legally be set above the level of avoided costs because setting it at a lower level would impede the efficient operation of the Postal Service. The Postal Service's "commitment" would undermine the goals of the statute, not further them.

Importantly, "pricing efficiency" is not a factor to be considered in setting rates, but encouraging "operational efficiency" is. *See* 39 U.S.C. § 3622(c)(7). The Commission's repeated insistence that the Postal Service reduce discounts that are perfectly legal has turned the statute on its head. It is past time for the Commission to abandon its insistence that all passthroughs exceeding 100% of avoided costs be reduced. If a passthrough is justified by 39

U.S.C. § 3622(e)(2)(D), it is legal, and for good reason.

II. FLATS PERFORMANCE CONTINUES TO DECLINE

The shortfall from Standard Mail flats grew to $753M in FY 2018, up from $669M in FY2017, with cost per piece increasing by 13.4 percent. The Postal Service alleges that this increase is the result of comailing as flats volume has migrated from the Flats and Carrier Route products into High Density Flats. ACR at 17. In response to this "finding" the Postal Service announces that it intends to evaluate combining Flats, Carrier Route Flats, and High Density Flats into a single Non- Saturation Flats product. This would be a significant change with unknown impact. In fact, in response to CHIR 1, the Postal Service acknowledges that it has no timeline for such a change. This creates the impression that the Postal Service is flailing; unable to come up with concrete solutions it hopes that some magic bullet will reverse trends that are leading inexorably to the end of flats as a viable part of the mail stream.

PostCom commends the Commission for its attempts to force the Postal Service to confront its failings with regard to flats, but must also reluctantly note that those efforts have failed utterly. Year after year, the Postal Service presents increasingly disappointing performance on flats. The response to the Commission's Flats Directives (ACR at 24-36) is particularly damning; all relevant operational and service indices show declines in performance. Cycle times are increasing, and bundle breakage is worsening. While the Postal Service has enumerated a list of operational changes it hopes to implement, it simultaneously maintains that it "is still unable to provide an estimate of the financial impacts of these operational initiatives. As the Postal Service has explained, "the information generated by the Postal Service's existing data systems does not support reliable estimates of the impact of operational initiatives on flats costs." ACR at

27).[2] Given this admission of defeat, there is no reason to expect that the operational changes outlined by the Postal Service will produce meaningful impacts. PostCom argues that until and unless the Postal Service demonstrates a willingness to understand what it is doing with regard to flats, price increases greater than the product average should end.

The Postal Service's response to CHIR No.1, Question 14 says it all: "The Postal Service remains unable to provide an estimated timeline. The unrelenting and highly variable decline in Flats volume takes away economies of scale and density, resulting in disproportionate cost pressures on products with declining volume. The extent to which workhour reductions will be able to keep pace with presumably continued volume decline is unknown. Therefore it is quite difficult to come up with a unique set of reasonable assumptions about the future course of Flats costs."

It is truly disappointing that the Postal Service remains largely indifferent to the importance of understanding how its operational decisions impact the costs that it is able to pass directly onto its customers due to its monopoly status. PostCom appreciates that the Commission has launched RM2018-1 to explore the issue of flats costs in a more exhaustive fashion. Until that effort has produced some insight into a sustainable path forward, ever increasing prices are unlikely to make the slightest difference.

III. THE FLATS STORY IS PART OF A LARGER PROBLEM

The Postal Service's total factor productivity (TFP) index barely moved (up 0.1 percent) in FY18 after reaching its lowest point since 2012 in FY 17.[3] Because it is an aggregate

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[2] To the extent this statement simply means that data systems designed to support reporting of costs and revenues in the ACR do not support these estimates, the Postal Service should explain these shortcomings more clearly in the ACR rather than claiming that it "is still unable to provide an estimate of the financial impacts of these operational initiatives." ACR at 27. Further, if the Postal Service has developed other estimates of the cost impacts or planned impacts of operational initiatives on flats costs, it should provide these estimates in the ACR.
[33] FY 2018 Annual Report to Congress at 30.

indicator that encompasses all products and inputs, total factor productivity is the single most important indicator of how well the Postal Services uses resources in carrying out its mission; the fact that TFP is stagnant indicates that productivity continues to lag expectations. While the Postal Service is quick to admonish that results should be looked at only over a period of years, productivity is negative over the last five years. On other indicators of productivity, the Postal Service has fallen short of its own planned performance as indicated below:

Deliveries per Total Work Hours, % Change Calculation

	FY2019 Plan	FY2018 Actual	FY2018 Plan	FY2017 Actual	FY2016 Actual	FY2015 Actual [1]
Work hours (millions)	1,161.0	1,169.6	1,141.0	1,163.9	1,157.6	1,127.9
Less adjustment to work hours based on earned workload [2] (millions)	(4.9)	(5.4)	(4.0)	(5.4)	18.0	15.4
Adjusted work hours (millions)	1,165.9	1,175.0	1,145.0	1,169.3	1,139.6	1,112.4
Total deliveries (millions)	48,358	47,825	47,835	47,604	47,366	46,829
Deliveries per total work hours (unadjusted)	41.7	40.9	41.9	40.9	40.9	41.5
Deliveries per total work hours (adjusted)	41.5	40.7	41.8	40.7	41.6	42.1
Deliveries per total work hours, % change [2]	1.4%	(0.5)%	2.1%	(0.5)%	0.1%	0.2%

IV. <u>TRANSPORTATION COSTS ARE INCREASINGLY CONCERNING</u>

Despite a continuation of recent trends in declining volume, the Postal Service’s transportation costs continue to grow at an alarming rate. In FY 2018, USPS Marketing Mail volumes declined by more than 1 billion pieces while weight was down 3.1 percent. Despite these declines, transportation costs for USPS Marketing Mail increased by 17.1 percent. The Postal Service provides limited insight into the drivers of transportation costs, making it difficult to draw meaningful conclusions about the increase.

PostCom urges the Commission to seek information that would allow a better understanding of changes in transportation costs, including but not limited to USPS information on capacity utilization and transportation productivity.

V. THE IMPORTANCE OF TRANSPARENCY IN REPORTING

As was the case last year, the Commission takes up the ACR while previous ACR dockets remain open. The duration of these proceedings and the fact that they have yet to lead to significant improvement in many areas remain a great concern to PostCom and its members. While the conduct of these proceedings may satisfy the Commission's statutory obligation to determine compliance with PAEA, as an inquiry into important operations and service issues they leave much to be desired. As in previous years, the Postal Service grudgingly offers required information that is often incomplete, heavily edited and or redacted, and lacking contextual information that might lead to clarity and insight. In fact, the Postal Service appears to be using the ACR to bolster its arguments in RM2017-3 rather than to seek meaningful improvements. The most glaring and galling example of this continues to be the Postal Service's indifference to the fact that flats costs are demonstrably out of control. The Commission has contributed to the inefficiency of these proceedings as well by failing to impose any kind of sanction on the Postal Service for declining to address relevant issues.

The mailing community must participate in the ACR process to maintain pressure on the Postal Service to meet its targets. The ACR process imposes significant costs on the interested parties yet allows the Postal Service to avoid any and all accountability for improving performance. PostCom notes the continued issuance of Chairman's Information Requests (CHIR) in this proceeding as helpful in identifying missing and potentially helpful contextual information. As a general principle, PostCom endorses all efforts to increase the transparency of the ACR process with regard to identifying relevant cost and cost avoidance estimates, operational performance data, and service information. But CHIRs should not be left open for years, well after the rates underlying the ACR in question have changed and compliance has been determined. It is one thing to require periodic reports from the Postal Service on matters.

But if a serious issue has been identified, the Commission should open a new docket, aggressively pursue an answer, and order any relief it finds appropriate.

Furthermore, PostCom reiterates last year's suggestion that the Commission encourage USPS to share much more unedited information. As the Postal Service's Informed Visibility (IV) platform expands, it creates millions of data points daily. USPS is collecting information on mailpieces and employee activity that could provide a wealth of information on USPS operations performance, yet much of that data is shielded from this inquiry. In part that may reflect the mere fact that technological change outpaces regulatory change. Given that some of the Postal Service's service and productivity problems appear intractable, we suggest that open access to raw information collected through IV—with appropriate safeguards to hide the identity of individual employees or customers—would benefit all parties.

VI. CONCLUSION

PostCom respectfully offers the foregoing comments on the FY 2018 ACR. As noted above, the Postal Service appears to be using its existing infrastructure in an inefficient manner and driving costs to mailers in a manner that does not reduce overall costs. In addition, the FY 2018 ACR illustrates a series of unexplained, and highly troubling, cost increases. These cost increases are a source of mystery to PostCom as the Postal Service has putatively been shedding costs through its continued transfer of tasks (as reflected in the Postal Service's increasingly stringent rules) to mailers. PostCom respectfully requests that the PRC encourage the Postal Service to make better use of the data in its possession, particularly IV data, to analyze ways in which it can improve its processes and its pricing practices.

Respectfully submitted,
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