

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

Postal Rate and Fee Changes, 2006)
Docket No. R2006-1)
)

DIRECT MARKETING ASSOCIATION, INC.
INITIAL COMMENTS
PURSUANT TO PRC ORDER NO. 8
(May 4, 2007)

The Direct Marketing Association, Inc. respectfully submits these Initial Comments pursuant to PRC Order No. 8 in this proceeding on the subject of the rates that the Commission should recommend upon reconsideration for Standard Mail flats.

I. INTRODUCTION.

DMA fully supports the Governors' findings that the rates recommended by the Commission for Standard Mail flats are, quite simply, too high.¹ As the Governors said,

“The Commission’s approach incorporates the full cost differences based on shape between letters and flats. This has led to steep price increases for flats. For example, those catalogs which pay the piece rates for automation flats entered at Sectional Center Facilities (SCF) closest to the delivery destination (DSCF) face a 41.1 percent increase under the Commission’s proposal . . . [T]he risks of misjudging how mailers (and thus mail volume) would respond increase significantly with rate changes of this magnitude.”²

The Governors continued,

¹ Decision of the Governors of the United State Postal Service on the Opinion and Recommended Decision of the Postal Regulatory Commission on Changes in Postal Rates and Fees, Docket No. R2006-1 (March 19, 2007) (“Decision”) at 8-10, 11-12.

² *Id.* at 9.

“We believe the more gradual transition to cost-based pricing proposed by the Postal Service would have better served to balance the considerations of both efficiency and the long-term health of the catalog industry.”³

Then, the Governors presented their suggestion as to how the Commission should provide relief for the mailers of Standard Regular flats:

“We therefore wish the Commission to reconsider whether some rebalancing between Standard Mail letter and flatrates might be appropriate.”⁴

DMA strongly supports the Governors’ request that the Commission reconsider the rates for Standard Regular flats and revise its recommendation to correspond with the rates initially proposed by the Postal Service. However, DMA objects, equally strongly, to the Governors’ suggestion that a revision downward of Standard Regular flat rates be accompanied with a revision upward of the rates for Standard Regular letters.

For the reasons articulated below, rate relief for Standard Regular flats is absolutely required. However, this rate relief can, and should, be provided without increasing the rates for any other class, subclass or rate category, including Standard Regular letters in particular.

II. “REBALANCING” OR INCREASES IN ANY OTHER RATES WOULD BE INAPPROPRIATE.

There are several reasons why the Commission should reject the Governors’ suggestion that the rates for Standard Regular letters should be “rebalanced” (*i.e.*, increased) in connection with a reduction of the rates for Standard Regular flats. Some of these reasons are legal; some are financial.

A. The Commission Must Comply with the Statutory Pricing Factors when Adjusting Rates Pursuant to the Governors Request for Reconsideration.

The USPS rate structure is divided into classes, subclasses, rate categories, rate elements, worksharing discounts and other ingredients that are all tightly interwoven, and the pricing process established by the Act requires the Commission to consider the inter-relationship among all the elements of this rate structure when setting the rates for any one element. For example, the issue of

³ *Id.*

⁴ *Id.* at 10.

whether the cost coverage for any particular subclass meets the “fair and equitable” test⁵ depends to a large extent upon its relationship to the cost coverages of all the other subclasses. This is particularly true of the cost coverages of the various subclasses of First-Class Mail and Standard Mail, which is an issue that has been litigated time and time again and is typically analyzed in great detail in the Commission’s Opinions.⁶

Thus, when granting rate relief to Standard Regular flats, the Act does not permit the Commission to follow the Governors’ suggestion and simply “rebalance” the relationship between Standard Regular letters and Standard Regular flats in a vacuum. The Commission would be required by the Act to consider the entire USPS rate structure and, in particular, alternative means of providing any additional revenues deemed necessary, including the possibility of raising the rates of First Class or other classes.

All the rates recommended on February 26 were determined by the Commission to be consistent with the record in this proceeding. Any increases in any of these rates would raise issues as to whether the revised rates are also consistent with the record, and justifying them would surely place the Commission in the uncomfortable position of having to explain why the increased rates are appropriate when it had initially recommended lower rates.

B. The Commission Can, and Should, Meet the “Break-Even” Requirement by Reducing the Provision for Contingencies.

From a financial point of view, a reduction in the rates for Standard Regular flats need not, and should not, result in any increase in the rates for any other mail class or category, including letter-shaped Standard Regular Mail – for two reasons:

First, following a reduction as proposed herein, the volume and revenue estimates for flat-shaped Standard Mail will become more realistic, correcting a serious revenue overstatement reflected in the estimates contained in the PRC’s Opinion. Correcting this overstatement will not deprive the Postal Service of any revenues that it can realistically anticipate, and therefore these revenues need not be “recouped” from any other source, as they did not exist in the first place.

Perhaps most importantly, the Commission included a full one-percent “contingency” in the revenue requirement on which the recommended decision is based. DMA demonstrated on the

⁵ 39 U.S.C. §3622(b)(1).

⁶ *E.g.*, PRC Docket No. R97-1 Op. at 441-48.

record of R2006-1 that a contingency of this size is not needed, given the current financial strength of the Postal Service. If (and we emphasize that it is a big “if”) the revenues realistically estimated to be produced from Standard Regular flats at the rates and volume levels reflected in the original USPS proposal still yield a revenue “shortfall,” this shortfall can and should be “taken” from the contingency.

In short, DMA respectfully submits that the risks the Postal Service will be undertaking if it implements the rates for Standard Regular flats recommended by the Commission far exceed the risks that the Postal Service currently faces from any other quarter. There will be financial damage to the Postal Service – not to mention the damage to the mailers. The only question is exactly how large that financial damage will be. DMA respectfully suggests that the Commission not force the Postal Service to run the risk of finding out.

These issues are discussed in more detail in Section IV, below.

III. THE COMMISSION’S INITIAL RECOMMENDED DECISION CONCERNING STANDARD REGULAR FLATS IS SERIOUSLY FLAWED.

A. The Commission’s Recommended Rates for Standard Regular Flats Are Unsupported by “Substantial Evidence.”

The rates for Standard Regular flats recommended by the Commission produce an average rate increase of 22%,⁷ which is more than double the increase of 9% proposed by the Postal Service.⁸ The rates for Standard Nonprofit Regular flats recommended by the Commission produce

⁷ This rate increase figure was calculated by dividing the average revenue per piece for Standard Regular flats under PRC-recommended rates by the average revenue per piece for Standard Regular flats under current rates and subtracting 100 percent. A two-step process was used to calculate average revenue per piece under PRC-recommended rates. First, PRC-recommended rates for Standard Regular flats were entered into USPS-LR-L-36, WP-STDREG-26. Second, the average revenue per piece under PRC-recommended rates was calculated by dividing the sum of flats revenue from USPS-LR-L-36, WP-STDREG-32 by the sum of flats volume from USPS-LR-L-36, WP-STDREG-30. The average revenue per piece for Standard Regular flats under current rates was determined by dividing the sum of Standard Regular flats revenues from USPS-LR-L-36, WP-STDREG-21 by the sum of Standard Regular flats volumes from USPS-LR-L-36, WP-STDREG-19.

⁸ With one exception, the method described in footnote 7 was used to calculate this percentage. The exception is that USPS-proposed rates in USPS-LR-L-36, WP-STDREG-26 were not replaced with PRC-recommended rates.

an average rate increase of 34%, triple the increase of 11% proposed by the Postal Service.⁹ Increases of this magnitude are very painful! They are especially painful when they are imposed with such little notice!! The PRC-recommended Standard Regular flat rates would impose on mailers an additional revenue burden in the amount of \$502 million, with an additional revenue burden of \$84 million being imposed on the mailers of Standard Nonprofit Regular flats.¹⁰ Although, as we explain below, these revenue estimates are unrealistically high, they give a good indication of the economic impact of these increases on mailers.

In its Opinion, the Commission fails to give adequate consideration to the impact that these painful rate increases will have on mailers, as required by Section 3622(b)(4) of the Act. In fact, the Opinion contains several important flaws.

First, in contrast to the Postal Service's proposal, the PRC ignored the "rate shock" effect on mailers, especially the substantial economic damage that would be visited upon a large number of enterprises that depend heavily on the mail. As the Governors explained,

"The Governors are concerned about the effect that the steep increases in the prices of Standard Regular flats would have on the vitality of the catalog industry. The long-term interests of the Postal Service and its customers are served by a healthy catalog industry that creates interest in the mail and contributes to the institutional costs of the Postal Service."¹¹

A review of the PRC's Opinion reveals that the Commission gave virtually no consideration to the impact that its recommendations for Standard Regular flat mail would have on mailers. For example, it seems content to make the unsupported assertion that mailers "should be able to convert lightweight pieces to more efficient, less costly letters if they feel that these cost-based rates are no longer the most cost effective way to send their mailings."¹²

⁹ These increases were calculated using the same methodology described in footnotes 7 and 8, with appropriate modifications in the referenced Workpapers.

¹⁰ These figures were calculated by subtracting flats revenue by subclass under USPS-proposed rates from flats revenue (at USPS-proposed volume levels) at PRC-recommended rates. To determine flats revenues by subclass under USPS-proposed rates, DMA summed flats revenues from USPS-LR-L-36, WP-STDREG-32. Similarly, flats revenues (at USPS-proposed volume levels) by subclass under PRC-recommended rates were estimated by summing flats revenues from USPS-LR-L-36, WP-STDREG-32 after entering PRC-recommended rates into USPS-LR-L-36, WP-STDREG-26.

¹¹ Decision at 9.

¹² PRC Op. at 249.

Second, the PRC's recommended decision is based on volume and revenue estimates as to which there is substantial doubt. As the Governors explained,

“. . . the much larger increase for flat mailers recommended by the Commission substantially increases the risk that a substantial portion of flat mail would disappear entirely rather than being converted to letters, with potentially serious adverse financial consequences on Postal revenue.”¹³

Again, a review of the PRC's Recommended Decision reveals that the Commission gave virtually no consideration to the likelihood that its rate recommendations were so high as to bring them outside the range of rates as to which the USPS elasticity estimates could be considered even reasonably reliable.¹⁴

Third, while DMA generally supports Efficient Component Pricing under appropriate circumstances, the Commission has taken this principle much too far in applying it to the rates of Standard Regular flats in this proceeding. In essence, it failed to take into account the inability of many flat mailers to modify their mailings to take advantage of lower rates for letter-shaped mail. ECP does not apply in those (many) instances. As the Governors explained,

“The Commission justifies the sharp increases for Standard Regular flats by applying ECP to shape-based differences as a way to promote more efficient mailer behavior. . . . [T]he ability to convert from flat-shaped to letter-shape is not shared by all mailers of Standard flats equally. . . . The Commission did not explain how flat-size mail pieces that already

¹³ Decision at 4-5. This statement was made in the context of First-Class Mail flats. The Governors were equally concerned with the estimated volumes and revenues of Standard Regular flats. For example, at page 9 the Governors stated, “As suggested by our earlier discussion regarding rates for First-Class Mail flats, the risks of misjudging how mailers (and thus mail volume) would respond increase significantly with rate changes of this magnitude.”

¹⁴ *E.g.*, Robert S. Pindyck and Daniel L. Rubinfeld, Econometric Models and Economic Forecasts, (2nd edition, McGraw-Hill, 1981) at 210 (“... as the new value of X gets farther from the mean [of the sample], it moves out of the range of experience used to estimate the model and generates less reliable forecasts. In general it is dangerous to extend a model much beyond its range of estimation.”); William H. Greene, Econometric Analysis, (4th edition, Prentice Hall, 2000) at 307 (“... the farther the forecasted point is from the center of our experience, the greater the degree of uncertainty.”).

In light of this serious flaw in the Commission's volume estimates for Standard Regular flat mail, it is somewhat ironic that the Commission has spent such a substantial effort dissecting the various strengths and weaknesses of competing estimates of the elasticities of various classes of mail, such as the debate over the impact of electronic communication media on future volumes of First-Class Mail. *See generally* PRC Op., App. I, *including* App. I at para. [6], sixth and seventh bullet points.

exceed the maximum letter thickness could change from flat shape to letter shape. Moreover, the Commission's rate design significantly increases the price not only of light-weight flats but also most heavy-weight flats. The Commission did not address heavy-weight flats in its decision."¹⁵

The Commission embraced "Efficient Component Pricing"("ECP") wholeheartedly in its Recommended Decision,¹⁶ stating,

"The Commission finds in this case that ECP is a sound starting point from which to make adjustments to satisfy the pricing factors and policies of the Act."¹⁷

The Commission also concluded,

"All of the Standard Mail rate categories are worksharing categories, and both the Postal Service and the Commission attempt to pass through 100 percent of the avoidable cost savings."¹⁸

Acknowledging that Witness Sidak "concludes that ECP does not apply to shape," and that the Postal Service agrees,¹⁹ the Commission nevertheless sided with witness Panzar, who "contends that mailers have some control over mail characteristics, e.g., shape and weight"²⁰ and concluded,

"The virtue of ECP or an ECP approach beyond worksharing is that it continues to promote productive efficiency."²¹

The Commission then used Bookspan as an example of a purported ability of mailers to "convert flat-shaped advertising pieces to letter-shaped pieces in exchange for a lower letter rate." It asserted that "[t]he Bookspan NSA demonstrates that mailers have some choice over mail characteristics"²² and concluded that,

"Mailers should be able to convert lightweight pieces to more efficient, less costly letters if they feel that these cost-based rates are no longer the most cost effective way to send their

¹⁵ Decision at 9-10.

¹⁶ *See generally* PRC Op. at 81 -91.

¹⁷ *Id.* at 91.

¹⁸ *Id.* at 84.

¹⁹ *Id.* at 86-87.

²⁰ *Id.* at 87.

²¹ *Id.*

²² *Id.* (citation omitted).

mailings. Accordingly, the Commission concludes that it is appropriate to recommend ECP rates for flats . . .”²³

The Commission’s critical error was to rely so heavily on ECP as to fail to recognize that a great many mailers, especially catalog mailers, have very limited ability to choose the shape of their mail. There is simply no basis in the record for concluding that this choice is significant, much less substantial -- as the Governors quite correctly pointed out.

The Commission’s view on this subject is summarized in the following statement.

“[I]t seems to be fundamentally fair that mailers pay the costs they impose upon the Postal Service plus the same contribution per piece that all the mailers make within the same subclass. This is the definition of an ECP price.”²⁴

DMA strongly objects to this conclusion concerning “fundamental fairness.” It has no basis in the record. There is no basis for concluding that Standard Regular flat mail should make the same per-piece contribution as Standard Regular letters -- or any other subclass, for that matter. Indeed, it is fundamentally unfair that the mailers of Standard Regular flats should be subjected to rate increases that are so much larger than those imposed on mailers of other categories and subclasses of mail. This statement by the Commission glosses over a pricing issue that is, in fact, rather complex and is at the crux of the problem. It is without adequate support in the record and simply does not withstand legal scrutiny.

For these reasons, the PRC-recommended rates do not meet the “substantial evidence” test and would be overturned if challenged on appeal. Thus, in DMA’s view, there is no question that the Commission must reconsider these rates and issue a Recommended Decision upon Reconsideration that recommends substantially lower rates for Standard Regular flats.

B. The Commission Should Recommend the Rates for Standard Regular Flats as Proposed by the Postal Service.

While, as a matter of law, the Commission has substantial latitude to choose alternative rates for Standard Regular flats, there is little record support for any such rate structure other than that proposed by the Postal Service. As a practical matter, therefore, DMA strongly urges the Commission to recommend the USPS-proposed rates.

²³ *Id.* at 249; *see generally id.* at 236-249.

²⁴ PRC Op. at 89.

In its Order No. 13 issued on April 27, 2007, the Commission asked mailers to propose specific changes to rate elements both of Standard Regular flats (presumably decreases) and of Standard Regular letters (presumably increases). We respectfully submit that such an exercise is beyond the ability of any intervenor because of the complicated calculations, both in terms of inter-cell rate relationships and in terms of volume and revenue projections, that would be required. Although the Commission has the technical expertise to make these calculations, we are unaware of any record basis for an alternative rate structure other than that originally proposed by the Postal Service. Accordingly, we strongly believe that the Commission should simply recommend the USPS-proposed rates for Standard Regular flats, and we respectfully urge the Commission to do so.

IV. THE COMMISSION SHOULD NOT ADJUST THE RATES FOR ANY OTHER CLASS OR SUBCLASS.

DMA strongly disagrees with the Governors that the Commission should increase (via “rebalancing”) the rates of Standard Regular letters at the same time that it lowers the rates for Standard Regular flats. Nor should the Commission adjust the rates for any other class.

As stated above, the Commission estimates that the Postal Service will realize additional revenue in the amount of \$586 million from its recommended rates for Standard Regular flats. This number is too high, because it is based on unrealistically high volume estimates. Thus, the Postal Service would lose less than \$586 million if the rates for Standard Regular flats were set at the levels proposed by the Postal Service.

At the same time, the Commission’s Recommended Decision gives the Postal Service more revenue than it estimates that it will need in the Test Year, by an amount of \$768 million, because it acceded to the Postal Service’s request that the Revenue Requirement include a “provision for contingencies” equal to a full one percent. Thus, there is more than sufficient room in the Revenue Requirement to reduce the rates for Standard Regular flats to the levels proposed by the Postal Service without increasing any other rates and still leaving the Postal Service with a substantial revenue “cushion.” For a number of reasons, that alternative is vastly superior to the “rebalancing” act that the Governors have requested.

A. The Commission Has Overestimated USPS Revenues.

As discussed above, the Commission’s estimates of USPS revenues overstate the revenue that the Postal Service can reasonably expect to realize. These numbers assume that the

Commission's volume projections are accurate. Reality is to the contrary. In fact, mailers are subject to budget constraints, cost-per-response constraints and competition from other marketing and advertising media. They will simply not be financially able to pay the postage at these high levels, and they will reduce the amount of flats that they mail. The extent of the overstatement is not known, but it will be substantial. To express the same thought in more technical terms, the own-price elasticity of demand underlying the Commission's volume estimates is unreliable, because elasticities are calculated on the basis of marginal cost increases and are valid only within a narrow range. The Commission's recommended rates are well outside the range where these elasticities have any credibility whatsoever.

Therefore, whether considered in the language of the businessman or the language of the econometrician, the Commission's estimates of USPS revenues from Standard Regular flats are too high -- to some unknowable extent. Moreover, the multiplier effect²⁵ works in reverse. For every catalog that is not mailed, sales are lost and new customers are lost.²⁶ The First-Class, parcel and other mail volumes generated by these sales are lost, also. Thus, the Commission's estimates of USPS revenues from other classes are too high, also -- again, to some unknowable extent.

B. The Postal Service Does Not Need a Contingency of One Percent.

As was demonstrated by DMA, writing on behalf of a large number of intervenors (the "Consortium"), a "reasonable" provision for contingencies, based on the record on this case, would have been zero percent. Rejecting the Consortium's arguments, the Commission determined that,

"... recommendation of a contingency provision of zero would require an extraordinary level of assurance that available Postal Service resources could accommodate financially adverse developments."²⁷

The Commission explained its decision in very summary fashion, simply finding that "there are several identifiable sources of financial uncertainty," citing the rebuttal testimony of USPS witness Loutsch. These uncertainties included energy costs, a possible inability to achieve the projected level of cost savings and the financial impact of the PAEA.²⁸ Accordingly, the

²⁵ *E.g.*, MC2005-3 Op. at 9-10.

²⁶ *E.g.*, Decision at 9.

²⁷ PRC Op. at para. 2039.

²⁸ *Id.*, at paras. 2040-2041.

Commission concluded that a one-percent contingency “is well within the zone of reasonableness.”²⁹

Significantly missing from the Commission’s analysis was a comparison between the extent of the financial uncertainties the Postal Service faces and the financial resources that the Postal Service has at its disposal to cope with any adverse developments that might materialize. Thus, the Commission simply failed to address a central (if not the most important) aspect of the analysis that the statute requires.

As the Consortium pointed out in its initial and reply briefs, the Postal Service has ample financial resources to cope with any under-estimate of costs or over-estimate of revenues, without imposing upon mailers the additional financial burden of a contingency provision. Without rehearsing all the arguments made by the Consortium, we would point out as an example that the Postal Service has a projected cash balance at the end of the Test Year of \$3.82 billion (disregarding the escrow balance and assuming a zero contingency in this case).³⁰

As witness Buc accurately summarized,

“With so much cash, so much equity, no Prior Year’s Losses to recover, the prospect of more frequent price changes, real estate worth more than its book value, and perhaps more revenue from real estate sales than is estimated in the Test Year, the Postal Service needs no contingency.”³¹

C. The Least Risky Alternative would be Simply to Reduce Standard Regular Flat Rates, without Increasing any other Rates.

The principal purpose of a “provision for contingencies” is to provide a financial cushion to guard against unforeseen adverse events.³² Under the current circumstances, imposing the extremely high rate increases on Standard Regular flat mailers initially recommended by the Commission would create a risk of adverse financial consequences that far exceeds any other risk facing the Postal Service today. This risk falls squarely in the realm of a “known unknown,” as opposed to an “unknown unknown.” In other words, we all can be certain that there will be

²⁹ *Id.*, at para. 2042.

³⁰ See DMA-LR-1, Tab 8, Comparative Analysis of USPS Revenue Requirement Requests.

³¹ DMA-T-1 at 17.

³² *E.g.*, Consortium Br. at 13.

substantial adverse financial consequences if the PRC recommended rates are allowed to go into effect. We simply don't know how serious the consequences will be.

In our view, it is not a close call: the best way to "spend" the contingency that the Commission awarded the Postal Service in its Recommended Decision is simply to reduce the risk posed by a financially threatened catalog industry and implement the USPS-proposed rates for Standard Regular flats, without increasing the rates for any other mail.

V. CONCLUSION.

For the reasons stated above, the Commission upon Reconsideration should recommend the rates for Standard Regular flats proposed by the Postal Service. At the same time, it should not recommend changes in the rates it recommended for any other class or subclass of mail, including Standard Regular letters.

Respectfully submitted,

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