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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products	)))	Docket No. RM2017-3

REPLY COMMENTS OF THE AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)

(March 4, 2020)

Pursuant to Commission Order No. 5337, "Revised Notice of Proposed Rulemaking," December 5, 2019, ACMA is pleased to submit these reply comments.

I. Introduction.

Catalogers use nearly all mail products, with concentration in the categories of Marketing Mail. In its initial comments, and by reference its comments in Docket No. ACR2019, ACMA explained that forcing higher and higher rates on non-ECR Flats will be detrimental to the viability of Marketing Mail and to the overall Postal Service, and that sufficient questions exist about the meaningfulness of the associated costs to make it speculative to use them as a basis for reordering relationships. A number of parties focused on the effects of large multi-year rate increases, but few provided record on the validity of the costs. If the costs do not respond to volume reductions in the way suggested by the cost assignments, the rate increases will leave the system with high costs and little volume.[1] The United States is a large and varied country; a universal mail system for it cannot have low volume, affordable rates, and high service levels.

In these reply comments, we go beyond our initial comments on the same matters and focus on (a) the comments of APWU on the Performance Incentive and (b) the comments of the Public Representative on the Density Incentive.

II. APWU's Version of the Performance Incentive Is Ill-advised.

In its initial comments, APWU refers to the Commission's Financial Health Cycle and to the need for funds to drive it (at 5). It points to the need to get the horse before the cart (at 6). It also recognizes that the "pre-PAEA rate of capital investment … may not be the right rate" (at 9-10). With all this, we agree.

Then, after discussing investments it believes to be worth considering, it reasons that the best way to fund the Cycle is for the Postal Service to present an investment plan and for the Commission to then fund it with an increase in cap authority (at 11). At this point, we disagree.

It is altogether appropriate to borrow funds to fuel a health cycle. If investments have acceptable ROIs and implementations are controlled, it should be easy to repay the debt and have money left over. According to the most recent Form 10-K, the Postal Service has $4.0 billion of borrowing authority and $8.8 billion in unrestricted cash.[2] Along with depreciation allowances, this should be adequate for investment purposes.

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1 In its initial comments, the Postal Service refers to the possibility that "attributable costs are not as volume-variable as measured" (at 50). At best, the costs are designed to be long-run in nature. Part of the long-run character is the piggyback factors, which link a range of adjustments to direct volume effects. If the volumes continue to change, these piggybacked costs may change, someday, but it could be five to seven years.

2 Form 10-K, filed with the Commission November 14, 2019, at 9, 39, and 41.

It is hard to argue that Congress intended otherwise. Thus, we do *not* agree that special funding for investments, through special cap authority, is needed.

We understand that the Postal Service is under pressure to plan only those investments that are essential and that have a payoff, and we believe this is as it should be. Particularly at a time of declining volume, when the productive system is being downsized accordingly, it should not pursue investments that are nice but not essential. Its competitors in the private sector are no doubt following the same rule. Further, we do not see that the Commission is in a position to evaluate which investments are needed and whether ROIs are likely to be realized. These decisions are best left to Postal management and its Board.

It is a good question whether the expected returns on past investments have been realized. We do not know of focused evidence on this. However, ACMA has found that since FY 1998, the compound average annual growth rate of the unit costs of MM Flats (with mix held constant) was 5.39% while factor prices increased at the rate of only 2.88%. And since FY 2008 (the first year of data for it), the growth rate of the unit costs of MM Carrier Route was 5.67% while factor prices increased at the rate of 2.48%.[3] Given the investment and operational initiatives during this period, one would expect much lower unit cost increases, likely lower than the factor price increases. Yes, volumes have declined, but the Postal Service is far too quick to write off the cost increases as due to scale diseconomies. Further, to the extent that there *are* scale diseconomies, there is a direct implication that the cost variabilities, most set at 100%, are too high and, accordingly, that the associated cost estimates are too high. This

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[3] Docket No. ACR2019, ACMA spreadsheet "ACMA_ACR2019_Workbook.xlsx" January 30, 2020, tabs 1-Factor P, 3-Flt, and 4-CR.

"implication" is not a matter of opinion—there is 100% agreement among economists and costing professionals that the implication is solid. More evidence is *not* needed. If the variabilities are right, the unit costs should not change with volume; if the unit costs do change with volume, the variabilities are wrong.

So there *is* some evidence that no return on past investments has been realized. This evidence adds further to our position that APWU's have-plan-give-money scheme is ill-advised.

III. The Public Representative Does Not Provide the Record Needed to Proceed with the Density Authority.

In his initial comments, the Public Representative provides review of the Commission's DRA (Density Rate Adjustment) formula, after noting its similarity to formulas he submitted earlier. He begins with a correct statement that the change in the density component of the "formula … can be rewritten as follows:"

$$\%\Delta D_{[T-1,T]} = \frac{V_T}{V_{T-1}} * \frac{DP_{T-1}}{DP_T} - 1.$$

In words, the percent change in density is equal to -1 plus the mathematical product of the volume ratio (period 2 over period 1) and the delivery-point ratio (period 1 over period 2).

After reasoning that each of these ratios would be expected to be between 0 and 1, the

> Representative concludes that by including both the change in the number of delivery points and change in volume in the DRA formula, the Commission *accounts* for two factors that generally cause per unit costs to increase. [At 12, italics added]

The Representative did not discuss whether it represents reality for the two ratios to enter a DRA formula in the same way, one ratio times the other. He did not discuss whether one would expect, say, a 3% change in the volume ratio to have the same effect as a 3% change in the delivery-point ratio. He did not discuss whether a change in the delivery-point ratio has implications for the volume or the volume ratio. New delivery points generate new volume, but he did not discuss the profitability of these new points, city or rural, now did he mention that rural points are growing faster than city points. And he did not discuss whether a change in density would have the same effect on costs whether it is the result of one set of ratios or another. For example, a volume ratio of 0.96 multiplied by a DP ratio of 0.98 would give the same mathematical product as a volume ratio of 0.95 multiplied by a DP ratio of 0.990316, but the cost and contribution effects would be different.

It appears that the Representative may have struggled with some of these questions. He says:

> It appears that volume is just one component of density. It would be correct to identify a decline in density with a decline in volume only if the decline in mail volume pieces followed the same trend as decline in density. [At 8.]

We do not understand what this means. However, what is clear is that a change in volume due to a change in the number of delivery points does not have the same effect as a change in volume for an unchanged set of delivery points (which could be due to a change in rates, a change in exogenous factors, a change in autonomous factors, or a secular trend). Until these questions are dealt with, there is no record support for the Commission’s DRA formula. Certainly the Representative has no basis for saying that the Commission's formula *properly* "accounts" for volume and delivery points.[4]

The difficulties, however, do not end here. If the density adjustment is to preserve contribution when volume is lost, then it is out of line with the direction the Postal Service should go. Consider a low-volume postal service with low fixed costs and a high-volume postal service with high fixed costs. It is perfectly obvious that if the high-volume service loses volume over time, it should move toward being like the low-volume service. But if the high-volume service attempts to *preserve contribution,* as the density adjustment is ostensibly designed to do, then the high-volume service moves in the direction of being a low-volume service *with high fixed costs*. This cannot be allowed to happen. All of the incentives in regulation should be designed to prevent it.

In a subsequent section on the same subject, the Representative discusses the "mail mix," and laments:

> The DRA formula does not account for mail volume declines either by class (as in the Public Representative's proposal) or by product (as in the Postal Service's proposal), which creates a number of problems. [At 14.]

As an example, the Representative says

> the Package Services class of mail has not experience [sic] year-over-year declines in density in recent years, and it appears unclear why it "*deserves*" additional rate authority to compensate for per-unit cost increases due to a decline in density. [At. 15, footnote omitted, italics added.]

In line with the focus of the DRA on lost contribution, we believe the Representative means "to compensate for <u>lost contribution</u> due to a decline in density." But it is the word "'deserves'" that raises the question. The Representative appears to favor the

[4] ACMA discussed these matters in its initial comments, introducing the notion of "anyhow volume" (at 8).

Postal Service saying to remaining mailers of a specific product: "because some of your fellow mailers went out of business, we are increasing your rates." We do not believe there is any basis for saying that a particular group of mailers "deserves" a rate increase because its volume (or some measure of density) declines.

The problem revealed here is much greater than just whether Package Services gets a rate increase. Losses in contribution, leading generally to reductions in net income, have been occurring since the inception of the Post Office Department, including since the creation of the Postal Service in 1970. Under the PRA, these losses led to rate cases that proposed rate increases to restore contribution and return to breakeven. To guide these rate increases, attention was given to notions of economic efficiency, competition and effects on mailers, nature of the service provided, demand elasticities, notions of fairness, rate relationships, objectives and factors in applicable law, national policy, and maybe rounding concerns, but no one has ever argued that a particular category "deserves" a rate increase because of something its former fellow mailers did (like going out of business). To direct increases on the basis suggested by the Representative is out of line with all we know about good ratesetting.

For all these reasons, the DRA misaligns incentives and is out of line with what should be happening.

Respectfully submitted,

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