
ANNUAL COMPLIANCE REPORT

Docket No. ACR2007

**REPLY COMMENTS OF VALASSIS DIRECT MAIL, INC. CONCERNING
THE POSTAL SERVICE'S FY2007 ANNUAL COMPLIANCE REPORT**

(February 13, 2008)

Pursuant to the Commission's Notice issued on December 31, 2007, Valassis Direct Mail, Inc. (formerly known as ADVO, Inc.), a wholly owned subsidiary of Valassis Communications, Inc., hereby submits its reply comments concerning the Postal Service's first Annual Compliance Report filed on December 28, 2007.¹ Our reply comments address the contentions made in the initial comments of Valpak Direct Marketing Systems, Inc. (Valpak).

Overview

Deep into its comments, Valpak alleges that the FY2007 ECR costs in the Postal Service's Report have "anomalies" that make them "unreliable for ratemaking." Comments at 28. It laments that the Postal Service's Report is "completely devoid of any testimony or discussion" of the costing results and contains "no explanation" for changes in costs. *Id.* at 36. Valpak proceeds to present simplistic and superficial comparisons of changes in unit costs for various ECR categories, then it leaps directly to the conclusion that the cost changes "cannot be explained, and are often anomalous and counter-intuitive." *Id.* at 38.

¹ Effective January 1, 2008, Advo's name was changed to Valassis Direct Mail, Inc.

Valpak has not done its homework. Had it looked at the Postal Service's supporting library references, instead of just spewing simplistic cost comparisons, it would have discovered that the cost changes it cites are, indeed, well explained. There, the Postal Service has clearly described a number of necessary improvements in its cost allocations for ECR mail that have produced the results Valpak decries – improvements that Valpak, curiously, does not even mention in its comments. Those adjustments are not only well-explained and justified, but also disprove Valpak's empty assertion that the resulting costs are "counter-intuitive."

We address Valpak's specific contentions below.

1. **Far From Anomalous, The Postal Service's FY07 Estimates Of ECR Saturation Letter And Flat Costs Correctly Reflect Both Changes In Mail Mix And Important Improvements In Cost Allocation.**

Starting at page 37 of its comments, Valpak complains about what it claims are "anomalous costs" for ECR mail categories in the Postal Service's report for FY 2007, compared to the costs presented in Docket No. R2006-1 upon which current rates were based. In particular, it cites the fact that costs have increased 16.3% for saturation letters, 23.3% for basic letters, and 9.6% for basic flats, but have declined 2.0% for saturation flats. These changes are not anomalous in the least, but stem from a combination of changes in mail mix (notably the reduction in volume of detached address labels or DALs) and important improvements in cost distribution that the Postal Service has implemented since the R2006-1 rate case.²

² We would note that the above cost increases are also due in part to the fact that the Postal Service's total variable labor costs have been increased by roughly 8% due to its new attribution of retiree pension and health benefit costs.

First, for ECR mail, the Postal Service has made several necessary improvements in distribution of city and rural carrier delivery costs which have had the effect of shifting incorrectly-allocated costs from saturation flats to other ECR rate categories.³ In particular:

- The FY07 DAL volume estimate is now derived from data collected as part of the City Carrier Cost System (CCCS) and Rural Carrier Cost System (RCCS). Previously, in Dockets R2005-1 and 2006-1, DALs were estimated and distributed to their respective cost systems on the basis of an industry estimate multiplied by its respective ECR saturation letter distribution factor.
- The FY07 proportions of ECR saturation letters and flats on city letter routes that are sequenced (taken directly to the street) are now estimated using data directly from the CCCS. Previously, this was estimated using IOCS costs in conjunction with very old saturation casing productivities.
- The FY07 rural boxholder volume is now distributed to shape based on new information collected as part of the RCCS. Previously, boxholder volume was distributed to shape based on RPW proportions.

Second, because the number of detached address labels in the system has declined due to introduction of the DAL surcharge, the DAL-related cost included in the total delivery cost of saturation flats (termed “saturation flat (with DAL) delivery cost” by the USPS) has likewise declined. This, as fully expected, has caused an absolute reduction in the delivery cost of saturation flats. Moreover, this, in combination with the improvement with the rural boxholder cost allocation noted above, has substantially increased the saturation letter rural delivery cost – correcting the previous cost

³ See Attachment-USPS-FY07 19.doc (page 2), *and* UDCModel 070211.xls in USPS-LR-FY07-19.

misallocation which shifted way too much rural letter/boxholder cost away from saturation letters and onto saturation flats.⁴

Third, the USPS has correctly disaggregated the dropship-adjusted mail processing costs to reflect the large differences in average piece-weight among the various ECR rate categories. This improvement has properly reduced saturation flat unit cost and increased saturation letter unit cost, relative to the R2006 estimates.⁵

Contrary to Valpak's implication, all of the above changes are clearly laid out and explained by the Postal Service, and they in turn explain the cost changes Valpak cites. Valpak has simply ignored them.⁶

2. Valpak's Concerns About ECR/NECR Parcel Costs Are Of No Real Consequence To ECR Letter And Flat Costs.

Valpak's concern about the large change in unit costs for ECR parcels between the R2006 estimates and FY07 actuals (Comments at 37) is inconsequential. In truth, these parcel costs are likely affected by sampling errors since parcels represent

⁴ Thus, although the actual FY07 total saturation letter volume has increased only 2.9% compared to the R2006 volumes, the volume of saturation *rural*(non -DAL) letters has increased nearly 60%. This latter increase is not a true volume change, but merely a correction to the erroneous rural volume estimates in R2006 which substantially understated the number of saturation (non-DAL) letters because way too many rural "letters" were incorrectly attributed as DALs and improperly charged to flats.

⁵ See USPS-FY07 18.doc (page 1), and FY07ECRDropAdj.xls in USPS-LR-FY07 18. As a result of these corrections, saturation letter adjusted unit mail processing cost has increased nearly 18% while saturation flat adjusted mail processing cost has decreased nearly 19%.

⁶ We would note that the cost change for basic letters is due in large part to the shift of automatable letters out of ECR, leaving the costlier non-automation letters in basic. This is evidenced by the 41% increase in city carrier in-office costs experienced by basic letters – from 1.78¢ in R2006 to 2.52¢ in FY07. Compare UDCmodel.xls results in PRC-LR-11 with USPS-LR07-19. Again, this cost increase is not at all "anomalous" but merely the result of a change in mail mix due to migration of lower-cost automatable letters.

only 0.01% (one-ten thousandth) of total ECR/NECR volumes, and likewise, saturation parcels represent only 0.01% of saturation non-letters. Given these infinitesimal parcel volumes, even if there were some misallocation of costs from either letters or flats to parcels, any such misallocation would have only a negligible impact on the associated letter or flat cost. Furthermore, these large differences between the R2006 and FY07 parcel unit delivery costs are also influenced by the costing improvements in both (a) the delivery cost allocation among ECR rate categories (USPS-LR-FY07 19), and (b) development of the ECR dropship-adjusted mail processing costs (USPS-LR-FY07 18). Finally, given that these infinitesimal parcel volumes are included within either the Carrier Route and High-Density/Saturation flat/parcel products groupings -- where the parcel-flat rate differentials are not subject to any PAEA requirement -- these changes, which have at most a miniscule impact on total product cost, are neither a cause for concern nor a reason to reject the USPS cost analysis.

3. Valpak's Worn Arguments About Delivery Costs Ignore The Facts.

Valpak argues simplistically that saturation letters, because they are DPSed, "should" cost less to deliver than saturation flats. Therefore, it claims that the similarity in unit delivery costs for saturation letters and flats (without DALs) means there is something wrong with the USPS delivery cost analysis. Valpak Comments at 37. Although Valpak chooses to ignore them, the reasons for the similarity in unit costs are apparent:

- For city carrier costs, sequenced bundle mail (i.e., mailer-DPSed saturation mail that is not cased but instead is taken directly to the street) is the lowest-cost mail to deliver, requiring no in-office casing and easy to handle on the street. Valpak's argument implies that virtually all saturation letters are DPSed; but in fact, only 49.4% of saturation letters delivered on city routes are DPSed. Together with the 15.5% of saturation letters that are handled

as sequenced bundle mail, this means that only about 65% of saturation letters bypass carrier casing and are delivered in pre-sequenced bundles.⁷ By contrast, over 74% of saturation flats are handled as sequenced bundle mail. Thus, saturation flats (without DALs) correctly have a slightly lower unit city delivery cost than saturation letters.

- For rural carrier costs, DPS and boxholder mail are the lowest cost mail to deliver. On rural routes, 56% of saturation letters are delivered as either DPS or boxholder mail, while 50% of saturation flats are delivered as boxholder mail. Thus, as one would expect, the saturation flat unit rural delivery cost is only slightly higher than that of saturation letters.⁸

Accordingly, when the city and rural carrier unit costs by shape are averaged together on a weighted-volume basis, the results for saturation letters and saturation flats are very similar. There is nothing either anomalous or counter-intuitive about these costing results.

4. Notwithstanding Valpak's Confusion, The Postal Service Has Correctly Calculated ECR Letter And Flat Costs Based On Correct Estimates of DAL Volumes.

Valpak raises various questions about detached address labels, questioning the Postal Service's count of DALs in the FY07 Billing Determinants and suggesting that there has been some underreporting or miscalculation that has skewed the costing numbers. Valpak Comments at 41-42. Valpak clearly does not understand what the billing determinant numbers represent, nor how costs are calculated.

The billing determinant volume of DALs (529 million) represents *only* those DALs entered *after* the May 15, 2007 rate change, and that were thereby subject to the DAL rate surcharge. However, these were *not* the volumes that the Postal Service used to

⁷ USPS-LR-FY07-19, VolAdj071211.xls. We would note that the USPS, without explanation, attributes in USPS-LR-FY07 19 a lower street time unit cost to sequenced bundle letters than to sequenced bundle flats.

⁸ See USPS-LR-FY07 19, UDCmodel011211.xls.

construct its costs. For carrier costs, the Postal Service's CCCS/RCCS annual data show 3.145 billion saturation DALs delivered by city and rural carriers, and a total of 3.350 billion DALs in the system during FY07.⁹ It was these *annual* volume figures that were, quite correctly, used in developing the delivery costs for both saturation letters and saturation flats.¹⁰ There is no error.

5. Valpak Does Not Understand The Substantially Different Rules Regarding Use Of DALs With ECR Parcels Versus Saturation Flats.

Valpak likewise doesn't understand the use of DALs with ECR parcels. Citing the fact that the FY07 billing determinants show a total of only 924,706 saturation parcels but 1,587,102 DALs, it claims that these figures must be mismatched. Valpak Comments at 43. Valpak apparently presumes that, as with saturation flats, only saturation parcels may use DALs. But under the Domestic Mail Manual, however, the use of DALs with parcels is not confined just to *saturation* parcels. Indeed, the use of DALs is *mandatory* for some ECR parcels and *optional* for others whenever they are distributed to at least 25% of the addresses on a route – far below the 90% distribution threshold for saturation mail. See DMM Section 602.4.1.3. Thus, the total number of DALs used with parcels (basic + high density + saturation) will inevitably exceed the volume of saturation parcels alone. There is no mismatch.

In conclusion, Valpak has presented nothing that throws into doubt the ECR costs presented in the Postal Service's FY07 Report. Those costs, and the data and

⁹ See USPS-LR-FY07 19, UDCInputs071211.xls.

¹⁰ For mail processing costs, the IOCS identifies and allocates DAL costs directly to the companion flat or parcel piece, so there never has been a concern about misallocation of DAL mail processing costs to saturation letters.

methodologies underlying them, are well-documented and explained, and, contrary to Valpak's careless allegations, represent a significant improvement over the costs presented in Docket R2006-1.

Respectfully submitted,

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