

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

POSTAL RATE AND FEE CHANGES, 2006)

Docket No. R2006-1

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC. REPLY COMMENTS
ON THE RECONSIDERATION OF STANDARD MAIL FLATS
(May 11, 2007)

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (hereinafter "Valpak") submit these reply comments with respect to the Commission's reconsideration of Standard Mail Regular flats pursuant to Order No. 13.

Initially, Valpak observes that none of the comments of any party has suggested any changes in any Standard ECR rates — only Standard Regular rates. Therefore, it is clear that all parties agree that Standard ECR rates are not currently before the Commission on reconsideration. *See* Valpak Initial Comments (May 4, 2007), p. 1-2. Although Valpak's primary use is of Standard ECR Mail, it files these comments because of the overlap of letter-flat issues between Standard Regular and ECR.

In Order No. 13, the Commission identified specific issues on which it sought comment.¹ Not one intervenor, however, including those associations whose members mail

¹ The specific questions posed were as follows:

1. Ordinarily, postal rates are viewed as a zero sum situation. That is, if certain rates are reduced, other rates must increase to offset the loss in revenue. If the Commission were to decide that certain Standard Mail flats rates were too high and that adjustments were necessary, specifically,
 - a. which particular rate cells should be reduced, by how much, and why;
 - b. which particular rate cells should be increased, by how much, and why.
2. If rebalancing among flats rate cells only is appropriate, specifically,

(continued...)

Standard Regular flats, and which have been critical of the rates originally recommended by the Commission, provided responsive comments that would help the Commission rebalance rates, if it decided that adjustments were necessary.²

For example, the Association for Postal Commerce (“PostCom”) rejected any rebalancing as an effort “to ‘rob Peter in order to pay Paul’” and “utterly irrational and unnecessary.” *See* PostCom Initial Comments at 1. Surely, PostCom understands that if not Peter, then someone else must provide the money to compensate for the lower rates which it seeks for Paul. The critical question, which PostCom does not address, is: Who will be taxed with this burden?

PostCom does not take the position that the shortfall should not be made up by mailers who mail letters, nor by mailers who mail highly presorted flats. PostCom implicitly urges the Commission to pay Paul by robbing an unidentified Peter — namely, the Postal Service, the contingency, and all other mailers — by advancing the date when the next general rate increase would be needed.³ Thus, PostCom advocates having **all** mailers foot the bill for tempering

¹(...continued)

- a. which particular flats rate cells should be reduced, by how much, and why;
- b. which particular flats rate cells should be increased, by how much, and why;
- c. should the Commission adjust the flats pound rate, by how much, and why.

² Discover Financial Services, LLC had no problem with the rebalancing within Standard Regular flats rate cells, but urged the Commission to “leave letters alone.” Letter from Colleen Zambole, May 4, 2007, p. 2.

³ Higher rates will be needed after exhausting the contingency, which is for unforeseen expenses. For instance, “[t]he growth in fuel costs was not foreseen in the rate case, and was thus not incorporated into the case.” Docket No. RM2007-1, Reply Comments of the United States Postal Service, May 7, 2007, p. 28.

Standard Regular flats rates. Nowhere, however, does PostCom acknowledge this obvious fact. Nor does PostCom acknowledge that the contingency was accepted as adequate by the Governors, who did not ask the Commission to reconsider it as part of this remand. The Direct Marketing Association (“DMA”) took a position generally in agreement with PostCom’s. *See* DMA Initial Comments, at 9. The Coalition of Catalog Mailers (“CCM”) attacked the notion of rebalancing within flats rate cells, preferring that the entire burden be put on letters. *See* CCM Initial Comments, at 10-11.

Only the Postal Service submitted comments containing “rebalancing” suggestions responsive to the Commission Order. It suggested that the Commission consider rebalancing Standard Regular rates by decreasing flats rates and increasing letter rates by an offsetting amount, so as to avoid a revenue shortfall. The “fix” offered by the Postal Service would reallocate the burden of an amount in the range of \$400 million from Standard Regular letter mailers to Standard Regular flat mailers. According to the Postal Service, its proposal would do the least harm to Standard Mail rate design, while continuing the cross-subsidization of Standard Regular flats by letters that the Commission finally sought to end in this docket. As the Financial Services Roundtable, *et al.*, stated in their initial comments: “The 17-year slog toward full recognition of shape-based cost differences since 1990 has already exceeded any reasonable transition period several times over” (at 9).

The dynamic that has resulted in the current problem involving flats (and letters) has a lengthy history that precedes this docket. An understanding of that history, and a refocus on record evidence presented in this docket, as distinguished from rhetoric, helps put the issue in perspective.

1. Accepted Principles of Ratesetting Do Not Support Elevating the Rates for Letters in Order to Provide Lower Rates for Flats.

In the face of ever-increasing competitive pressures, Valpak and a number of other mailers have built their business models on the use of letter-shaped pieces, while other mailers have built their business models on the use of flats. This choice of mailpiece has many ramifications. For example, mailers opting for flats typically have greater advertising display space. And a key difference between letters and flats is the cost which they cause the Postal Service to incur to deliver them. Valpak believes that postal rates should reflect costs incurred in a reasonable way. There should be neither undue preference for flats nor discrimination against letters — or vice versa. *See* 39 U.S.C. § 403(c). Each type of mail should be required to bear its own costs, along with its proportionate share of overhead.

In Docket No. R90-1, the Postal Service first proposed and the Commission first recommended that rates for letters in third-class (now Standard Mail) should have lower rates than corresponding rates for flats, based largely on cost differences between the two. The current situation is that cost differences are not recognized appropriately. It is time to have appropriate cost recognition, and true up the rates, as the Commission has done in the instant docket.

The current situation is an unfortunate outcome of a series of turns and twists in ratemaking, including failure of the Postal Service to propose a fix to this problem, the position that many mailing associations find themselves in as they are called upon to represent the interests of mailers with directly opposing financial interests, the absence of record evidence (in some prior dockets), and settlement (by most mailers) of two consecutive omnibus

rate cases before the Commission. Other factors also may have played a role, but irrespective of how the mailing community got to where it is, pre-May 14, 2007 rates unquestionably have been preferential to mailers of Standard Regular flats, and punitive to mailers of Standard Regular letters. This situation needs to be rectified, not perpetuated.

Although current emphasis is on the commotion caused by flats mailers who now, for the first time ever, are being asked to pay cost-based rates, the position of letter mailers must not be ignored. As Valpak witness Robert W. Mitchell explained:

The mailers in the second group [*i.e.*, letters] would seem to have much more ‘standing’ to support changes than the mailers in the first group [*i.e.*, flats] would in support of further delays. It does not seem reasonable for mailers receiving a preference at variance with appropriate principles to say: ‘It is unfair to take away the preferential treatment that has been bestowed upon me.’
[Response to USPS/VP-T1-19, Tr. 25/8917-19.]

Comments of certain parties seem to rely on some type of social policy that would favor flats over letters. (*See, e.g.*, “Catalogers typically have contractual commitments to vendors for extended periods of time, and may need to lay off employees (with severance pay) if catalog operations are hastily curtailed.” CCM Initial Comments, p. 6.) The absence of citations to undergird these arguments demonstrates that they are without record support. The record, however, does contain substantial testimony relating to policy issues. For example, Valpak witness Mitchell explained:

I agree that consideration is sometimes given to social policy in setting rates. However, this is most often done as a matter between subclasses. With the exception of First-Class, the extent to which social policy is a factor within subclasses is more limited, and I do not see much role for it within Standard, a bulk subclass serving the business needs of firms and other organizations. For example, I do not see any social policy

reasons to favor flats with a relatively low markup, compared to letters. [Response to ADVO/VP-T1-10, Tr. 25/8824-35. *See also* VP-T-1, p. 116, ll. 5-13.]

Thus, the record reflects, if anything, policy reasons which could be said to favor letters. The Postal Service's strongest identification is associated with letters. Witness Mitchell explained:

The Postal Service, if it is anything, is a carrier of letters. Its greatest achievement in automation has been in the processing of letters, primarily because the task of automating them has been found less formidable than that of automating flats.... A goal of the Postal Service should be to make this low-cost mailstream available to mailers on favorable terms. Yet it continues to propose substantially higher contributions from letters than from flats, on both a per-piece and a percentage basis. [VP-T-1, p. 115, l. 16 - p. 116, l. 4.]

These same issues can be addressed on grounds of fairness, which also is addressed on the record. Witness Mitchell stated:

If fairness were the only consideration in rates, and Congress had stopped at this point, the presumptive approach to the setting of rates might be to estimate the costs associated with *each mailer's* mail, and apply a **uniform markup factor**, multiplicative in nature, sufficiently high to allow breakeven. [VP-T-1, p. 67, ll. 13-16 (*italics original, emphasis added*).]

As discussed in section 2, *infra*, the Commission stopped short of applying this basic approach to flats and letters generally.⁴

Finally, the Commission stated that it would decide the remand based exclusively on record evidence.

While the procedures adopted herein provide an opportunity for comments, the Commission reminds potential commenters of the

⁴ The Commission has said: "Questions of fairness ... primarily involve the relationship of costs and rates." Docket No. R80-1, *Op. & Rec. Dec.*, ¶ 0686.

need to rely on record evidence. Anecdotal comments unconnected to the record ... are problematic and cannot be relied on by the Commission in resolving issues raised on reconsideration. [PRC Order No. 8, p. 6 (footnotes omitted).]

The testimony of Valpak witness Mitchell provides both ample and strong record evidence supportive of nondiscrimination against letter mailers. Of course, most of the content of filings by the parties herein seeking rate relief for flats are not based on record evidence. (The six non-record letters from mailers appended to CCM Initial Comments are most certainly not record evidence and, it is submitted, can be given only the status of commenter letters.)

2. The Commission's Evaluation of the Record Already Has Accorded More Deference to Flats than Other Parties Acknowledge.

Matters relating to the most appropriate relationship between the rates for Standard letters and flats received considerable attention on the record in this case. Not only were complete competing rate schedules developed and discussed, but considerable attention also was given to the theory that should guide development of these rates. For Regular Standard Mail, two complete sets of rates were proposed.

The first set of rates was proposed by Postal Service witness James M. Kiefer in USPS-T-36. His rates were developed in stages, apparently by selecting reference rates for letters and flats separately, passing judgment on the resulting percentage increases, and making further adjustments to achieve the desired revenue from the subclass. His testimony did not evaluate, nor even discuss, the relative costs involved, and there is no evidence that he applied any theoretical guidance relating to how rates should be set. Under his proposed rates, at the mixed ADC level, flats, relative to letters, would pay only 58.4 percent of their additional costs.

The second set of rates was developed by Valpak witness Mitchell in VP-T-1. He discussed the costs of letters and flats, and their histories, and displayed them in presort-tree format. He also provided considerable discussion of what the letter-flat rate differential should be, including attention to the theory that should guide this aspect of ratesetting. *See* VP-T-1, p. 11, ll. 1-10; p. 114, l. 8 - p. 123, l. 4; p. 156, l. 20 - p. 161, l. 5; p. 178, l. 11 - p. 186, l. 10; and pp. 192-97 (showing percentage increases). In the end, witness Mitchell proposed that flats, relative to letters, pay 95 percent of their additional costs, at the mixed ADC level.⁵

Theory that should guide the setting of rates for letters and flats also was discussed in considerable detail by Pitney Bowes Inc. witness John C. Panzar in PB-T-1. He explained that notions of efficient component pricing, expanded to apply beyond worksharing proper, could be applied, and that this would lead to a passthrough into rates of 100 percent of associated cost differences. He explained that this route would be expected to lead to the highest levels of technical efficiency in the mailing sector. Beyond this, witness Panzar explained that notions of economic efficiency also could be applied, and that this would be expected to lead to higher levels of total surplus in the postal sector, possibly with passthroughs of over 100 percent, depending on the particulars of the situation.⁶

Witness Panzar provided four reasons why he leaned toward technical efficiency, with 100 percent passthroughs, instead of economic efficiency. PB-T-1, pp. 47-50. In response,

⁵ The suggestion of FSR/MMA/NAPM/NPPC in its Initial Comments (May 4, 2007) that witness Mitchell proposed a “full” passthrough of the letter-flat cost difference is therefore incorrect (p. 11).

⁶ The Commission recommended passthroughs that are calculated to be in the range of 92-93 percent.

witness Mitchell explained that arguments provided by witness Panzar were not unequivocal and that a case could be made for more emphasis on economic efficiency and higher surplus, which would lead, witness Mitchell believed, to passthroughs of the **letter-flat cost differential of over 100 percent, quite possibly up to the coverage of the subclass.** *See* Valpak witness Mitchell response to ADVO/VP-T1-10, Tr. 25/8824-35.

An issue central to letter-flat pricing is whether letters and flats have a high cross-elasticity. That is, are letter-flat decisions by mailers highly responsive to the rate difference? If cross-elasticity is high, it becomes important that rates contain a cost-based signal. On the other hand, if the cross-elasticity is low, the activity of letter-flat selection becomes less important and a case can be made for focusing more attention on economic efficiency and total surplus.⁷

CCM, in its Initial Comments (May 4, 2007), states that witness Mitchell “conceded” that “[m]any flats could not in any reasonable way be converted into a letter” and that “[o]thers are part of a business model that would not be served by a letter instead of a flat” (p. 8). Actually, this was not a concession. Witness Mitchell said:

The cross elasticities between letters, flats, and parcels are generally thought of as rather low. It is easy to conceive of a mailer saying to a mail preparation agency: ‘You can put a barcode on that flat if you want to, but don’t you dare convert it into a letter.’ The reality is that separate markets are involved, again consistent with the notion of separate products. [Valpak witness Mitchell response to USPS/VP-T1-7, Tr. 25/8895-96.]

⁷ *See* “Postal Service Says Shape Matters,” USPS Press Release No. 07-41, dated May 7, 2007, urging mailers to consider taking the contents of a First-Class large envelope and folding it so as to fit in a letter-sized envelope.

Similarly, in response to ADVO-VP-T1-11 (tr. 25/8836), witness Mitchell said: “So far as I know, the conventional wisdom on this question is that the cross elasticities in question are reasonably low. In this regard, it is interesting that Postal Service witness Thress did not put a rate difference into his letter-flat share equations. *See* USPS-T-7, pp. 365-397.”

It is true that witness Panzar included “shape” as one of “many [] intrinsic properties of their mail[]” that mailers “can choose.” PB-T-1, p. 45. He did not, however, indicate that there was an active market in letter-flat choices.

After considering all of these issues, the Commission indicated that it found “Panzar’s argument persuasive.” *Op. & Rec. Dec.*, p. 87, ¶ 4024. On the question of letters versus flats, the Commission noted that “Panzar contends that mailers have some control over mail characteristics, *e.g.*, shape and weight.” *Id.*, ¶ 4023. It also said that witness Panzar’s approach to cost recognition “send[s] effective price signals.” *Id.*, p. 88, ¶ 4026. Then in a section on rate design, the Commission said: “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 efficient way to send their mailings.” *Id.*, p. 249, ¶ 5470.

The Commission pointed to witness Panzar saying that mailers have “some control” over the shape of their mail, among other things, and it also pointed to the potential role of “effective price signals,” as quoted above. Both are significant, but neither indicates an active market in changing letters into flats or to a high cross-elasticity. In its rate design section, as also quoted above, the Commission pointed to the ability of mailers to convert flats into letters and said that this would be done “if they feel that these cost-based rates are no longer the most cost efficient way to send their mailings.” These conditional statements do not indicate an

active market in making such changes. Indeed, the record contains no basis to support a conclusion that such an active market exists, which would be a quite different statement from saying that letter-flat changes are possible.

The Commission recommended that flats, relative to letters, pay only 93 percent of their additional costs, at the mixed ADC level. Although the Commission expressly addressed neither the reasons witness Panzar gave to leaning toward technical efficiency, nor witness Mitchell's critique of Panzar's reasons, the Commission apparently concluded that on this record flats, relative to letters, should be charged most of their additional costs, but no more than their additional costs. That is, flats should pay the additional marginal costs they cause the Postal Service to incur, but no additional contribution. Inherently, this is a high form of consideration, however justified. In competitive outcomes, it is not ordinary for higher-cost products to be charged their additional costs and no more. Therefore, the Commission's position on flats in its *Opinion and Recommended Decision* already was much more favorable to flats than might have been justified on the record.

3. The Record Contains No Evidence About the Volume of Magazines Entered as Standard Flats.

ABM argues that some publishers send periodicals via Standard Regular flats and deserve some "educational, cultural, scientific and informational" ("ECSI") value. American Business Media ("ABM") Initial Comments, at 4. However, ABM, which participated actively in the docket, did not submit any testimony concerning the practice of using Standard Mail for sending magazines to subscribers. Nor, to the best of Valpak's knowledge, does the record contain any kind of evidence, anywhere, about the volume of magazines that follow this

practice. Nor did ABM ask the Commission to reopen the record to permit the introduction of any such evidence on remand. Assuming that some publishers in fact follow this practice on occasion, and giving ABM the benefit of any doubt on this point, the volume of such magazines could be but a relative handful of pieces swimming in a sea containing billions of catalogs and other advertising pieces. Indeed, one could speculate that there could be more publications (*e.g.*, newsletters) being sent as Standard Mail letters than flats. However, the record contains no evidence for giving ECSI value to Standard Regular Mail, and there is no citation provided that this has ever been done. Moreover, singling out rate categories within a subclass for ECSI consideration, as ABM would have the Commission do on reconsideration, should be denied.

CONCLUSION

If Standard Regular flat mailers are interested only in “adequate lead time” or greater “notice” as stated by certain mailer associations,⁸ the Commission is certainly without authority to remedy the problem. Only the Board of Governors can give additional lead time by exercising its statutory authority to choose the timing of rate increases. *See* VP Opposition to CCM Motion to Reopen and Supplement the Record, April 19, 2007, p. 3.

If, on the other hand, Standard Regular flat mailers are interested in much longer-term relief — until the next omnibus rate increase, and perhaps beyond — as reflected in DMA’s

⁸ “Imposing unexpected rate increases of the magnitude recommended by the Commission without **adequate lead time** will threaten the vitality of the catalog industry and result in unnecessary harm to catalog companies.” CCM Initial Comments, p. 11 (emphasis added). *See also* DMA Comments, p. 5. (Increases of this magnitude are “especially painful when they are imposed with such **little notice**.”)

claim that the Commission's cost-based rates are "fundamentally unfair" because they are higher than rate increases for other rate categories⁹ — these mailers not only missed the opportunity to present evidence during the docket, but they also have now missed their opportunity to point to any record evidence justifying a transfer of hundreds of millions of dollars from those businesses which mail letters to those businesses which mail flats.

No mailer should be asked to pay artificially higher rates to continue to allow mailers of certain Standard Regular flats to pay artificially reduced rates. Enough is enough. The rates originally recommended by the Commission are fully consistent with the record in this docket, and should be reaffirmed.

Respectfully submitted,

William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.

⁹ "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." DMA Initial Comments, p. 8 (emphasis original).