

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268

Annual Compliance Report, 2008

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Docket No. ACR2008

**REPLY COMMENTS OF TIME WARNER INC.
ON ACR2008 IN RESPONSE TO ORDER NO. 161**
(February 13, 2009)

Time Warner Inc. (Time Warner) hereby submits its reply comments in response to Order No. 161, Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment (issued December 31, 2008).

These reply comments primarily address, either directly or indirectly, the subject of Periodicals class cost coverage, which has been discussed extensively in several earlier Commission proceedings (beginning with Docket No. RM2007-1, in which the Commission adopted comprehensive regulations implementing the Postal Accountability and Enhancement Act (PAEA)). Rather than to recapitulate previous debates, these comments aim to: (1) point out the considerable area of agreement that has emerged respecting *what should be done at this time* to address the problem of continuing negative Periodicals class cost coverage; and (2) make several specific recommendations that we believe are consistent with what is now a widely shared view among participants in the ratemaking process.

- 1. There is broadly shared agreement that the current financial situation of Periodicals class requires aggressive measures to bring Periodicals costs into line with Periodicals revenues, and that the methods available to the Postal Service for accomplishing this are continued cost control, improved operational efficiencies, and more efficient price signals.**

No commenter in this docket has urged the Commission in its Annual Compliance Determination (ACD) to make a determination of non-compliance under § 3653(b) of the PAEA with respect to Periodicals class cost coverage in FY 2008, or has attempted to present an analysis that establishes a sound legal basis for a finding. No commenter has asserted that the Commission should impose mandatory remedies under § 3653(c) with respect to Periodicals class cost coverage, or has indicated what remedies the Commission has available under that section would be prudent and consistent with the public service functions of the Postal Service under the Act.

These facts are quite significant, because two of the participants who have addressed this issue most extensively--Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. ("Valpak") and the Public Representative--originally viewed it as a matter involving Postal Service compliance with a clear mandate of the Act and Commission enforcement of that mandate under either § 3653 (Annual Determination of Compliance) or § 3662 (Complaints).¹ Neither Valpak nor the Public Representative has abandoned the view that compliance with

¹ See Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Regulations Establishing a System of Ratemaking in Response to Commission Order No. 26 (September 24, 2007), at 17-20; and Office of the Consumer Advocate Comments in Response to Order No. 26 Proposing Regulations to Establish a System Of Ratemaking (September 24, 2007), at 18-22.

the attributable-cost recovery provision of § 3622(c)(2) is mandatory. But both appear to have abandoned previous suggestions that a failure to bring Periodicals class revenues *immediately* up to 100 percent of attributable costs necessarily constitutes a remediable act of non-compliance under § 3653 or a justified basis for a complaint under § 3662.

In their initial comments in this docket, filed on January 30, 2009, both Valpak and the Public Representative appear to accept that bringing Periodicals class immediately to full cost coverage is neither practicable nor likely to be adjudged legally obligatory by the Commission. The Public Representative, for example, refers to "[t]he predicament that the Periodicals class faces and comments:

The Commission has taken the prudent course of letting events unfold before initiating any remedial step to bring Periodicals into compliance.

Public Representative Initial Comments at 13.

Valpak states in its initial comments:

The consequence of insistence by certain Periodicals mailers on the inviolability of the price cap is that it leaves only cost reductions, including use of rate incentives to achieve that end, on the table.

Valpak Initial Comments at 21.

Of course, what is or is not on the table is not a decision that the Act puts in the hands of "certain Periodicals mailers." It seems more likely that Valpak's changing perception of what is on the table can be ascribed to the insistence of the Postal Service, repeated as recently as the Postmaster General's testimony before Congress on January 28, that an exigent rate increase would be "counterproductive" and that it has no intention of requesting such an increase, along with the

Commission's strong indication in its *Report on Universal Postal Service and the Postal Monopoly* (issued December 19, 2008) ("USO Report") that it is inclined to give the price cap provision pre-eminence in the absence of a Postal Service request for an exigent rate increase. *Id.* at 134 (discussed further below).

The last point is particularly significant, because the Commission has made an important legal finding respecting Periodicals class cost coverage since the parties last had an opportunity to address the issue. In its *Report on Universal Postal Service and the Postal Monopoly* (USO Report), which it transmitted to the President and the Congress on December 19, 2008, as required by section 702 of the PAEA, the Commission addressed the issue of the Periodicals class negative cost contribution in FY 2007:

Under the PAEA price cap, the losses in FY 2007 from the two subclasses that make up the Periodical class could not have been eliminated. Therefore, the FY 2007 loss of \$448 million by Periodicals was made necessary by current statutory obligations. Consequently, the negative contribution made by them should be included with the costs of the USO.

USO Report at 134.

The same logic applies to losses in FY 2008, which also could not have been eliminated consistent with the statutory price cap.²

The Postal Service has also made it clear, both in ACR2007 and ACR2008, that it does not read the § 3622(c)(3) factor as mandating that it take actions that will immediately achieve full cost coverage, no matter how drastic the increases over

² See United States Postal Service FY 2008 Annual Compliance Report (December 29, 2008), at 32-33.

existing rate levels or how destructive such actions may be to the system overall or to other policy objectives of the Act. In ACR2008, the Postal Service reiterates the position that it has taken consistently under the PAEA: namely, that bringing Periodicals class to full cost coverage is an important statutory policy but not an urgent statutory command that trumps all other policies and considerations:

The Postal Service, Periodicals publishers and mailers, and the Commission have recognized the special role and current situation of Periodicals. Significant efforts are underway to try to improve Periodicals, such as the joint PRC/USPS review of Periodicals. It would be premature to make any definitive pronouncement on the future actions necessary to improve the current situation while such work is in progress. The Postal Service will continue to pursue these efforts, as well as use the annual price change mechanism to fine-tune prices that lead to cost-reducing behavior. . . .

Although Periodicals is challenged in terms of cost coverage, its important role in allowing for dissemination of educational, cultural, scientific, and information value to the recipient of mail matter is vital, and promotes the public policies of title 39. Efforts will continue to improve Periodicals in order to benefit the Postal Service, publishers, mailers, and recipients of periodicals and other publications.

ACR2008 at 33-34.

Time Warner agrees with the Postal Service's view that measures that are more gradual and circumscribed, but far less disruptive, than those originally suggested by Valpak and the Public Representative, are the only measures that can be considered to be available in a practical and realistic sense.

However, while Time Warner has no difficulty in also agreeing with the Postal Service that "[i]t would be premature to make any definitive pronouncement on the future actions necessary to improve the current situation" while the joint PRC/USPS review of Periodicals class is in progress, we do not think that it is also premature to

take actions whose desirability is already soundly established, such as measures to constrain costs and improve operational efficiency to which Postal Service management has long expressed its commitment, and further progress toward a rate structure that better reflects underlying costs, as emphatically endorsed by the Commission in Docket No. R2006-1 and strongly emphasized in provisions of the new law such as

§ 3622(b)(1)'s objective to "maximize incentives to reduce costs and increase efficiency," § 3622(c)(12)'s concern with "the need for the Postal Service to increase its efficiency and reduce its costs, including infrastructure costs, to help maintain high quality, affordable postal services," and § 3622(e)'s limits on workshare discounts.

Time Warner therefore agrees with the Magazine Publishers of America's ("MPA") strong emphasis on the need for the Postal Service to follow through on its commitments to undertake substantial cost-savings measures. We also agree strongly with MPA and Valpak on the need to continue to make modifications to the Periodicals rate structure that move in the direction approved by the Commission in Docket No. R2006-1, to induce Periodicals mailers to adopt the most efficient mailing practices they are capable of. In that regard, Valpak states:

MPA and ANM recently have given strong endorsement to more reliance on designing rates to induce desired responses by Periodicals mailers.

Ignoring [allied labor piece-related cost avoidance] when designing rates is **inappropriate** and sends **unsound** and **inefficient price signals** to mailers. First, the Efficient Component Pricing Rule ("ECPR") indicates that all cost avoidances should be recognized in designing rate differentials.

Second, as ANM and MPA explained in Docket No. ACR 2007, including allied operations in cost avoidance estimates is consistent with the methods used to estimate cost avoidances in other classes of mail.

These recommendations by ANM and MPA (i) are fully consistent with section 3622(b)(8) of PAEA [emphasis added], which supports pricing flexibility and explicitly provides for differential rate changes within a class of mail, and (ii) will result in larger rate increases for those publications that cause the Postal Service to lose money on each copy mailed. . . .

As MPA/ANM noted, appropriate pricing incentives send mailers the right signals and provide them with strong incentives, while inappropriate pricing incentives send the wrong signals. Within the Periodicals pricing structure, meaningful incentive effects are overdue. Periodicals rates also should reflect fully the effect of all important cost drivers, in accord with the principle of efficient component pricing, as MPA/ANM recommend.

Valpak Initial Comments at 21-22, 23 (internal citation omitted).

In light of this background, it behooves all participants who are in a position to do so to indicate ways in which either Periodicals class rates or Periodicals processing operations may be improved incrementally so as to ameliorate the problem of negative cost coverage. In the remainder of these reply comments, we address what we believe is one of the principal reasons for the low Periodicals cost coverage.

2. Far too many Periodicals flats are still being sorted manually in Postal Service facilities

With the extensive deployment of AFSM-100 as well as UFSM flats sorting machines, and given the reduced flats volumes experienced in recent years, it should be possible today to sort nearly all machinable flats at high speed on automated equipment. Yet, as demonstrated below, Periodicals flats continue to be

manually sorted in many postal facilities, at a very high cost to the class.

One way to see the extent to which Periodicals flats continue to be sorted manually is to compare IOCS results for Periodicals and Standard regular non-carrier route flats in automated and manual flats sorting operations.

Standard regular accounts for more than half of all non-carrier route flats. Periodicals Outside County has the second largest volume of such flats. Both Standard and Outside County non-carrier route flats are mostly presorted to the 5-digit bundle level, with smaller portions at 3-digit or lower presort levels.³

Most automated sorting of flats is performed at AFSM-100 machines, in the AFSM cost pool. Most manual sorting, whether performed in MODS or NonMODS facilities, are in cost pools named MANF. The NonMODS MANF is by far the larger, representing manual sorting performed in associate offices.⁴

The FY08 clerk and mailhandler costs attributed by IOCS to Standard Regular and Outside County flats at each of the cost pools described above are shown in USPS-FY08-7, part 3. Dividing those costs by the respective volumes of non-carrier route flats gives the per-piece attributed costs presented in Table 1

³ First Class provides the third largest category of non-carrier route flats. But these flats are mostly single piece, requiring several iterations of piece sorting, whereas most Periodicals and Standard flats need only one sort before going to the carriers. Additionally, many First Class flats have handwritten address, making automated sorting difficult. We focus therefore on comparing Standard and Periodicals flats, which have many characteristics in common.

⁴ Some flats are also sorted on UFSM machines. We ignore them here because the volume is small compared with the AFSM-100 volumes and because a portion of the sorting on UFSM machines is done in a manual keying mode that is not much faster than sorting at a manual flats case. Some manual sorting is done in various other cost pools, including the LD43 pool, which represents flats processing at stations and branches. However, since most manual sorting occurs in the two MANF pools, it is sufficient for our purposes here to focus on them.

below.⁵

Comparing the per-piece costs in Table 1, it is clear that:

- (1) Periodicals flats are much less likely than Standard flats to receive automated sorting; and
- (2) Periodicals flats are far more likely than Standard flats to be sorted manually.

	AFSM 100	MANF Cost Pools		
		MODS	NonMODS	Total MANF
Std Flats:	3.16	0.47	1.77	2.24
Outside County:	2.39	1.27	3.43	4.70

That Periodicals are more likely than Standard flats to be sorted manually is hardly a new observation, although at times Postal Service officials have been reluctant to acknowledge the fact. In Docket No. R2006-1, however, Postal Service witness McCrery did acknowledge that Periodicals often are processed manually even when they could be machine sorted, and listed many of the reasons why this may occur.⁷ Time Warner has addressed the issue on several occasions, most recently in our initial comments in Docket RM2009-1 (at 17-18).

What is surprising is that the sharp recent decline in total flats volume, which should have made ample automated processing capacity available for all flats, and

⁵ The volumes of flats in each category can be found in the billing determinants, USPS-FY08-4, or in the USPS-FY08-11 Periodicals flats model, where the volumes of non-carrier route flats are tabulated in cells c92:d100 on sheet 'ACR 2008 MODIFICATIONS'.

⁶ The costs shown reflect clerk/mailhandler costs only, not other costs piggybacked on top of the direct labor costs.

⁷ See Docket No. R2006-1, Response of Witness McCrery to TW/USPS-T20-9, redirected from witness Miller (Tr. 11/3091-92).

the extensive publicity given to the low Periodicals cost coverage, do not appear to have diminished the excessive manual sorting of Periodicals flats.

For example, from FY2007 to FY2008, the total volume of carrier route flats declined by 17.6%, from 21.432 billion to only 17.659 billion, and the overall percentage of flats receiving automated incoming secondary sorting was estimated to have increased from only 74.3% in FY 2007 to 86.8% in FY 2008.⁸ It stands to reason that so large an increase in the degree of automated flats sorting must have benefited Periodicals by reducing its manual sorting to some extent.

But apparently the Periodicals class received no such benefit in FY2008. If one repeats the calculations behind Table 1 using FY2007 data, one finds that in FY2007 the combined MODS and NonMODS per-piece IOCS cost of Outside County flats at the MANF operations was 4.36 cents, versus 4.7 in FY2008, an increase of 7.8%, in spite of the sharply increased availability of machine capacity.⁹

Stralberg provided another way to see that the manual processing of Periodicals flats is excessive in his paper that was appended to Time Warner's comments in response to Order 99 in Docket No. RM2008-2 (Appendix B at B2-3 and B12-13). In commenting on the CRA2007 version of the Periodicals flats model, he noted that the costs attributed by the CRA to Periodicals at manual flats sorting operations exceeded, by well over \$100 million, the costs that the model predicts.

⁸ See cells c94:d104 on worksheet 'ACR 2008 MODIFICATIONS' in the RM2009-1 version of the Periodicals model, using FY2007 data, and the USPS-FY2008-11 version of the same model using FY2008 data.

⁹ Note that in its FY2008 model version the Postal Service has assumed that 86.8% of Periodicals flats also received automated/mechanized incoming secondary sorting in FY2008. It seems very unlikely that this occurred, since if it had occurred then manual sorting costs for Periodicals should

The discrepancy between modeled and CRA Periodicals piece sorting costs is thus essentially the same in the FY 2008 version of the flats model as in the FY 2007 version, although the model has been improved in some respects.¹⁰

If the manual sorting costs in excess of those predicted by the model could somehow be eliminated, the Periodicals class would take a very major step towards covering its own costs. Why then has so little progress been made in controlling these costs? When he asked personnel at mail processing facilities why so many Periodicals are still sorted manually, Stralberg often received the answer that it is done for “service reasons.” In other words, some incoming Periodicals flats are observed at a processing plant too late to be processed on the machines if they are to be delivered next morning. So the managers of the processing facility send them to the various associate offices or stations and branches, where they are sorted manually. Some offices may still keep “hot lists” of Periodicals, usually magazines or newspapers that have been the subject of some complaints from subscribers about late delivery.

If Periodicals costs are ever going to be controlled, these extremely costly practices have to stop. There must be an agreement, which we believe most publishers would accept, that if a publication arrives too late at a facility to receive the most efficient processing and still be delivered the next day, it will instead be

have dropped very sharply in FY2008. Instead, they increased further.

¹⁰ The discrepancy in the current model (in USPS-FY2008-11) can perhaps be viewed most easily on worksheet ‘CRA FLATS’, where cell F92 shows the direct piece sorting costs (\$391 million) that the model indicates Periodicals flats should have incurred in FY2008. Cell G92 shows the much higher costs (\$560 million) attributed by CRA at the piece sorting operations. The discrepancy (\$169 million) is due to much larger manual sorting costs than the model predicts.

delivered the following day.

It is understandable that local postmasters find it necessary to have at least some personnel available who can perform manual incoming secondary sorting, which requires scheme knowledge about the particular Zip codes served by the facility. Every post office needs at least someone who possesses such knowledge, and it may be convenient to justify the high cost of such personnel by keeping them occupied part of the time sorting Periodicals flats manually. But such costs should not be borne only by Periodicals, since they are incurred not so much for the benefit of Periodicals as at their expense. Instead, every effort should be made to assure that Periodicals that can be machine sorted are machine sorted. This will increase substantially in importance in the coming FSS era, when flats that previously were carrier route presorted also will need machine processing. Sending such flats to manual sorting could cause cost increases so large as to defeat the purposes of the FSS deployment.

Clearly, discovering and correcting all the reasons why Periodicals continue to receive so much manual processing will require an in-depth analysis for which there is insufficient time in the current proceeding. The issue must, however, be fully addressed, and it can be fully addressed most appropriately in the joint PRC/USPS study of Periodicals provided for by § 708 of the PAEA. Time Warner is committed to resolving the causes of rising Periodicals costs and stands ready to make its resources available to the Postal Service and the Commission in working toward that end.

Respectfully submitted,

s/ _____
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