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ANNUAL COMPLIANCE REPORT : Docket No. ACR2008

REPLY COMMENTS OF VALASSIS DIRECT MAIL, INC. AND THE SATURATION MAILERS COALITION CONCERNING THE POSTAL SERVICE'S FY2008 ANNUAL COMPLIANCE REPORT

(February 13, 2009)

Valassis Direct Mail, Inc., a wholly owned subsidiary of Valassis Communications, Inc., and the Saturation Mailers Coalition hereby submit their reply comments concerning the Postal Service's second Annual Compliance Report (ACR) filed on December 28, 2008. Our reply comments are confined to issues raised by two parties: the Public Representative and Valpak.

The Public Representative has, in general respects, accurately portrayed the Postal Service's worsening financial condition, and some of its suggestions, including restructuring labor costs, are good ones. However, we disagree with its cursory conclusion that volume growth is unimportant, and that cost-based rates are preferable to market-based rates in achieving financial viability. Private sector businesses, particularly in difficult times, price their various products primarily on market factors as a means to maximize profit, with cost differentials playing only a secondary role. The USPS must do likewise if it is to weather the storm.

Valpak's arguments focus mostly on technical aspects of costing, particularly with respect to the costs of Saturation detached address labels (DALs). Most of its concerns were fully addressed in our Initial Comments. We here briefly reiterate those points, and address the other costing issues raised by Valpak.

I. THE PUBLIC REPRESENTATIVE HAS HIGHLIGHTED THE POSTAL SERVICE'S SERIOUS FINANCIAL CRISIS, BUT MARKET-BASED PRICING IS A BETTER REMEDY THAN ITS SUGGESTED COST-BASED PRICING "SOLUTION."

We commend the Public Representative (PR) for addressing the seriously deteriorating financial condition of the Postal Service. In particular, we share the PR's concern about the long-term viability of the postal system as we know it today. We also agree that the Postal Service must aggressively pursue additional cost cutting and operational efficiencies. However, we disagree with the PR's suggestions that increases in mail volumes will not improve the Postal Service's financial situation and might even harm it:

> ". . . if unit costs continue to grow, restoring volume (even increasing volume) will not stem the losses that the system would incur. Indeed, if unit costs continue to grow faster than unit revenue, adding volume would only deepen the resulting deficit." PR Comments at 4.

From this premise, the PR appears to recommend that the Postal Service's attempts at market-based pricing should be replaced with some form of cost-based efficient-component-like pricing, which the PR proclaims is the best means to remedy its financial problems. *Id*. 6-7.

The analysis upon which the PR bases its conclusion that volume growth is relatively unimportant – a charting of *annual* mail volumes versus *cumulative* net income from 1972 through 2008 – is puzzling and does not really tell much. The Postal Service's net income over virtually that entire period was constrained by the "breakeven" requirement under the old cost-of-service ratemaking scheme, with rates largely set by the regulator. Its cumulative net income would therefore be expected to be relatively flat over time, particularly compared to annual mail volume fluctuations. This seeming "lack of relationship" cited by the PR is due to the peculiar nature of its analysis and the breakeven constraint, and does not support the sweeping conclusion that volume growth is unimportant (much less undesirable) as a means to improve the Postal Service's financial condition.

We take exception with its conclusions for three key reasons:

- Revenue from postal products and services covers current postal system cost on an on-going basis;
- Market-based pricing that maximizes annual contribution and encourages longer-term profitable volume is good for the Postal Service, the industry it serves, and the national economy; and
- The Postal Service currently has insufficient management tools to undertake "major cost efficiencies" and reverse its financial situation.

Thus, although the PR is correct in its assessment that the Postal Service is in severe financial trouble, it is incorrect in suggesting that market-based pricing and encouragement of volume growth will worsen the problem. The PR is also incorrect in assuming that substantial Postal Service cost reductions, even if the Postal Service had the management tools to do so, would be sufficient to reverse the financial problem. Instead, the problem must be addressed from both the cost and revenue sides. On the cost side, the Postal Service must be relieved of the burden of having to pay large sums for non-current (legacy) costs, and must work with the cooperation of the unions to achieve greater labor-cost savings. On the revenue side, market-based pricing that maximizes longer-term contribution is a critical management tool.

A. Revenue from Postal Products and Services Covers Current Postal System Cost on an On-Going Basis

Overall, postal products and services cover current postal system costs and have been doing so for the past three years. A comparison of operating revenues to current operating expenses actually caused by the mail in each of the past three years (i.e., eliminating the "legacy" costs) shows that the Postal Service has covered its current system costs and earned profits. Current operating expenses have increased by very small amounts – less than one percent in both FY07 and FY08, despite periodic wage and COLA increases for postal labor. This is because the Postal Service has been steadily reducing the costs over which it has control. PMG Potter has enumerated some of those reductions in his January 28th testimony to the Senate Subcommittee on Financial Management, Government Information, Federal Services and International Security.[1] These efforts should have enabled it to accumulate some retained earnings.

Instead, *total* annual postal expense has grown tremendously over the past few years because of the additional legacy costs imposed by Congress on the USPS – originally the overfunding of CSRS pension costs, which has now been perpetuated through the excessive prefunding of retiree health benefits. It is these non-current costs that cannot be covered with operating revenue.

The following two tables show adjusted Postal Service income statements for FY06-FY08 under two different "current cost" scenarios. Table 1 assumes that the current retiree health benefits cost is represented by the annual premium payment that the Postal Service must make for current retirees—all other expenses related with legacy costs are eliminated. Table 2 assumes that the current retiree health benefits cost is represented by the "normal" cost for those benefits – i.e., the annual increase in the Postal Services Retiree Health Benefit Fund (PSRHBF) obligation. Both tables

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[1] See also USPS 10-K for the quarter ending December 31, 2008 (Management's Discussion and Analysis of Financial Condition and Results of Operation.

eliminate the FY07 and FY09 annual PAEA contributions to the PSRHBF and the FY06 escrowed amount.

Table 1
Adjusted USPS Three-Year Income Statements
Retiree Health Benefit Premium = Current Cost
(Dollars in Millions)

	FY08	FY07	FY06
Operating Revenue	**$74,932**	**$74,778**	**$72,650**
Current Employee Comp & Benefits	53,585	54,186	54,639
Retiree Health Benefit Premium	1,807	1,726	1,637
Transportation	6,961	6,502	6,045
Other Expenses	9,785	9,333	9,334
Operating Expense	**72,138**	**71,747**	**71,655**
Net Interest Income	0	185	162
Net Income	**2,794**	**3,216**	**1,157**

Table 2
Adjusted USPS Three-Year Income Statements
Normal Retiree Benefit = Current Cost
(Dollars in Millions)

	FY08	FY07	FY06
Operating Revenue	**$74,932**	**$74,778**	**$72,650**
Current Employee Comp & Benefits	53,585	54,186	54,639
Retiree Health Benefits (“Normal Cost”)	3,389	3,175	2.975
Transportation	6,961	6,502	6,045
Other Expenses	9,785	9,333	9,334
Operating Expense	**73,720**	**73,196**	**72,993**
Net Interest Income	0	185	162
Net Income	**1,212**	**1,767**	**(181)**

Note: FY06 figure for “normal cost” is estimated.

Both tables show that, regardless of how “current cost” is defined, over the three-year FY06-FY08 period, postal revenues have covered current system costs and made a net profit. There is no reason to claim that mail volume should be discouraged in order to save costs. Indeed, mail volume that is able to cover the costs that it causes and contribute to the system's current institutional cost should be encouraged rather than discouraged. Moreover, such a business operation continues to provide substantial benefits to the national economy, even if it cannot generate sufficient revenue to cover imposed legacy costs. Those legacy costs are sunk. If the Postal Service is forced to cover the entirety of those costs through rates, that will precipitate further volume losses that will ultimately cause an on-going viable, economically valuable operation to collapse -- an extremely inefficient result that will seriously harm the national economy.

B. Market-Based Pricing that Maximizes Annual Contribution and Encourages Longer-Term Profitable Volume is Good for the Postal Service, the Industry it Serves, and the National Economy.

The Postal Service currently has substantial fixed and non-attributable costs associated with its universal system. In addition, it also must pay a tremendous amount of legacy costs (actually incurred in past years) annually. Both types of cost are largely "institutional" and together represent roughly 40 percent of total postal annual cost. Even for its remaining "attributable or variable" costs, the Postal Service cannot instantly adjust them in response to changes in volumes. Many "attributable or variable" costs are actually longer-term variable and require an extended time to reduce. In many cases, as suggested by the PR, beneficial cost reductions require substantial restructuring of postal operations, network facilities, and union contracts – clearly a necessary but longer-term project given the current postal management tools available. Further, a large portion of variable cost is also subject to scale and scope economies (e.g., transportation and delivery). Thus, the majority of postal costs is relatively fixed over the short-term and cannot immediately be saved when volumes are lost – as has occurred in the last several years.[2]

Consequently, contribution-generating volume is good and should be encouraged. The Postal Accountability and Enhancement Act (PAEA) provided the Postal Service with a management tool to design rates that cover attributable cost, maximize contribution to institutional cost, and encourage longer-term profitable volume growth. Market-based pricing gives the Postal Service needed flexibility to (a) identify and disaggregate products and services within the system, and (b) design rates for each that reflect their individual cost and market/demand characteristics. Differences in rates among these products and services should not be based on cost differences alone, but should also reflect the ability of each of those products and services to provide contribution on a total product/service basis (not simply on a unit contribution basis).

Market-based pricing results in reduction of both average (unit) total and average (unit) variable cost, improvement in Total Factor Productivity, and maximization of longer-term contribution to Postal Service institutional cost.

Unfortunately, this pricing approach requires time to implement and does not ensure that all legacy costs are covered. First, the Postal Service needs time to refine its market-based pricing approach – it is clearly impractical to expect the Postal Service

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2 In large part, the volume declines of the past three years, combined with the short-term fixity of "variable" cost (as well as most of the variability percentages used to calculate "variable" cost) has caused the increased unit variable costs described by the PR. In addition, the Postal Service's service standards, combined with union contract provisions, impose some cost fixity because the Postal Service must be prepared to provide the appropriate service level regardless of how volumes vary over the year.

to immediately understand the needs of all its markets and then to immediately change all rates to meet optimum efficiency. Moreover, it initially must be cautious to ensure that rate shock doesn't decimate a product or service market, and that rate reductions will actually accomplish their intended objective. Second, attempting to cover all legacy costs can result in the notorious "downward spiral," if postal product and service markets respond negatively to rates that cover such costs. But clearly, current postal products and services cover current system costs. Compared to cost-based "efficient-component" pricing which ignores market differences, market-based pricing will provide greater, longer-term total contribution, retain a greater postal share of profitable product/service markets, and provide more time for postal management to restructure operations to improve efficiency.

C. The Postal Service Has Insufficient Management Tools to Reverse Its Current Financial Situation

Currently, the Postal Service is bankrupt financially and in severe need of both financial and operational restructuring. Its liabilities (including legacy obligations) far exceed its assets, and it cannot earn a net profit under its current constraints. Its markets have changed structurally due to major changes in consumer/business behavior and the presence of newer communications technologies. Moreover, although it continues to take considerable cost out of the system, it is still encumbered by serious constraints on management of its operations and facilities:

- Its efforts to downsize or restructure are subject to political oversight;
- It must provide employee benefits through CSRS, FERS, and FEHB plans that are generally not subject to collective bargaining;

- It is required by law to pay increasing amounts of legacy costs annually;
- Its employees are protected under both union agreements and federal employee regulations, and have substantial political clout;
- As a federal entity, its contracting activities are constrained by numerous statutory requirements;
- It has a limited ability to borrow from the US Treasury and for years was prevented from earning a profit – leaving it in a precarious retained equity position and retarding high-tech capital investment;
- Despite the PAEA, it still must price its products under numerous constraints – e.g., price caps, worksharing discount and negotiated service agreement limitations, etc.

This contrasts starkly with the tools that are available to private businesses to restructure in times of crisis. A private company can negotiate fringe benefits such as pensions and health care with its workforce, and is not even required to offer retiree health coverage; for the Postal Service, these benefits are “off the table” and are largely dictated by federal law. Even those private companies that choose to offer or retain retiree health benefits are not required to pre-fund them; the Postal Service is now required by law to pre-fund these benefits – on a payment schedule crafted by Congress solely for the purpose of achieving “budget neutrality.” A private company can renegotiate and restructure its debts and obligations; for the Postal Service, however, the creditor is the federal treasury and restructuring requires an act of Congress. And in extreme circumstances, a private company has the option of declaring bankruptcy, a process commonly used not only to restructure obligations but to alter labor agreements so that the company can emerge leaner and stronger; bankruptcy is not a viable option for the Postal Service, even in circumstances where its balance sheet smacks of impending insolvency.

If nothing is done to relieve the Postal Service of its legacy obligations and provide postal management with the serious tools it needs to manage and restructure its operations and facilities to match the needs of its current markets, even with market-based pricing, volumes will continue to decline as rates are raised to cover both legacy costs and excessive current expenses. Increasingly high and inefficient rates will force volumes and revenues out of the system, and the underpinnings for universal service will eventually disappear. On the other hand, efficient restructuring of the postal network, operations, and obligations can keep the Postal Service relevant in the 21st century. Despite the current economic downturn, mail is still an important distribution means for large market sectors that can provide profitable volumes. Those market sectors – as well as the entire nation – need a viable, efficient postal system.

The downward spiral has already begun, exacerbated by volume reductions caused by the national economic downturn. Avoiding the whirlpool will require the immediate and concerted efforts by, and cooperation among, the Postal Service, its labor force, the Congress, and mailers. The Commission has an important role, as well, not only in giving the Postal Service the regulatory flexibility it needs to manage the crisis, but also in informing Congress of the impending risks and the need for meaningful relief from the onerous financial burdens imposed on the Postal Service by the PAEA. But the one thing the Commission should not do is to adopt the “cost-based” rate approach suggested by the PR – a throwback to cost-of-service ratemaking under the old law that gave inadequate weight to market and demand factors.

II. VALPAK'S COMMENTS DO NOT WARRANT ANY CHANGES OR SHIFTS IN COSTS BETWEEN SATURATION/HIGH DENSITY LETTERS AND FLATS.

We here address the four main costing issues raised by Valpak in its Initial Comments:

- The alleged mismatch of DAL "RPW" volumes in USPS-FY08-19 to DAL billing determinants (Valpak Comments at 31-32);
- The low proportion of CCCS/RCCS DALs compared to billing determinants DALs (id. 35-36, 38);
- Attribution of DAL city carrier in-office, mail processing, and transportation costs. (id. 36-39, 54-55); and
- The assumed cost of High-Density/Saturation "Letter Shapes Rated as Flats" (LSRAFs) that is shifted to High-Density/Saturation flats. (id. 52-54).

With respect to the first three issues, Val Pak presumes that there are some DAL costs (associated with High-Density/Saturation flats and parcels) that are incorrectly attributed to High-Density/Saturation letters, and that those costs should be reassigned to flats and parcels. With respect to the fourth issue, Val Pak claims that High-Density/Saturation LSRAFs cost more than Letter-Rated Letters (LRLs), and that more letter-shape cost should therefore be shifted to flat-rated mail.

A. The Alleged "Mismatch" of DAL RPW Volumes in USPS-FY08-19 to DAL Billing Determinants.

The USPS procedure for developing unit delivery cost for Saturation/High-Density letters and flats (in USPS-FY08-19 and its predecessors) requires estimates of the systemwide number of DALs, the number of DALs delivered by city carriers, and the number of DALs delivered by rural carriers. In Docket R2005-1, these numbers were estimated using industry-supplied data on the number of DALs delivered on city routes, rural routes, and by other means. Consequently, the data also provided a total systemwide estimate of DALs. In Docket R2006-1, for lack of any better data, the industry data were updated by the USPS (through volume growth rates) and used to estimate unit delivery costs.

In FY2007, as reported in Docket ACR2007, the USPS started collecting data on the actual numbers of DALs delivered by city and rural carriers in its CCCS and RCCS data collection systems. Those CCCS/RCCS DAL volumes were then used to accurately shift FY07 DAL costs from letters to flats (in USPS-FY07-19). However, the USPS still did not have an estimate of total system DALs, since DALs were not separately charged for the entirety of the year. To estimate the total FY07 number of DALs in the system, the USPS again updated the original industry data (through volume growth rates) and used the results with the actual CCCS/RCCS data to make an estimate of the total DALs in the system (i.e., RPW DALs) for FY07. That total system-level estimate was simply used to develop the DAL unit delivery cost (i.e., total DAL delivery costs divided by system-wide number of DALs). It had no impact on the amount of city and rural carrier cost shifted from letters to flats because this latter was accomplished with CCCS/RCCS volumes.

For FY08, the USPS again used the CCCS/RCCS DAL data to accurately shift DAL costs from letters to flats. Moreover, because the DAL surcharge was in place for the full year, accurate DAL billing determinant information is now available to develop the DAL unit delivery cost. Unfortunately, instead of using the billing determinant DAL volumes, the USPS used the old ACR2007 unit delivery cost procedure to determine total system-level DALs. It should more properly have used the actual FY08 billing determinant volumes to determine the correct DAL unit delivery cost.

This simple and logical correction, we would emphasize, has nothing to do with Valpak's confusion and unsupported skepticism about the DAL volumes reported in the CCCS and RCCS – volumes developed from statistically reliable, extremely large-sample USPS data collection systems. As we explained in our Initial Comments, and briefly below, those DAL volumes are consistent with the shifts in distribution patterns by delivery mode caused by the introduction of the DAL surcharge in May 2007, and do not provide any basis to question the reliability of the amount of DAL costs shifted from city out-of-office and rural carrier costs of High-Density/Saturation letters to High-Density/Saturation flats and parcels.

B. The Low Proportion of CCCS/RCCS DALs Compared to Billing Determinant DALs

Val Pak has noted that the volume of DALs reported in the CCCS/RCCS data collections is significantly lower than the total systemwide DAL volume reported in the billing determinants. From this, Val Pak assumes that the CCCS/RCCS volumes must be understated, requiring a further shift of costs from High-Density/Saturation letters to flats. We have already fully addressed this issue in our initial comments. Briefly, since the implementation of the DAL surcharge in May 2007, a large number of DAL mailers have eliminated their DALs. Those who have not tend to be the smaller, more rural mailers who are unable, for economic reasons, to eliminate the DALs. We have shown that those are the very mailers whose mail is delivered, in large part, to P.O. boxes, general delivery, and on highway contract routes – not using city or rural carriers. Given the information we have presented and its explanation, there is no reason to believe that the proportion of CCCS/RCCS DALs to total DALs in the system is incorrect. *See* our Initial Comments at 2-6.

Further, as we there noted, the ratio of CCCS plus RCCS volumes to total billing determinants for High-Density/Saturation letters is very similar to that for High-Density/Saturation flats and parcels. *Id*. at 2-6. This corroborates that the city and rural delivery costs for each product are already reasonable (since they are attributed on the basis of the CCCS/RCCS volumes) and should not be tampered with. In short, there is no reason to question the reliability of the CCCS and RCCS results, nor the reliability of the DAL costs shifted from city out-of-office and rural costs of High-Density/Saturation letters to High-Density/Saturation flats and parcels.

C. Attribution of DAL City Carrier In-office, Mail Processing, and Transportation Costs

Val Pak states that it cannot separately identify the city carrier in-office, mail processing, and transportation costs for DALs. It therefore surmises that some of those DAL costs may be incorrectly attributed to High-Density/Saturation letters. This is simply not a problem. Both city carrier in-office and mail processing costs are attributed and distributed on the basis of the In-Office Cost System (IOCS). The IOCS attributes the DAL cost to its associated flat or parcel – as was again confirmed at the PRC January 26 technical conference. This correct attribution of DAL costs can be seen directly in USPS-FY08-19, in the NewUDCInputs.xls spreadsheet (tabs CARMM and CARMM) where the DAL city carrier in-office cost is identified.

The mail processing cost for DALs is also correctly attributed by the IOCS to its host flat or parcel, not to letters. However, the USPS did not separate out that DAL cost from the High-Density/Saturation flat/parcel total cost in USPS-FY08-18. In our Initial Comments, we have recommended that this separation be done in the future, and the DAL unit mail processing cost be added to the DAL unit delivery cost so that a total DAL unit cost can be identified. Initial Comments at 11. Clearly, however, that failure to disaggregate the DAL costs from the flat/parcel costs has no impact on the costs for High-Density/Saturation letters, which are correctly calculated.

Finally, Val Pak speculates that some DALs that are delivered by mailers to the DDU may then hauled back to the DSCF for DPSing, using local USPS transportation. It therefore speculates that some local transportation costs used by DALs may be incorrectly attributed to High-Density/Saturation letters. While we do not know precisely how much DAL postal transportation cost is attributed, we do question the extent to which DALs use local postal transportation. It should be a very minor amount for two reasons:

- High-Density/Saturation mailers need reliable delivery dates and try to dropship their mail just prior to those dates, usually either at the DDU or DSCF. If the USPS had to transport DDU-dropped DALs back to the plant, delivery dates would be jeopardized. Consequently, the mailers would likely make sure themselves that the DALs were dropshipped at the plant in time for DPSing to make the desired delivery dates, regardless of when the host pieces were dropped at the DDU.[3]

- DALs weigh very little and take up very little space, compared to other types of mail.

In any case, Val Pak's question as to how DAL transportation cost is attributed is a good one that we also would like to see answered. However, we do not believe it will make much difference in either the coverage for High-Density/Saturation letters or High-Density/Saturation flats/parcels.

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3 DALs are prepared by Saturation mailers in advance the finalizing and dropping the host pieces. Therefore, the DALs can be dropped at the DSCF in advance of the host pieces being dropped at either the DSCF or DDU.

D. The Assumed Cost of High-Density/Saturation "Letter Shapes Rated As Flats" (LSRAF) Shifted to High-Density/Saturation Flats

We agree, in theory, with the transfer of High-Density/Saturation LSRAF cost and volume to High-Density/Saturation flats. But we disagree with Val Pak's simplistic argument that LSRAFs cost more than "Letters Rated as Letters" (LRLs) because they are not automated and may weigh more than LRLs. Valpak Comments at 52-54.

As explained in our Initial Comments, at the saturation level at least, LSRAFs are likely to have unit mail processing costs (prior to adjustment to origin-level) more similar to that for flats than to LRLs – where the flat unit cost is lower than that for letters. This is because Saturation LSRAFs are already delivery-point sequenced.[4] Like saturation flats, they potentially can avoid virtually all plant and DDU clerk/mail-handler operations while LRLs cannot. Moreover, because city and rural carrier delivery costs are attributed on the basis of shape, LSRAFs would appropriately incur a letter-shape unit delivery cost. Even more importantly, LSRAFs are more likely to be treated as sequenced mail by city carriers or as boxholders by rural carriers. Thus, it is possible that LSRAFs could even have a slightly lower unit delivery cost than LRLs.

Like Val Pak, we take issue with the USPS cost assumption that LSRAF unit costs are the same as LRL unit costs, and would like to see an improved estimate of actual LSRAF unit costs. Contrary to Val Pak's simplistic assumption, it is entirely possible that LSRAF unit costs are overstated rather than understated. In any case, the

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[4] Val Pak notes that sometimes Saturation non-automation letters (LSRAFs) require manual sortation by carriers. But, any such mail would be relatively easy to case manually because its delivery point sequencing matches the case sequencing. Sorting *per se* would not be required.

USPS cost assumption in this case is probably adequate for this initial cut at the analysis, although we hope the USPS will refine its approach in subsequent analyses.

In sum, none of Valpak's arguments warrant any change in the costs for Saturation letters or flats as estimated by the Postal Service.

Respectfully submitted,

/s/

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