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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2008	)))	Docket No. ACR2008

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
REPLY COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2008 ANNUAL COMPLIANCE REPORT
(February 13, 2009)

On December 29, 2008, the Postal Service filed its Annual Compliance Report ("ACR") for fiscal year 2008 as required by 39 U.S.C. section 3652. On December 31, 2008, the Commission issued Order No. 161, and set January 30, 2009 as the deadline for initial comments and February 13, 2009 as the deadline for reply comments. Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") submitted Initial Comments on January 30, 2009. Initial Comments also were filed by American Catalog Mailers Association, American Postal Workers Union, Association for Postal Commerce, Major Mailers Association, Parcel Shippers Association, Pitney Bowes Inc., the Public Representative, Stamps.com, Time Warner Inc., and Valassis Direct Mail, Inc./Saturation Mailers Coalition. Valpak submits these reply comments in response to Order No. 161.

I. AMERICAN CATALOG MAILERS ASSOCIATION

Initial Comments of the American Catalog Mailers Association ("ACMA") offer general observations regarding the catalog industry — *e.g.*, postage constitutes a substantial portion of catalogers' total costs; catalogs are affected by postal rates; catalogers are sophisticated users of the mail; catalogs are important to their customers; catalogers are affected by events in the national economy (including the financial sector); many jobs are supported by the catalog industry; positive responses to catalog prospecting generate sales, which then lead to billing and other fulfillment activities; and catalogs provide certain societal benefits. ACMA Initial Comments, pp. 1-12. In these regards, the catalog industry demonstrates only that it exhibits similarities to other industries that place major reliance on the Postal Service.

Beyond these general observations, ACMA raises several pricing issues that have received attention from certain mailers before the Commission in the past. Valpak addresses these issues to defend important, established pricing principles that ACMA apparently would ask the Commission to disregard or overturn.

A. Prices Need to Reflect Actual Costs

ACMA argues:

> had catalogs received their *pro rata* share of automation investment and policy attention in the past that other types of mail have received, other than depressed volumes caused by the recession, catalog volumes would not be in a downward spiral of declining volume today. [ACMA Initial Comments, p. 4.]

Further, ACMA states that "while other types of mail have enjoyed the results of the USPS' substantial investment in automation to reduce the direct cost of its handling, flat-shaped mail has not historically been the beneficiary of this capital investment," and "[w]ere it highly automated, arguably, the cost to handle catalogs and other flats would be much less today." ACMA Initial Comments, p. 8.

Since the 1970's, mailers of flats have argued that the Postal Service should do more to develop handling systems that would lower the cost of handling flats, while also arguing that any steps by the Postal Service to impose piece uniformity and machinability would reduce their ability to use the mail effectively. Although flats automation has been more difficult to achieve than letter automation, the Postal Service has invested substantially to achieve it. Mailers have seen development of the wide-area barcode reader and several generations of flats sorters, leading to the AFSM-100 and, now being installed, Flats Sequencing System ("FSS") machines. These developments hardly reflect a lack of attention from the Postal Service.

Regardless of whether more could have been done, pricing must recognize such costs as **do** exist. All notions of **efficiency** of resource allocation center on prices that recognize **marginal costs** (which have been the focus of significant investment in costing systems). A marginal cost is an estimate of effects on the economy of producing more or less of the product in question. These effects are real. One might wish that they were different, and even argue in a perfect world that they somehow **should** be different, but costs are what the costs are, and no equity or efficiency arises from having someone else cover them. ACMA's argument provides no reason to neglect the costs, as developed.[1]

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[1] ACMA asserts that "volume degradation has been a significant driver of higher attributable costs for catalogers," presumably referring to unit costs. ACMA Initial Comments, p. 7. ACMA also argues that "the dramatic volume degradation certainly must have affected the data upon which the USPS determines catalog processing and delivery costs." *Id.*, p. 8. From these statements, it appears that ACMA believes that the marginal cost of handling catalogs increases as volume declines. Valpak knows of no evidence that Postal Service marginal costs are anything but relatively constant. In other words, volume-variable costs are, in fact, volume variable.

B. Costs for Flats (and Letters) Have Been Calculated for Years

ACMA argues generally that costs for Standard flats “may not be well understood,” that they “may not yet be fully defined,” that they are “preliminary [in] nature,” that they “may not be as well documented as [the costs of] other types of mail,” and that “[t]his is the first year this information has been broken out in this form so there is not accurate historical comparison as to how much costs have increased in the past year.” ACMA Initial Comments, pp. 6-7. These statements are contrary to history.

The Postal Service has been developing separate costs for letters and flats in what is now Standard Mail since Docket No. R90-1, approximately 19 years ago. These costing efforts have led to sophisticated mail-flow models with dozens of inputs, adequate to support separate presort discounts for flats and letters, including barcode and automation discounts. Members of ACMA presumably have enjoyed the benefits of these discounts for many years.

For discount purposes, attention has focused primarily on mail processing and carrier costs, which make up about 90 percent of the costs of flats. *See* Docket No. R2006-1, USPS-LR-L-135; *see also* Docket No. R2005-1, USPS-LR-K-120.

Although it is true that this is the first time the final Cost and Revenue Analysis (“CRA”) document has shown costs and coverages for flats as a separate Standard Mail product, it is far from the first time separate cost and coverage data have been available for flats.

C. Standard Regular Products Have a Lower Elasticity than Standard ECR Products

On January 16, 2008, by letter, the Postal Service submitted an elasticity estimate for Standard Regular of -0.37. “MD.Descpt.Demand.Equations.Nov.2007.doc,” p. 44. Exactly one year later, on January 16, 2009, it submitted an elasticity estimate for Standard Regular of -0.31. "DemandEquations-Nov2008.doc," p. 43. The more recent measure shows a slightly lower elasticity. Since the volume of letters is much larger than flats, the elasticity of all Standard Regular Mail, being a weighted average, is, to be sure, weighted toward letters. Nevertheless, to the extent that it applies to flats, and there is no evidence that it does not, the indication is (under any notion of economic efficiency) that **the cost coverage for flats should be close to the cost coverage for letters**, the latter shown in the FY 2008 CRA to be **192.67 percent**. Thus, at a cost coverage of **94.16 percent**, the rates for flats are way too low.

ACMA indicates that catalog "volume expands [] or contracts [] in mutually reinforcing loop." ACMA Initial Comments, p. 4. It is not clear what this statement means. In the same paragraph, however, ACMA refers to a recent Revenue, Pieces & Weight ("RPW") report indicating: "Standard Mail flats is down 23% and Standard Mail Carrier Route (CR) flats is down 22%." Actually, these volume declines do not fit well with ACMA's general theme that flats demands are highly elastic. In Docket No. R2006-1, the docket where certain rate increases for flats have been characterized as "large," the rate increase for **Regular flats was 23.2 percent** and for **CR flats was 13.2 percent**.[2] If rates were the primary influence, one would expect the volume decrease for **CR flats** to be lower than the volume decrease for

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[2] This increase of 23 percent is not unusually large. It is smaller, for example, than the 25-percent increase for all third class recommended by the Commission in Docket No. R90-1, after the Postal Service proposed an increase of 17 percent. Docket No. R90-1, *Op. & Rec. Dec.*, p. i. Part of the increase experienced by some catalogers in Docket No. R2006-1 was due to deaveraging of the 3/5-digit presort category, which many mailers had sought. Before Docket No. R2006-1, mail sorted to 3-digit and 5-digit levels paid the same rate, even though the 5-digit mail had lower cost. With deaveraging, 5-digit mail received a smaller increase because it was no longer required to pay for 3-digit mail's higher costs.

Regular flats. As ACMA points out, however, they are approximately the same. If elasticity of Regular flats were in the neighborhood of -1.0, which is close to the **high** elasticities normally associated with Enhanced Carrier Route ("ECR"), the volume decline **would** be near the 23 percent quoted above, but this would leave no room for the effect of other factors that are understood to be quite influential. This reasoning supports a relatively low elasticity for catalogs instead of a high one.[3]

D. How Should Catalog Mailers Be Working with the USPS?

After stating that potential volume exists, ACMA states:

> Catalogers understand fully the concept of lowest total cost and how to take costs out of a supply chain. Catalogers have a long history of re-engineering in partnership with complex supply chain partners. Yet historically, catalog companies have not partnered with the USPS to optimize catalog delivery and processing costs. [ACMA Initial Comments, p. 9.]

Any failure by catalogers to work with the Postal Service is not a problem solvable by the Commission. Certainly, worksharing opportunities abound for catalogers, and to date the Commission has played a role in much of the progress in this area. Carrier route discounts became a part of third-class mail in 1979, with 5-digit discounts in 1981. The notion of lowest combined costs has been part of the postal lexicon at least since the late 1980's. Dropship discounts resulted from Docket No. R90-1, and the great bulk of Standard Mail is now

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[3] In its Initial Comments in this docket, Valpak noted several factors that would be expected to lead to volume declines for catalogs. These were the increase in paper prices, the increase in fuel prices, the decline in the state of the economy, the lightweight flats that changed their format into letters, and the fact that several catalogers went out of business. *See* Valpak Initial Comments, p. 52, n.62.

dropshipped. It is not clear that the Commission can do more other than urge ACMA and its members to utilize worksharing opportunities already available.

E. A Healthy Catalog Industry May Be Desirable, but It Should Pay Its Own Way

ACMA discusses the role of catalogs in the nation, saying:

> Catalogs provide substantial societal benefits unavailable elsewhere…. Catalogs provide a wealth of products and services to rural Americans without ready access to well developed **retail shopping areas**. Catalogs fill a need for time-starved dual income households and single-parent households that find it difficult to shop in **traditional retail outlets** by virtue of their personal schedules. [ACMA Initial Comments, p. 10 (emphasis added).]

ACMA also refers to the possibility that buyers might shop in a catalog and then make "the ultimate purchase [] from a physical retail location." *Id.* (Of course, the converse also might occur; that is, buyers might examine a product at a retail location and then purchase it from a cataloger.) ACMA's comments, therefore, raise a serious question about competition and level playing fields.

Catalogers and retail stores are in direct competition with one another. Although catalogers sell a large volume of goods each year, if those goods were not purchased from catalogs, it is likely these goods would be purchased from retail stores. At present, many retail stores are having serious financial difficulties, along with the rest of the economy.[4] One

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[4] "In an interview with CNBC's Margaret Brennan, J.C. Penney's (JCP) CEO Mike Ullman said Washington has no idea how much pain the retail industry is going through and how many jobs the sector will lose over the next year. Ullman was quoted as saying: 'We're getting the result of the slow down in the economy, there may be as many as 100,000 retail jobs lost per month in 2009.'" http://www.theflyonthewall.com/permalinks/entry.php/JCPid1046634 (Feb. 11, 2009), http://www.cnbc.com/id/15840232?video=1030062273.

might argue about whether retail stores are having more or less difficulty than the nation's catalog mailers, but the matter need not be resolved. The proper policy approach to such matters is to provide a level playing field and let fair competition occur. This means that catalogers should pay their way, just like other mailers.

ACMA does not refer to any provision in PAEA that points to special rates for catalogs or other mailers of Standard flats. It is the position of Valpak that none exist. Catalogers should be provided with a range of price alternatives, based on Postal Service costs, and should be allowed to choose among them, just like other mailers. No basis exists for giving them special consideration with respect to prices.

II. ASSOCIATION FOR POSTAL COMMERCE

Initial comments filed by the Association for Postal Commerce ("PostCom") discuss, *inter alia*, (i) the status of service performance measurement, and (ii) adjustments to the established methodology of attributing revenues and costs to subclasses or rate categories. Valpak offers the following comments on these two issues.

A. PostCom's View that Service Performance Measurement Needs to Be Improved in this Docket Is Correct

PostCom reviews the Postal Service's statutory obligation to provide service performance information in its Annual Compliance Report, and then notes that:

> [d]espite these requirements, the Postal Service's report on its progress in satisfying these statutory goals amounts to essentially a one-sentence conclusion: "The Postal Service will continue to implement these systems, in order to report a broader range of data in its FY 2009 ACR." (United States Postal Service FY2008 Annual Compliance Report, p. 12.) The Commission should **use**

> **this docket to develop** a deeper understanding — **on the record** — of the implementation status of the proposed hybrid service performance measurement system.... [PostCom Initial Comments, unnumbered p. 2 (emphasis added).]

The inadequacy of the Postal Service's submission pointed out by PostCom violates the expectations expressed in Commissioner Goldway's Concurring Opinion in Order No. 140.

> The Commission and the Postal Service have been consulting on these issues for almost two years. The Commission views accurate and comprehensive service performance measurement as **a requirement** of the Postal Accountability and Enhancement Act. Unjustified, **further delay** in obtaining reliable, representative service performance measurements **will not be acceptable.** [Docket No. PI2008-1, Order No. 140 (Nov. 25, 2008), Concurring Opinion of Commissioner Goldway (emphasis added).]

Valpak agrees with PostCom that (i) the Postal Service's treatment of this issue in its FY 2008 ACR in a single sentence should not be considered acceptable, and (ii) the FY 2008 ACR should have shown much more progress vis-a-vis the FY 2007 ACR. *See* Valpak Initial Comments, pp. 58-65.

In addition to providing an update on the status of the proposed hybrid service performance measurement system, Valpak would urge the Commission to require the Postal Service, in this docket, to use its existing database to provide information, in the format specified by the Commission in its Annual Compliance Determination ("ACD") last year, on mail not delivered within the performance standard (*i.e.*, on the tail-of-the-mail) for single piece parcels and First-Class Mail with 1, 2, and 3-day delivery standards.

B. Recording of Revenues and Volumes Must Be Consistent with the Attribution of Costs to Preserve the Integrity of Products

Addressing the Postal Service's adjustment concerning **letters** that fail to meet automation requirements and that consequently are rated for postage as **flats**, PostCom states:

> While **it is generally reasonable for both revenues and costs for a particular type of mailpiece to be reflected in the same subclass or category**, the identification of the subclass or category to which such revenues and costs are allocated and assumptions regarding unit costs should be based on knowledge of the **handling** of the piece (and not necessarily based on the default **postage paid**). [PostCom Initial Comments, unnumbered p. 3 (emphasis added.]

Valpak agrees with PostCom that "it is generally reasonable for both revenues and costs for a particular type of mailpiece to be reflected in the same subclass or category," and would add that the volume should be "reflected" there too. In fact, keeping costs together with volumes and revenues must be a guiding principle.

Furthermore, and especially in light of the new product categories developed under the Postal Accountability and Enhancement Act ("PAEA"), Valpak agrees with the Postal Service that it is more important to keep together data on revenues, volumes, and costs **by product** than it is to keep together such data **by shape**. *See* Request of the United States Postal Service for Modification of Commission Order No. 169 (Jan. 16, 2009), p. 3.

It is not altogether clear what PostCom means when it says "assumptions regarding unit costs should be based on knowledge of the handling of the piece (and not necessarily based on the default postage paid)." PostCom Initial Comments, unnumbered p. 3. If PostCom means that the Postal Service should try to avoid using averages or proxies as means of estimating costs, particularly when there is no logical link between the proxy and the estimate needed, and strive for a more suitable measurement, based on the way pieces in questions are actually handled, Valpak would concur. For example, the present methodology for shifting costs of letter-shaped pieces rated as **flats** simply **assumes** that **non-machinable letter-shaped pieces** have the same average cost as **machinable letters**. Valpak agrees that significant cost differences could exist between the two categories of letter-shaped pieces. Assuming that more accurate cost information were available for those letter-shaped pieces rated as flats, the costs of these **flat-rated pieces** could then properly be shifted out of letters to flats. Costs of these **flat-rated pieces** should be kept with all other pieces that pay flat rates. *See* Valpak Initial Comments, pp. 52-55.

However, if PostCom seeks to justify occasional separation of costs from recorded volumes and revenues, Valpak would not agree. For example, although detached address labels ("DALs") are letter-shaped and are handled as letters (including DPS), their costs belong to flats. When DALs are cased by carriers before leaving the office, the costs (IOCS tallies) are routinely charged to flats. However, when DALs are DPS'd on letter-sorting equipment, that does not mean that these costs should be charged to letters while the revenues and volumes of accompanying host pieces are assigned to flats. Assigning any DAL costs to letters destroys the integrity of Postal Service data systems and produces meaningless costs unsuitable for use in pricing.

III. MAJOR MAILERS ASSOCIATION

Initial Comments filed by the Major Mailers Association ("MMA") focused on development of First-Class Mail workshare cost savings in the FY 2008 ACR. Although

Valpak takes no position on those workshare cost savings, Valpak does agree with the arguments regarding principles of due process raised by MMA.

A. The Postal Service Should Not Impose Unilateral Methodological Changes

MMA states that "mailers and the Commission must be afforded an opportunity to consider the merits of [methodological] changes in a public forum *before* they are imposed upon mailers in a severely time-constrained ACR proceeding." MMA Initial Comments, p. 1 (italics original). Indeed, the Commission, in its FY 2007 ACD, expressly agreed with MMA (and Valpak) that "there needs to be an **opportunity to vet** nonperfunctory changes to **input data** and to **analytical methods** in a more thorough and deliberate procedure than has been available here **before they are relied upon** in the Postal Service's standard financial reporting to the Commission." FY 2007 ACD, p. 10 (emphasis added), cited in MMA Initial Comments, p. 7.

The Commission's proposed rules on Postal Service periodic reporting address changes to analytical principles: "If the Postal Service seeks to **change the analytical principles** that it used in its most recent annual report provided under the PAEA, the proposed rules would require it to **justify the change** in an informal rulemaking **prior to filing** its annual report." Docket No. RM2008-4, Order No. 104 (Aug. 22, 2008), p. 25 (emphasis added). Although instructive, these proposed rules are not yet finalized, and thus are not controlling. Moreover, they do not provide for any review of new data, no matter how anomalous the outcome, an important issue raised by MMA.

The Postal Service did submit some analytical (or methodological) changes for the Commission's review prior to the FY 2008 ACR (*see* Docket Nos. RM2008-2, RM2008-6, RM2009-1, and RM2009-2). However, as MMA points out, some changes were not submitted for prior review and reflect, over the past two ACRs, a shift of workshare cost savings which MMA estimates as over $200 million. *See* MMA Initial Comments, pp. 7-9.

The Commission should consider ways to subject unilateral changes by the Postal Service to input data as well as analytical principles (which MMA described as "Black Box ratemaking"[5]) to additional scrutiny by mailers. The reason behind the proposed rule to require prior approval of changes to analytical principles for periodic reporting was in furtherance of the PAEA goal of increased transparency. In addition to the review for purposes of the ACD, the Commission should conduct a review of changes such as discussed by MMA in a more comprehensive proceeding.

B. The Postal Service Should Be Required to Explain Anomalies

MMA's Initial Comments also pointed out aspects of the input data changes that appeared to have anomalous results. *See* MMA Initial Comments, pp. 12-19. MMA poses many questions that it believes the Commission should require the Postal Service to answer. At several points, MMA requests the Commission to require the Postal Service to provide "*complete*, coherent answers," "identify and explain the rationale," and "a thorough explanation." *Id.*, pp. 13, 15 (italics original).

Likewise, in Docket No. ACR2007, Valpak's Initial Comments addressed several costing changes that resulted in apparent anomalies, also pointing out that the Postal Service

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[5] *E.g.*, MMA Initial Comments, p. 4.

did not provide any discussion of the changes. *See* Docket No. ACR2007, Valpak Initial Comments (Jan. 30, 2008), pp. 35-36.

Furthermore, in Valpak's Initial Comments on the Commission's proposed rules on periodic reporting, Valpak emphasized the importance of requiring the Postal Service to provide a discussion and a "full and detailed explanation" of the various aspects of the ACR. *See* Docket No. RM2008-4, Valpak Initial Comments (Oct. 16, 2008), pp. 15-20. Contrary to the Postal Service's view that "[a]rguing over what can at times be somewhat esoteric cost relationships could devolve into a rather academic exercise, devoid of real world implications" (Docket No. RM2008-4, Postal Service Reply Comments (Nov. 14, 2008), p. 7), MMA's Initial Comments point out anomalies that are not so much arguments as questions, and have significant real world implications — $200 million of real world implications.

Finally, contrary to the Postal Service's idea that the mere filing of ACR data constitutes increased transparency (*see id.*, p. 4), where unexplained changes cause apparent anomalies to arise and the Postal Service provides no discussion, the Postal Service should expect the mailing public and the Commission to have questions. Therefore, Valpak agrees with MMA that the Postal Service should provide thorough explanations to MMA's questions, which Valpak trusts will be required by the Commission's final rules in Docket No. RM2008-4.

IV. PUBLIC REPRESENTATIVE

A. Cost-Based Prices Drive Down Unit Costs

Initial Comments of the Public Representative provide what it calls a "non-technical examination" of "recent trends" in Postal Service finances, using the broadest measures possible, such as total volume and cumulative net income. PR Initial Comments, p. 2. In anticipating future financial problems for the Postal Service, the Public Representative makes class-wide comparisons — average unit costs versus average unit revenues. *Id.*, p. 5. Such an analysis is based, *inter alia*, on an unstated assumption that Postal Service pricing within classes would utilize average increases not just for each class, but for all products within each class, and even below the product level.

It is clear, however, that pricing under PAEA is not occurring on an across-the-board basis, as it generally did in Docket No. R2005-1, for example.[6] The Postal Service's recent Notice of Price Adjustments claims to have made significant (albeit somewhat inconsistent[7]) efforts to send better price signals by giving greater-than-average increases to various high-cost products with low coverages. *See generally*, Docket No. R2009-2, United States Postal Service Notice of Market-Dominant Price Adjustment (Feb. 10, 2009). If the Postal Service uses its pricing flexibility appropriately under PAEA, that can be expected to reduce average

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[6] In Docket No. R2005-1, the Commission recommended a 5.4 percent across-the-board rate increase requested by the Postal Service with only minor adjustments. Docket No. R2005-1, *Op. & Rec. Dec.*, Nov. 1, 2005, p. i.

[7] Notably, the Postal Service gave a below-average increase to Standard flats, a product with large volume that did not even cover its costs in 2008, and it is unclear whether rate changes indicated for Periodicals will make matters better.

costs for classes, especially for Periodicals, and the Public Representative's straight-line projections serve more as a wake-up call — if nothing is done — than a realistic portrayal of the future.[8] If the Postal Service, however, fails to use its pricing flexibility to give above-average rate increases to categories that have low, or even negative, coverages, then something like the Public Representative's nightmare scenario could occur.

B. The Public Representative Correctly Identifies Periodicals as Being in Violation of 39 U.S.C. section 3622(c)(2)

The Public Representative reviews the status of the Periodicals Class and concludes:

> As in FY2007, the Periodicals class **did not comply** in FY 2008 **with section 3622(c)(2)** of the PAEA requiring revenues at the class level to cover attributable costs. According to the latest Cost and Revenue Analysis (CRA), Periodicals revenues and variable costs in FY 2008 were $2.294.9 million and $2.732.1 million, respectively. Therefore, not counting a small amount of product-specific costs … the present deficit stands at $437.3 million or 19.1 percent of revenues. [PR Initial Comments, pp. 10-11, emphasis added.]

The Public Representative anticipates that "unless there is a change in direction with respect to variable costs, the **non-compliance** of Periodicals with section 3622(c)(2) will only get worse…. With respect to Periodicals … **non-compliance** with section 3622(c)(2) is clear." *Id.*, p. 11, 13 (emphasis added).

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[8] The Public Representative's proposed solution to the problem of higher-unit costs includes what he terms a "comprehensive examination of … **passthroughs** that … result in **discounts** that bear an almost arbitrary relationship to the costs avoided by **worksharing or** the inherent cost differences between mail characteristics (primarily **shape**) that occur in mail…." PR Initial Comments, p. 6 (emphasis added). The Public Representative correctly discusses passthroughs and discounts in the context of worksharing, but if this recommendation intends to relate passthroughs and discounts to shape differences, it makes no sense. Cost or price differences based on shape are wholly unrelated to worksharing, and there are no discounts or passthroughs based on shape to be analyzed.

If PAEA is to be followed faithfully, and not ignored when following would be inconvenient, the Public Representative's conclusion must be seen as true and correct, and the Commission would be required to make a finding of noncompliance. Once it makes such a finding, it is required to take "appropriate action" under 39 U.S.C. section 3653(c). *See generally* Valpak Initial Comments, pp. 2-3.

C. Under PAEA, Commission "Appropriate Action" Includes Requiring that Each Class Pay Its Own Way, by Raising Rates Above the Cap, if Necessary.

PAEA's "appropriate action" is described by the Public Representative as "compliance remedies under section 3653" (PR Initial Comments, p. 19). The Public Representative makes no recommendation as to what the Commission's remedies would include. Exactly what constitutes "appropriate action" by the Commission is not specified in PAEA (other than by reference to section 3662(c) and (e)), and is subject to some disagreement.

Although not yet reviewed by the Commission, the Postal Service's noticed price adjustments for May 11, 2009 claim to have made some attempts to encourage preparation and entry of Periodicals in ways designed to reduce Postal Service costs. These claims will need to be subjected to critical review, as Periodicals rates are somewhat complex, and there needs to be firm assurance that coverage under these rates will be markedly higher than the 81 percent coverage recorded in 2008. The Commission could view this new pricing to be sufficient "appropriate action," at this time, as it did in Docket Nos. ACR2007 and R2008-1.

However, the Public Representative's analysis of future Periodicals' deficits assumes that Periodicals class pricing cannot exceed PAEA's cap on class price increases. *See, e.g.*, *id.*, p. 15. This assumption about PAEA is unwarranted. The Commission has yet to decide this issue and has not yet performed the type of detailed analysis of the PAEA text necessary to resolve this thorny issue of statutory interpretation. Since enactment of PAEA, the Commission has made it clear that it understands the importance of the CPI-based cap. Yet, at the same time, the Commission has not ignored the importance of the other aspects of the Title 39, including the factors, objectives, and requirements of 39 U.S.C. section 3622, particularly the requirement of section 3622(c)(2).

1. Docket No. RM2007-1

In Docket No. RM2007-1, with respect to exigent price adjustments, the Commission stated:

> The Commission acknowledges the interest some commenters express in resolution of several issues related to interpretation and administration of the PAEA's provision for an exigent increases, including adoption of definitive interpretations on rescission, application of increases, and impact on unused rate adjustment authority and the **attributable cost floor**. It **declines at this time** to adopt to either policy statements or specific regulations on these points. The state of the record on these issues, as the Postal Service points out, makes such actions **premature**. [Order No. 43 (Oct. 29, 2007), pp. 72-73 (emphasis added).]

2. Docket No. ACR2007

In Docket No. ACR2007, the Commission's Annual Compliance Determination acknowledged the importance of rates exceeding costs for each class, but awaited results of Postal Service price changes designed to improve pricing signals:

> *Commission evaluation*. As explained in the Introduction to this report, 39 U.S.C. § 3653 requires the Commission to apply PAEA rate setting standards, rather than those of the prior law (the PRA), in conducting its annual review of rates and service, including its initial review. Under either law, however, there is a **requirement to consider whether rates generate revenue in**

> **excess of attributable costs in the year under review**. The attributable costs of Periodicals in FY 2007 clearly exceeded their revenues. In addition to increasing efficiencies, the rates implemented in July 2007, were designed to generate a very substantial increase in revenue. The recent further rate increases approved for the Periodicals class in Docket No. R2008-1 reasonably approximate the allowable CPI cap. **At this point in time**, it is most appropriate to allow the recently adopted strategy for overcoming the Periodicals revenue-cost relationship a reasonable interval of time to succeed. [*Id.*, p. 70 (emphasis added).]

3. Docket No. R2008-1

With respect to the Periodicals class' continuing failure to cover its attributable costs, the Commission concluded: "The Commission has considered this circumstance, but **does not find it a reason** to require the Postal Service to file an amended notice or **to take other remedial steps in this case**." Order No. 66 (Mar. 17, 2008), p. 28 (emphasis added). *See also id.*, pp. 29-30.

4. Docket No. ACR2008

The Commission may not need to resolve the issue in the instant docket[9], unless it were to determine that "appropriate action" should include an above-cap Periodicals' price increase. Despite the Public Representative's assumption about the dominance of the cap, PAEA appears clear that the Commission may order price increases for a class higher than the cap under its remedial authority, even in the absence of an exigent rate case. (*See* Section D, *infra*.)

[9] The Commission would need to address this issue directly in now-pending Docket No. RM2008-4 ("Periodic Reporting Rules") if it adopts rules governing the compliance review under section 3653.

5. General Observations

Although the Commission has not yet resolved the issue, it is by no means clear that it is in the best interests of either Periodicals mailers or the Postal Service for the Commission to take the view that the cap trumps the requirement of section 3622(c)(2). If that position were taken, the Commission would throw away an important tool it could use to implement PAEA, as it would be barred from ordering even a 1 percent increase over the cap, to help preserve Periodicals as a class for the future. Down the road, if economic difficulties persist, and annual deficits increase, as the Public Representative projects, the Postal Service may have no alternative but to price in a draconian manner, causing most below-water periodicals to pay such high increases that they may not succeed. *See* Valpak Initial Comments, pp. 21-22, discussing MPA/ANM pricing recommendations in Docket No. RM2008-4. And, if the Public Representative's "wake-up call" predictions of future annual, recurrent Periodicals losses, culminating in a FY 2013 annual Periodicals negative contribution of $913.8 million, were actually to occur for this one class alone, it certainly would jeopardize the Postal Service itself.

D. An Analysis of the Language of PAEA Demonstrates that the Cap Does Not Trump the Requirement of Section 3622(c)(2)

While the Public Representative's Initial Comments implicitly adopt the position that the cap cannot be breached, some mailers assert this position with vigor. *See*, *e.g.*, Docket No. RM2008-4 ("Periodic Reporting Rules"), the Magazine Publishers of America, Inc., Alliance of Nonprofit Mailers, and American Business Media (hereinafter "MPA, et al.") Reply Comments (Nov. 14, 2008), pp. 2-3. Both such views disregard both the structure and the language of section 3622. For example, according to MPA, et al., "Section 3622 establishes a hierarchy of regulatory authority":

> At the **bottom** Section 3622(c)(2) and the thirteen other **factors** enumerated in §3622(c)(1) through (14).... **Above the factors** enumerated in §3622(c) are the nine "**objectives**" enumerated in §3622(b).... At the **top** of the hierarchy, however, is the **CPI-based cap** established by §3622(d)(1). This is the only ratemaking standard that the legislation requires the Commission to enforce as an absolute command ("shall ... include"). [MPA, et al. Reply Comments, App. A, pp. A-3 – A-4 (emphasis added).]

Contrary to MPA, et al.'s claim that the cap is "the top of the hierarchy," the cap appears at the end of section 3622, not at its beginning. Yet MPA, et al. believe that the order of items in the statute is highly significant. Using MPA, et al.'s own terms, the "objectives" are described as "above the factors" (which is true), but to be consistent, MPA, et al. should describe the cap as "below the factors"; however, they do not. Contrary to the representation of MPA, et al. that the cap "is the only ratemaking standard that the legislation requires the Commission to enforce as an absolute command ('shall ... include')," section 3622 uses the word "shall" as an "absolute command" for subsection b ("shall be applied"), and subsection c ("shall take into account"). It is no answer to say that "shall include" is stronger than "shall take into account" when the latter phrase is followed by the words "the requirement that..." each class pay its own way. In fact, **at best**, the statute uses the exact same term, "requirement," to describe both statutory commands, and it has been left to the Commission to balance competing interests on a case-by-case basis.

Actually, section 3622 **begins** with **objectives** in subsection (b) — "Such system **shall** be designed [by the **Commission**] to **achieve** the following objectives, each of which **shall** be applied **in conjunction with the others….**" (Since under 39 U.S.C. section 3622(a) the ratemaking system is to be "established" by the Commission, this language can be read to include the inserted bracketed words "by the Commission.")

Section 3622 **then** sets out **factors** in subsection (c) — "In establishing or revising such system, the Postal Regulatory **Commission shall** take into account" 14 factors. Of these, only one, the second factor, is described as a "**requirement**" — "(2) the **requirement** that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type…."

To be sure, section 3622 includes certain **requirements** and **limitations** in subsection (d) — the first of which states "(1) In general.—The system for regulating rates and classes for market-dominant products **shall**— (A) **include an annual limitation** on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index for All Urban Consumers…." But note that none of the **objectives** in subsection (b), and none of the **factors** in subsection (c), is qualified in any way by an overarching duty to ensure that the combination of **objectives** sought, or **factors** taken into account, meet any percentage measurement tied to the CPI.

Instead, subsection (b) states that the system for regulating rates and classes for market-dominant products "**shall** be designed to achieve [nine] objectives, each of which **shall** be applied **in conjunction with the others,**" not one of which includes any reference to any limitation tied to the CPI. Indeed, if such a CPI limitation were applied as an "absolute command," it could compromise four of the nine objectives:

- Objective 1, that the system should "maximize incentives to reduce costs and increase efficiency" (which could be impaired by a ban on above-cap rate increases);
- Objective 5, that the system should "assure adequate revenues, including retained earnings, to maintain financial stability";
- Objective 8, that the Postal Service should not be prohibited "from making changes of unequal magnitude within, between, or among classes of mail"; and
- Objective 9, that Postal Service is to "allocate the total institutional costs of the Postal Service appropriately between market-dominant and competitive products."

Additionally, subsection (c) states that "[i]n establishing or revising such system, the [PRC] **shall** take into account" 14 factors, not one of which includes any reference to any limitation tied to the CPI. Most importantly, if such a CPI limitation were to be applied as an overarching mandate, it would completely nullify factor number 2. If the CPI "requirement" were given "primacy" over this cost-covering mandate as urged by MPA, et al., then it would not be a "requirement," but only a discretionary factor like the other 13 factors listed in subsection (c), contrary to the plain language of subsection (c)(2).

The Public Representative's assumption that the cap trumps section 3622(c)(2) is not well founded.

V. VALASSIS DIRECT MAIL, INC. AND SATURATION MAILERS COALITION

Both before and during the technical conference held on January 26, 2009, Valpak raised questions about the mismatch between the total number of DALs shown in the billing determinants (901.5 million) and the total number of DALs shown in the City/Rural carrier network (601.5 million).[10]

The Initial Comments of Valassis Direct Mail, Inc. and the Saturation Mailers Coalition ("Valassis") concerning the Postal Service's FY2008 Annual Compliance Report criticize Valpak's concerns about DALs.

> **Valpak**, and subsequently the **Commission**, have raised questions about the apparent disparity in Saturation DAL volumes as shown in the FY2008 Billing Determinants (BD) versus the City Carrier/Rural Carrier Cost Systems (CCCS and RCCS). The Billing Determinants show DAL volumes of 901.5 million, compared to 640.8 million in the CCCS/RCCS. This has led Valpak to **presume** that the CCCS/RCCS volumes must be understated, which it **believes** requires some adjustment to shift carrier costs from saturation letters to DALs and flats. To the contrary, however, this differential between CCCS/RCCS and BD volumes correctly reflects the **fundamental change** in DAL delivery characteristics caused by implementation of the DAL surcharge in Docket R2006-1. [Valassis Initial Comments, p. 2 (emphasis added).]

Valassis speculates that the entire difference between the total number of DALs in the Billing Determinants, 901.5 million, and what it refers to as "640.8 million in the CCCS/RCCS" is accounted for by the number of DALs delivered by way of (i) P.O. Boxes, (ii) highway contract routes, and (iii) general delivery (hereafter collectively referred to as "POBox"). Valpak responds to this speculation as follows.

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[10] Additional observations about Valassis' Initial Comments and this DAL data mismatch appear in Appendix One.

A. Valassis Misstates the Number of DALs in the CCCS/RCCS.

With respect to the volume of mail delivered to POBox,[11] Valassis acknowledges that "there are no USPS data systems that can directly quantify this difference by delivery type…." *Id.*, p. 4. Consequently, until the Postal Service collects data on the number of DALs delivered by way of POBox, reasoned analysis must be relied upon.

The magnitude of the issue is seen clearly on the 'DALs' tab of UDCInputs08.xls, in USPS-FY08-19. There, the Postal Service shows DAL volume as follows:

Description	**FY2008** (000)
DALs on City routes	459,052
DALs on Rural routes	142,430
City/Rural subtotal	601,482
DALs to Hwy & PO Boxes	39,342
	640,824
From the Billing Determinants: Total system DALs	901,550

The Postal Service develops the POBox figure as 6.54 percent times 601,482. The proportion 6.54-percent is adopted from a library reference filed by Valassis Direct Mail, Inc.'s corporate predecessor, Advo, Inc. *See* ADVO-LR-1, Docket No. R2005-1. Consequently, using this percentage, the Postal Service infers that 39.342 million DALs were delivered by POBox, not the 300 million which Valassis speculates were delivered by

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[11] The volume of mail delivered via the various components of POBox is a residual (*i.e.*, total Billing Determinant volume — CCCS/RCCS volume), and is not directly measured by any independent sampling or other data system. Consequently, accuracy of this volume estimate depends entirely on accuracy of the estimated volume delivered by city and rural carriers.

POBox.[12] Valassis rejects the Postal Service estimate. The 640.8 million DALs which Valassis refers to as being "in the CCCS/RCCS" thus includes the Postal Service's estimate of DALs delivered by POBox. Valassis speculates **all** of the other 260.726 million DALs **also** are delivered by POBox.

B. Valassis Gives an Incomplete Picture of CY 2004 Proportions of DALs by Delivery Type

In its Initial Comments, Valassis presents a table showing the proportions of DALs delivered to POBox in 2004 by Advo, Advo's subsidiary Mail Marketing Systems, Inc. ("MMSI"), and 14 participants in a marketing network known as ANNE. The data in that table, which are reproduced in the first four rows of Table 1 here, are presumably accurate, insofar as they go. However, they provide an incomplete picture for drawing inferences about 2008.

The balance of DALs in CY 2004 is shown in rows 5 and 6 of Table 1. As noted in footnote 2 of Valassis' Initial Comments, "[i]n R2005-1, the Commission estimated the total volume of Saturation DALs at 4.314 billion." This total is shown in row 6, column 1. As noted above, since Docket No. R2005-1, the Postal Service has relied on Advo data for its assumption that the number of DALs delivered via POBox is equal to 6.54 percent of all

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[12] In Docket No. R2005-1, ADVO-LR-1 broke out volumes among PO Boxes, General Delivery, and Highway contract routes, as well as City/Rural carriers. For FY 2004, that library reference shows that only 0.01 percent of DALs go to **General Delivery** destinations and 1.00 percent go to **Highway contract routes**. Therefore, if the ADVO-LR-1 proportions are indicative, the volume that is outside the City/Rural carrier network is essentially equivalent to the volume going to **P.O. Boxes**, and the question of whether the Postal Service intended to refer to Hwy & P.O. Box or to these two plus General Delivery is immaterial.

CCCS/RCCS saturation DALs, which would indicate that in CY 2004 a grand total of some 264,819,600 DALs were delivered via POBox. The data shown in row 5, for "All Others," is simply the difference between the subtotal for Advo and the grand total shown in row 6.

Table 1

2004 Proportion of DALs by Delivery Type

		CY 2004 Total DALs (1)	P.O. Box, Highway Contract & General Delivery DALs (2)	% PO, HC & Gen. Del. DALs (3)
1.	Advo	3,145,472,576	156,672,844	4.98%
2.	MMSI	53,581,776	9,409,000	17.56%
3.	ANNE	383,785,000	53,879,000	14.04%
4.	Subtotal	3,582,839,352	219,960,844	6.14%
5.	All Others	731,160,648	44,918,756	6.14%
6.	TOTAL	4,314,000,000	264,879,600	6.14%

In using the data of Table 1 to speculate about the data mismatch in FY 2008, Valassis relies heavily on the percentages shown in column 3 (especially rows 2-3) to argue that delivery of DALs to POBox is a much higher percentage in smaller, rural areas.[13] Further, Valassis states:

[13] Valassis disclaims any economic interest in the issue: "We would note that a shift of costs from Saturation letters to DALs, as contemplated by Valpak, would not have any adverse impact on Valassis because it **has converted all** of its shared mailings to on-piece addressing." *Id.*, p. 5 (emphasis added).

> these smaller mailers who are **unable to convert** to on-piece addressing will continue to be forced to use DALs and pay the surcharge. Their only alternatives today are **to switch to private delivery** where addressing is unnecessary (**as some have done** and others are considering), or go out of business. [*Id.*, p. 6, emphasis added.]

So, where does Valassis leave us regarding analyzing the data mismatch? First, referring again to Table 1 above, we are informed that the entirety of Advo's POBox DALs shown in row 1 (156,672,844) no longer exist, as **all** of them now have been converted to on-piece addressing.[14] When those converted DALs are subtracted from the total 264,879,600 DALs delivered to POBox in 2004, that leaves 108,206,756 DALs, assuming that **none** of the DALs by MMSI, ANNE, or all others converted to on-piece addressing. According to Valassis' Initial Comments, those 108 million DALs sent to POBox swelled, by 277 percent, to 300 million in FY 2008.[15] At the same time, however, we are told that some of the mailers

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[14] Advo's former subsidiary, MMSI, was reportedly bought and merged into Valassis on December 31, 2008. Interestingly, Valassis does not mention whether any of MMSI's former DAL mailings have converted to on-piece addressing. If some or all of MMSI's mailings have been converted to on-piece addressing, that would indicate a further reduction in the number of DALs remaining from CY 2004 (row 2 in Table 1), including those delivered via POBox.

[15] If smaller mailers servicing rural areas, such as MMSI, were to send to POBox as much as 20 percent of their DALs (an even higher portion than the 17.56 percent sent by MMSI in 2004 and the 14.04 percent sent by ANNE in 2004), and that 20 percent represented 300 million DALs (as Valassis suggests), the implication is that in 2008 these smaller mailers entered approximately 1,500 million DALs.

originating those 108 million DALs in 2004 have switched to **private delivery**,[16] which would suggest **a decrease** in non-city/non-rural DALs.

In these times, when overall mail volume is declining, advertisers of all types are having very tough times, and certain mailers of DALs are said to be switching to private delivery, it would appear more than unlikely that the volume of DALs delivered to POBox has grown from 108 to 300 million in just four years.

Instead of drawing inferences from 2004 data, however, last year's data are available. In its Annual Compliance Review for FY 2007, the Commission's workpapers[17] show City/Rural DALs of 3,144,576,000 and POBox DALs of 205,680,000, the latter obtained by applying the same ADVO-LR-1 proportion of 6.54 percent to a City/Rural DAL volume of 3,144,576,000.[18] **There was no mismatch in last year's ACR**, assuming the number of DALs systemwide was 3,350,256,000 (3,144,576,000 + 205,680,000), as indicated on the same sheet of the workpapers. If last year's review was correct, then Valassis would be

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16 In responses to VP/ADVO-3-4 in Docket No. R2005-1, Advo indicated that only 0.29 percent of MMSI's and only 0.23 percent of ANNE's non-city/non-rural DALs go to offices providing **General Delivery**. Similarly, only 18.91 percent of MMSI's and only 15.04 percent of ANNE's non-city/non-rural DALs go to **Highway contracts**. The bulk of the non-city/non-rural DALs, at least for these mailers, clearly goes to **P.O. Boxes**. Not discussed by Valassis is how mailers that switch to **private carriers** could possibly have their DAL mail delivered to P.O. Boxes.

17 *See* PRC-LR-7, file UDCInputsACR07.PRC.xls, tab 'DALs'.

18 Valassis speculates that 300 million DALs were delivered to POBox, while 601.5 million were delivered in the city and rural carrier network. If Valassis' speculation were correct, then the 6.54 percent factor that has been applied to CCCS/RCCS volume would no longer be valid, as it would have changed to 49.89 percent.

arguing that the number of DALs going to Hwy & P.O. Boxes **increased** in one year by 45.9 percent, from 205,680,000 to 300,068,000.

On balance, it is difficult to adopt Valassis' speculation. Valassis explains that about 7.7 percent of saturation letters are delivered outside the City/Rural network, *i.e.*, in the POBox network. Applied to total letter-size pieces, this means 472,468,000 pieces. Valassis Initial Comments, p. 2. If the number of DALs in the POBox network were 300,068,000 as Valassis suggests, that would imply that 63.5 percent of the saturation letters going to POBoxes are DALs, a surprisingly high proportion.

Valassis' efforts to rationalize the large mismatch between the volume of DALs in the Billing Determinants and in the CCCS/RCCS spreadsheets are not persuasive. Nor was the Postal Service, at the technical conference on January 26, able to reconcile satisfactorily the DAL volumes in the CCCS/RCCS spreadsheets with DALs volumes in the Billing Determinants. Even Valassis acknowledges that "[a]dverse impact on small mailers, of course, is not a justification for failing to correct erroneous cost data." (*Id.*, p. 6.) Valpak's questions about the volume of DALs delivered in the City/Rural network remain, as the Valassis explanation does not appear to be well founded.

C. The Data Mismatch Issue Is Not Enlightened by Discussion of Simplified but Certified Addressing

Valassis's comments about the data mismatch focus on usage of DALs by "smaller mailers operating in predominantly rural areas where post office box, general delivery, and highway contract deliveries can account for over 40 percent of the total deliveries." *Id.*, p. 3. Valassis states that:

> concern about the impact of the DAL surcharge on smaller mailers in more **rural markets** is what prompted the Saturation Mailers Coalition (SMC) in Docket R2006-1 to urge the Postal Service to offer a "simplified addressing" alternative to the DAL. [*Id.*, p. 5.]

However, Valassis quotes SMC witness Pete Gorman's testimony that:

> For many, conversion to 'city-style' on-piece addressing is not cost-effective or workable. … [and] is the key reason why the SMC has been pressing for a 'simplified but certified' addressing alternative **on city routes**. [*Id.*, p. 6, emphasis added.]

Valpak takes no position here with respect to the "simplified but certified" proposal, but notes that the Valassis proposal for "simplified but certified" **on city routes** is unlikely to change the picture as regards the number of DALs delivered "in predominantly **rural areas** where post office box, general delivery, and highway contract deliveries can account for over 40 percent of the total deliveries." *Id.*, p. 3.

D. The DAL Surcharge Should Be Compared to DAL Unit Costs

In its Initial Comments, Valassis states:

> that the Saturation flat unit mail processing costs … include the IOCS-identified DAL mail-processing costs. The **DAL surcharge** should be compared to **DAL units costs** while the Saturation flat rate should be compared only to the unit costs caused by the flats themselves. Because of the inclusion of DAL costs, the Saturation flat units costs … are somewhat overstated, **particularly since DAL costs may have increased due to DPSing.** [Valassis Initial Comments, p. 11 (emphasis added)]

One result from DPSing saturation letter-shaped pieces may be to increase unit costs,[19] and Valassis is correct that "[t]he DAL surcharge should be compared with DAL unit costs." However, a compilation of all DAL costs has not been presented, and Valpak has not been able to locate and isolate all components thereof. At a minimum, these components would include:

1. CCCS/RCCS costs shifted
2. Other delivery costs:
   a. Delivery to P.O. Boxes
   b. Delivery by highway contract carriers
   c. General delivery
3. Mail processing and in-office city carrier costs
   a. Cost of DPS (including piggybacks)
   b. In-office sortation by city carriers
4. Intra-SCF transportation costs between SCFs and DDUs associated with DPSing

Needless to say, any such cost compilation should include the costs of handling and delivering all 901.5 million DALs recorded in the Billing Determinants, not some reduced number such as the 640.8 billion shown in the Postal Service's spreadsheets.

In conclusion, Valpak again calls this situation regarding DAL volumes and costs to the Commission's attention and requests that the Postal Service be asked to produce a compilation showing the full cost of handling and delivering the 901.5 million DALs recorded in the Billing Determinants.

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[19] The question of the conditions under which the Postal Service would opt for a more costly handling procedure (*e.g.*, capacity constraints on the number of extra bundles that city carriers can handle), and whether the Postal Service costing system (which assumes that capacity constraints do not exist) is capable of accurately reflecting marginal costs under those conditions, was the subject of extensive testimony in Docket No. R2006-1.

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Appendix One

VALASSIS' SPECULATION ABOUT THE VOLUME OF DALS OUTSIDE THE CITY/RURAL NETWORK RAISES QUESTIONS THAT GO BEYOND THE QUESTION OF ADJUSTING COSTS

Valassis states that the rate for a Saturation flat should be based on the costs for all Saturation flats, "whether they are addressed or not." Valassis Initial Comments, p. 12. Then, after this rate is paid, some of the flats (the unaddressed ones) would pay a DAL surcharge and the remainder of the flats (the addressed ones) would not pay the surcharge.

Valassis' Comments highlight a strange situation when costs are analyzed:

> First, there is the cost of handling a **label**.
> Second, there is the cost of handling an **unaddressed flat** (separate from the cost of handling an accompanying label).
> Third, there is the cost of handling an **addressed flat** (an attached-label flat). (Addressed flats would include any letter-size pieces that pay flats rates.)
> Fourth, one could find an **average cost for the last two** (an unaddressed flat and an addressed flat).

To help make clear some of the discussion, we will refer below to the following hypothetical levels for these costs:

Cost of label	3.0 cents
Cost of unaddressed flat	4.0 cents
Cost of addressed flat	5.0 cents
Cost of average flat	4.5 cents[20]

In its Table 1, tab '1.Table 1' in UDCmodel08.xls, USPS-FY08-19, the Postal Service shows a cost for a **Saturation flat without a DAL** of **4.481 cents**. Upon looking at the

[20] Note that the cost for the average flat would be a **weighted average** of the two costs above it, not necessarily halfway between them.

derivation of this cost, it appears that it is similar in kind to the cost of 5.0 cents in the above hypothetical.

Valassis argues that it is inappropriate to focus on the "cost of addressed Saturation flats" and that, "[i]nstead, the Saturation flat unit cost should include the costs of all Saturation flats ... whether they are addressed or not." *Id.*, pp. 11-12. Valassis then presents a new figure. Valpak interprets the new figure as similar in kind to the figure of 4.5 cents in the hypothetical.

If rates were set equal to costs with no markup, then the rate for an **addressed flat** would be 5.0 cents, in the hypothetical. The postage for an **unaddressed flat with its DAL** would be 7.0 cents (4.0 cents plus 3.0 cents). Thus, if an official "Rate Schedule" showed only one rate for flats, and a surcharge for DALs, an unaddressed flat would pay the same 5-cent rate plus a surcharge of 2.0 cents. If a decision were made during rate design to set the DAL surcharge below 2.0 cents, and have the shortfall covered by **all** flats, this could be done. In any case, however, the reference point for the rate for the **addressed flat**, which is a stand-alone piece in no need of an accompanying label, should be 5.0 cents. If Valassis intends a figure of the 4.5-cent kind to be the reference point, Valpak disagrees.

But the costs shown by the Postal Service in its Table 1, referenced above, are not developed for the purpose of setting absolute rates. Rather, they are developed for the purpose of setting discounts and surcharges. Importantly, then, one is interested in the **differences** among these costs. And, of course, Table 1 has other costs in it too, which are **all** for this purpose. Thus, the costs should be developed so that differences among them can be used as a reference point for discounts and surcharges. (Presumably, the Commission would want to assure that the Postal Service has done this.)

What Costs Should Be Included?

Suppose the Postal Service is developing a cost for a product that is delivered through one of three channels: (i) the City carrier network; (ii) the Rural carrier network; or (iii) P.O. Boxes, Highway contract routes, and offices that provide General Delivery (collectively referred to as "POBox"). Assume the total volume (often called permit volume or billing-determinant volume) is 1,600 pieces, 800 through the first channel, 300 through the second channel, and 500 through the third channel. Assume the volume-variable cost of city carriers is $1,000, of rural carriers is $350, and of POBox is $900. The unit costs can be developed as follows:

	Volume	Total Cost	Unit Cost
City carriers	800	$1,000	1.25
Rural carriers	300	350	1.17
POBox	500	900	1.80
Total	1,600	$2,250	1.41

In each case, the unit cost is the cost divided by the corresponding volume on the same line, expressed in cents per piece. The unit cost of 1.41 cents can be thought of as a weighted average of the three unit costs above it.

If the same rate is set for all pieces, regardless of the channel through which they are delivered, the unit cost of 1.41 cents is relevant. Note, however, that one cannot obtain this unit cost by adding 1.25 and 1.17 and 1.80. In order to obtain "unit costs" that can be added, the Postal Service often structures the development in a different way:

	Permit Vol.	Cost	Unit Cost
City carriers	1,600	$1,000	0.63
Rural carriers	1,600	350	0.22
		Subtotal =	**0.85**
POBox	1,600	900	0.56
Total	1,600	$2,250	1.41

Here, the total cost ($2,250) is the same as before, but the full system volume is shown on each line and the unit costs in the last column can be added to obtain the average unit cost of the product, *i.e.*, 0.63 + 0.22 + 0.56 = 1.41. A layout of this kind is shown in tab '11.SummaryBY' of UDCmodel08.xls. Considering Excel line 92 for Saturation letters,

- Column M is "Permit Volume" and is used for both City carriers and Rural carriers;
- Column Q is "City Carrier Total Unit Cost" (2.88 cents, comparable to the cost of 0.63 cents in the above example);
- Column R is "Rural Carrier Total Unit Cost" (1.52 cents, comparable to the cost of 0.22 cents in the above example); and
- Column S is "City Plus Rural Unit Cost" (4.39 cents, equal to 2.88 cents + 1.52 cents, after rounding, comparable to the cost of 0.85 cents in the above example).

The "Unit Cost" headings are in many ways misnomers. The unit costs in Columns Q and R are, in effect, **cost contributions**; one could say that City carriers (Column Q) **contribute** 2.88 cents per piece to the cost of Saturation letters and that Rural carriers (Column R) **contribute** 1.52 cents to the same cost.

The costs in the Postal Service's Table 1, which are used generally for establishing cost **differences** and setting discounts and surcharges, are similar in kind to the "Subtotal" of 0.85 cents in the above example. That is, costs of the POBox channel are not included. Rather, the workbook UDCmodel08.xls is limited to City and Rural carriers. Thus, in the above example, although the appropriate unit cost for accomplishing delivery should be 1.41 cents, the cost being used is 0.85 cents.

Should Costs Match the Volumes?

Column M of tab '11.SummaryBY' and Column K of tab '1a.DAjustment' in UDCmodel08.xls are "Permit Volume[s]", and therefore include all volume going through all delivery channels. For purposes of establishing discounts, and to be consistent with these volumes, the analysis would be improved if costs of delivering through the POBox channel were included in the spreadsheets, but they are not. The Commission should consider the importance of including the costs of all delivery channels in the analysis. It is clear that **as the proportion of volume going through the POBox channel becomes larger**, a volume on which Valassis focuses, **the relative importance of including the POBox costs in the analysis increases.**

To Go with the Costs, Do We Know the Volume of Saturation Flats with Attached Addresses?

Consider two special cells in the Postal Service's spreadsheet. Cell K20 (which is equal to Cell K14) of tab '1a.ADjustment' and Cell M119 of tab '11.SummaryBY' contain volumes labeled as estimates of the total number of Saturation flats **with attached addresses** going through the entire postal system, meaning through **all** delivery channels. The Postal Service develops this volume (all numbers in thousands) as 11,517,282 (the number of saturation flats in the postal system) **minus** 640,824 (the number of DALs in the CCCS/RCCS (601,482) **plus** the number of DALs in the POBox system (39,342), the latter figure estimated using the 6.54-percent proportion). However, assuming the volume of DALs in the billing determinants

(901,550) is correct, it is clear that the volume in Cells K20 and M119 should equal 11,517,282 minus 901,550.

There are two ways to view the total billing determinant volume of 901,550 DALs. Valassis argues that it is equal to the CCCS/RCCS volume of 601,482 plus a POBox volume of 300,068 (the latter figure being relatively unchanged from earlier years, now equal to 49.89 percent of the CCCS/RCCS volume). Valpak is concerned that the number of DALs in the CCCS/RCCS system may be in error and that the 601,482 should be much higher. Such a higher value plus a revised volume of DALs going to POBoxes (possibly near 39,342, possibly not) would equal 901,550. Either way, the volume in Cells K20 and M119 is substantially in error.