Postal Regulatory Commission
Submitted 2/13/2008 2:36:33 pm
Filing ID: 58973
Accepted 2/13/2008

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report	)))	Docket No. ACR2007

VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. REPLY COMMENTS ON THE UNITED STATES POSTAL SERVICE FY 2007 ANNUAL COMPLIANCE REPORT
(February 13, 2008)

BACKGROUND

Pursuant to the Postal Accountability and Enhancement Act ("PAEA"), Public Law 109-435 (39 U.S.C. § 3652(a)), the Postal Service filed its "FY 2007 Annual Compliance Report") on December 28, 2007. The Commission established a deadline for initial comments of January 30, 2008, and for reply comments of February 13, 2008. Commission Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment (December 31, 2007).

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") previously filed joint initial comments, and now submit these joint reply comments.

I. THE EXPERIENCE OF WORKING THROUGH THIS INITIAL FY 2007 ANNUAL COMPLIANCE REVIEW REVEALS THE NEED FOR POSTAL SERVICE ANALYSIS IN ITS ANNUAL COMPLIANCE REPORT, AS WELL AS REVEALING INHERENT DIFFICULTIES WHICH WILL REQUIRE COMMISSION CREATIVITY TO MAKE THE SYSTEM FUNCTION FOR THE BENEFIT OF ALL.

The Public Representative's Initial Comments point out that the Postal Service did not supply any analysis, despite PAEA's statutory requirement that the Annual Compliance Report of the Postal Service "shall analyze costs, revenues, rates, and quality of service, using such methodologies as the Commission shall by regulation prescribe, and in sufficient detail to demonstrate that all products during such year complied with all applicable requirements of this title." 39 U.S.C. § 3652(a)(1). Public Representative Initial Comments, p. 3. Instead, the Public Representative notes that the Postal Service only "filed a large amount of data and left it to others to perform the analysis and demonstration required by section 3652(a)(1)." (*Id.*) Valpak agrees with the observations of the Public Representative. *See also* Valpak Initial Comments, p. 36. As discussed herein, this lack of any analysis by the Postal Service elevates an already difficult assignment for mailers into one which is nearly impossible. It is useful to examine the need for a complete Annual Compliance Report to see how it fits in the overall statutory scheme.

PAEA requires the Postal Service to file its Annual Compliance Report ("Report") within 90 days of the end of the (fiscal) year. Understandably, this places a substantial burden on the Postal Service. Merely generating the data that were in this Report in 90 days is obviously an arduous task, and it is important to note what the Postal Service did accomplish in its first Report. At the same time, the Postal Service Report never acknowledged PAEA's requirement that it "analyze" costs, etc., nor offered any reason for its failure to comply. The reasons could be several. First, it could be due to the lack of any Commission-established regulations for the Annual Compliance Report (which are expected to be forthcoming), and therefore will be solved by issuance of regulations before the FY 2008 Report cycle begins.[1] Second, the Postal Service could disagree that it is required to file an analysis. If so, this disagreement may, or may not, be resolved by the issuance of Commission regulations. Third, it could have been a lack of time and resources, which would need to be rectified.

However, even without analysis from the Postal Service, several lessons have been learned already from this compliance review.

First, the process of updating costs to the current period is not simple, and errors are possible. As a result, it is possible for cost outcomes to raise serious questions of accuracy and relevance. *See* Time Warner Inc. Initial Comments, pp. 11-14; Valpak Initial Comments, pp. 35-39.

Second, when improvements are needed in the costing models and methods, mailers need to be able to raise questions, as illustrated in this docket by changes made to the Periodicals cost models, requiring two technical conferences.

Third, after the Postal Service submits its Report, PAEA gives the Commission 90 days to complete its compliance review. In this docket, the Commission chose to give mailers (and

[1] In that Rulemaking, the Commission needs to require that the Postal Service file a complete "analysis," including not only of costs but also evidence relating to markets, factors affecting volume, mailers' use of the Postal Service, postal operations, and policies. Further, the Postal Service's position on how the rates noticed comply with PAEA should be set out clearly.

other interested parties) 30 days to analyze and comment on the FY 2007 Report, and then another 14 days to file reply comments.[2] Mailers commented on the difficulties posed by a short review period.[3] Further, this 90-day review period imposes a burden on the Commission. However, the procedures which the Commission establishes in its subsequent rulemaking should give mailers as much time as possible to provide their input.

Fourth, in view of the time limitations discussed above, the omission of any analysis in the Postal Service's FY 2007 Report should be viewed as especially serious. When Commission regulations are issued, they should require the Postal Service to file what PAEA requires — a complete analysis of the various Objectives and Factors of the ratemaking system in 39 U.S.C. section 3622, including not only an analysis of costs, but also market factors affecting volume, mailers' use of the Postal Service, and postal operations and policies "in sufficient detail to demonstrate that all products during such year complied with all applicable requirements of this title." 39 U.S.C. § 3652(a)(1). Indeed, PAEA appears to allow increased reliance on market considerations, but the Postal Service FY2007 Report is devoid of any such information. The Postal Service's views on how rates comply with PAEA should be outlined. Having regulations which require the Postal Service Report to provide this kind of information should improve the quality of the review substantially.

---

[2] By way of comparison, under the Postal Reorganization Act of 1970 ("PRA"), Docket No. R2006-1, mailers were allowed 72 days for written discovery on the Postal Service, with follow-up discovery and oral cross examination after that.

[3] *See, e.g.,* Major Mailers Association Initial Comments, p. 7; *see generally* National Association of Presort Mailers, p. 3.

Fifth, the timing of the Commission's review within the annual rate cycle needs reconsideration. PAEA and the Commission's rules applicable to rate increases (emanating from Docket No. RM2007-1) seem to contemplate that costs and other findings emanating from this review will be relied on by the Postal Service in the next rate adjustment. The obvious problem is that in all likelihood each subsequent rate adjustment may be filed before the determination in this Review is available, as has already occurred in this docket.[4] Consequently, for all the hard work undertaken by mailers and the Commission in the review, the effect that it will have on the next round of rate changes is not clear. Failure to find a way to integrate results of the compliance review could have the unintended consequence of encouraging more complaint cases to be filed. This recurrent timing problem needs to be revisited.

II. FOR AN EVALUATION OF RATESETTING RESULTS, COSTS AND RATES BEING REVIEWED NEED TO BE OF THE SAME VINTAGE.

Initial comments by a number of parties focus on the temporal mismatch of rates and costs submitted for review, along with issues created by this mismatch. Succinctly, rates which were implemented on May 14, 2007,[5] and now expected to be in place until May 12, 2008, are being reviewed, while available cost data cover the period from October 1, 2006 to

[4] Due dates for the Postal Service's Report and the Commission's review are tied by PAEA to the end of the fiscal year. However, timing of filing for rate increases is at the discretion of the Postal Service. On February 11, 2008, the Postal Service filed a Schedule of Regular and Predictable Price Changes which indicated that the Postal Service plans to implement rate changes in mid-May of each year. Pushing back the date when rate increases are noticed to, say, April, with an effective date 90 days later in July, would enable the Postal Service to receive and digest the Commission's review before it files for new rates.

[5] New Periodicals rates were implemented July 15, 2007.

September 30, 2007. Pitney Bowes ("PB") refers to a "failure to align the measurement periods" (PB Initial Comments, p. 4). The Direct Marketing Association and Parcel Shippers Association ("DMA/PSA") refer to "[c]omparing discounts in one time period with costs avoided in another" (DMA/PSA Initial Comments, p. 3). Major Mailers Association ("MMA") notes that two different sets of rates were in effect during FY 2007, and refers to "any comparison of the R2006-1 workshare discounts with the cost savings derived from PFY 2007 data … [as] an apples to oranges comparison" (p. 6). These points are well taken.

A fundamental tenet of ratesetting is that costs used as a basis for setting rates should cover the same period as that for which the rates are in effect. To do otherwise creates a mismatch between rates and costs, rendering the costs a benchmark of dubious value in helping lead to fair and efficient rates. To avoid a mismatch, regulatory frameworks involving prospective test years often are constructed. The instant docket, of course, requires an evaluation that is retrospective, rather than prospective.

Several subsections of the new law explicitly require **efficient** ratesetting (*see* Valpak Initial Comments, pp. 27-35). Efficiency was important under PRA, but Congress has emphasized its importance even more explicitly in PAEA. Given this increased statutory importance, attention must be given to the relevance of the costs used.

Beyond the general need for accurate and relevant costs generally, in the area of **worksharing**, PAEA goes even further. It provides specific constraints, requires certain comparisons between discounts and their associated cost avoidances, and outlines considerations that may receive attention if results of the comparisons stray from the constraints. Under these circumstances, attention to the vintage of any costs relied upon rises to the level of a requirement.

The problem, however, is not limited to the need to prepare a cost estimate suitable for comparison with current discounts. That problem might be accommodated by simply allowing a few percentage points leeway in comparisons. As pointed out by PB (PB Initial Comments, pp. 2-3) and the National Association of Presort Mailers ("NAPM") (NAPM Initial Comments, p. 2), the Postal Service has indicated that "[t]he workshare data provided in [its] Annual Compliance Report will also be used when [it] files a notice of rate adjustment" under the new law, which is expected to occur shortly, quite possibly before the Commission's compliance review is completed (Annual Compliance Report, p. 20, fn. 9).

With the Postal Service filing of a rate adjustment on February 11, 2008, with rates to be implemented May 12, 2008 and remain in effect until May 2009, referencing costs for a fiscal year that began October 1, 2006 simply will not do. DMA/PSA correctly describe the possibility of such an occurrence as involving "a huge temporal mismatch between the discounts and the costs" and "[i]t will be critical to update the costs avoided to the same time period as the discounts." DMA/PSA Initial Comments, p. 3.

Both DMA/PSA and PB point out that the Commission's rules only require that "[t]he avoided cost figures must be **developed from** the most recent PRC Annual Compliance Report." (39 CFR § 3010.14(b)(5), emphasis added.) DMA/PSA suggest that "the proper way to 'develop' future-year avoided costs from the avoided costs shown in the ACR is to inflate each of the ACR cost avoidances by the CPI used in the cap calculation." DMA/PSA Initial Comments, p. 4. This approach has the advantage of being both straightforward and expeditious, and reasonable. Yet another approach would be to allow the Postal Service to prepare and present what it believes to be the most appropriate cost estimate. The Postal Service has had considerable experience in preparing such cost estimates in rate cases under PRA.

Whichever approach is taken, the problem warrants specific attention, and it appears that the Commission's rule that avoided cost figures must be **developed from** the most recent "PRC Annual Compliance Report" has properly anticipated this need. In addition, the same approach is needed for any costs used in ratesetting, regardless of whether they are characterized as cost avoidances. Costs are important in ratesetting, and none of them should be of irrelevant vintage. Indeed, this review demonstrates the wisdom of having the Commission's rules with respect to avoided costs expanded to apply to all costs used for rate setting.

III. ENACTMENT OF PAEA DID NOT ENDOW PERIODICALS WITH A "BIRTHRIGHT" TO A CONTINUAL, NEVER-ENDING CROSS-SUBSIDY FROM OTHER CLASSES OF MAIL.

Comments of Alliance of Nonprofit Mailers and Magazine Publishers of America ("ANM/MPA") address the issue of cross-subsidies received by Periodicals as follows:

> Periodicals rates would not be unlawfully low under PAEA even if the revenue actually received from Periodicals class mail in some future year failed to cover attributable costs. PAEA does not allow the Commission to impose rate increases that exceed the CPI-based adjustment index established by 39 U.S.C. § 3622(d) merely because Periodicals rates would otherwise fail to cover attributable costs. As previously explained by MPA and other parties in Docket No. RM2007-1, the language, legislative history, and economic policies of § 3622(d) preclude the Commission from allowing the attributable

> cost floor to trump the rate cap for individual classes of mail.
> [ANM/MPA Initial Comments, pp. 9-10, footnote omitted.]

It is a documented fact that Periodicals have received a substantial cross-subsidy from other classes of mail for the last 11 years. *See, e.g.,* Valpak Initial Comments, p. 46, Table 1.[6] ANM/MPA's position seems to be that if annual increases in Periodicals revenues permitted by the Consumer Price Index ("CPI") cap never rise to the point where they cover attributable costs, then Periodicals are entitled to enjoy the resulting cross-subsidy *ad infinitum*, as a sort of birthright bestowed by PAEA upon its enactment.

To be sure, if the cost of handling periodicals in fact were to be reduced through some combination of the different ways mentioned in ANM/MPA's Comments — *e.g.*, improved preparation, co-mailing, sortation on the FSS, various cost initiatives, etc. — that would help reduce and possibly eliminate the annual shortfall and resulting cross-subsidy. Such an outcome would be the most desirable and least contentious way to resolve the issue. However, all future cost reductions mentioned by ANM/MPA are speculative, and many publications have repeatedly averred that some of these measures range from impractical to impossible.[7] As some evidence of how speculative these cost reductions may be, year after year, for the last 11 years, hoped-for cost savings projected for the Test Year of successive rate cases have failed to materialize as projected.

---

[6] It has been discovered that this table contains a minor error, in that certain cells omit In-county Publications. A corrected table will be filed with comments on the Postal Service' Notice of Market-Dominant Price Adjustment.

[7] *See*, for example, Comments of The Nation Magazine, regarding co-mailing. (p. 2).

Under PAEA, a variety of features, such as the Test Year, the cost roll-forward, and all the assumptions that went into the roll-forward, no longer exist. In their stead, accountability vis-a-vis statutory requirements is to be achieved through an annual after-the-fact compliance review of what actually happened in the prior year, not what may happen in some future Test Year. In turn, the annual cycle mandated by PAEA contemplates that analysis of the prior year can affect the next rate change. As indicated in footnote 3 of the Commission's Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comments, "[i]f public comments ... identify potential problem areas several weeks in advance of the Postal Service's rate filing, this may inform or influence the Postal Service's pricing decisions."[8]

ANM/MPA believe that the rate cap restricts the Commission (and the Postal Service) from raising rates sufficiently high to cover costs of the class, and increasing rates at the cap is the only option available for eliminating the revenue shortfall and cross-subsidy. Even if the rate cap trumps the requirement for covering costs, which Valpak contests strongly, and even if the Postal Service does not choose to file a "Periodicals only" exigent rate case under 39 U.S.C. section 3622(d)(1)(E), there still would be another way to solve the problem. The shortfall between revenues and attributable costs most definitely can be reduced, and probably eliminated altogether, in a fairly short time span by having the Postal Service "focus the entirety of its rate increase, to the maximum extent feasible, on those cost drivers (and on

---

[8] Although the Commission's footnote pertains only to this year's filing, it would appear to be equally applicable to subsequent compliance reviews. *See* Section I, *supra*.

those publications) that do not cover attributable costs." *See* Valpak Initial Comments, p. 50. Implications of this alternative are elaborated on briefly below.[9]

Succinctly, for analytic purposes, the Periodicals class of mail can be divided into two groups of publications. In one group (A, say), are all those publications that at least cover their attributable costs. Collectively, revenues from this group of publications more than cover their attributable costs. The second group (B, say) consists of all publications that fail to cover their attributable costs. Were it not for the publications in group B, Periodicals would have a coverage comfortably in excess of 100 percent. For the last 11 years, regrettably, contributions by Group A have not been sufficient to cover losses incurred by Group B.[10]

Within Group B, some publications probably fail to cover their attributable costs by a wide margin. Assume, hypothetically, that one such publication in group B has a cost coverage of only 50 percent. This means that for each $10 of revenue which the Postal Service receives from this particular publication, it incurs $20 of costs, *i.e.*, it loses $10 for each $10

---

[9] Presentation of this alternative should not be read as support for it, but the 11-year old cross-subsidy to Periodicals should be eliminated as swiftly as possible so as to bring rates into accord with statutory requirements of both PRA and PAEA. These comments take no position on the most desirable way to achieve this result for the Periodicals class.

[10] Moreover, within the Periodicals class, the ECSI provision is used to provide a substantial discount for all editorial matter. The rate for advertising is somewhat above cost, and it is advertising matter that generates contributions in well excess of cost, *i.e.*, magazine advertising supports the ECSI rate reduction. All print advertising (including not only Periodicals, but also Standard Mail) increasingly must compete with the Internet. To the extent that magazines collectively fail to attract sufficient advertising revenues to support the rather generous rate reduction now given to editorial matter, the aggregate amount of that subsidy to editorial matter somehow may have to be reduced.

received in revenues.[11] And every time this hypothetical magazine publishes, the Postal Service loses money.

To illustrate what is involved, we consider the effect of a large but restricted rate increase of, say, 20 percent, on some mailers that nevertheless is within the overall CPI cap. Those publications that would be most affected by such a rate increase might describe it as "draconian."[12] It can be analyzed as follows.

If this publication were to pay the full amount of the rate increase and not suffer any decline in volume (*i.e.*, totally inelastic demand, the extreme case and a most unlikely event), Postal Service revenues from this publication would increase by 20 percent. The Postal Service then would have reduced its losses to only $8 for each $10 of revenues received from this publication. This 20 percent reduction in loss resulting from continued mailing can be described as the "demand" side effect.

At the other extreme, if the publication (and its readers) were unable (or unwilling) to pay the 20 percent rate increase, and forced to cease publication altogether, then for each $10 of reduction in revenues heretofore paid to the Postal Service, it could save $20 in costs, and

---

[11] Any publication such as the hypothetical one described here is seen to operate on a business plan which requires a substantial cross-subsidy every time it is published. Such a business plan is generally at cross-purposes with numerous provisions in PAEA; *see* Public Representative's Initial Comments, p. 6, fn. 14.

[12] The Nation Magazine's Initial Comments anticipate, with foreboding, "serious rate increases for other magazines, well in excess of the CPI." (p. 3)

reduce its losses by a full $10.[13] A reduction in Postal Service losses by virtue of money-losing magazines ceasing publication can be described as the "supply" side effect.[14]

For publications with rather low cost coverages, supply side effects can be more effective in reducing Postal Service losses than demand side effects. For instance, if a weekly magazine with a coverage well below 100 percent were to switch to a bi-weekly format and mail only 26 times a year, the supply side effect from the reduced frequency would reduce the Postal Service's annual loss on this publication by a material amount. And a low coverage magazine switching from a semi-monthly to a monthly format would have a similar beneficial supply side effect.

To conclude, if "PAEA does not allow the Commission to impose rate increases that exceed the CPI-based adjustment index," as ANM/MPA asserts, then in order for the new, modern ratesetting process to comply with PAEA, the Commission will need to insure that rate increases for Priodicals are targeted in a manner designed to elicit supply side effects sufficient to eliminate the shortfall between revenues and costs — *i.e.*, the cross-subsidy to Periodicals.

---

[13] This savings from a reduction in cost owing to a reduction in money-losing volume is similar to, but not the same as, costs avoided from worksharing.

[14] As regards reducing the revenue shortfall, this supply side effect applies only to publications with a coverage less than 100 percent. In the normal course of events, each year various publications are born, while others die. Some of those that have ceased publication were never distributed through the mail (*e.g.*, newspapers), hence changes in postal rates had no bearing on their demise. Since the time of the "founding fathers," countless publications that depended largely on distribution through the mail have come and gone. Doubtless many were small, but others were not so small — *e.g.*, *Collier's, LIFE*, and *Saturday Evening Post*.

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.