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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Report to Congress and the President on	)	
Universal Postal Service and the Postal Monopoly	)	Docket No. PI2009-1

VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. INITIAL COMMENTS REGARDING THE COMMISSION'S REPORT ON UNIVERSAL POSTAL SERVICE AND THE POSTAL MONOPOLY
(February 17, 2009)

On December 19, 2008, the Commission issued its Report to Congress and the President on Universal Postal Service and the Postal Monopoly (hereinafter "Report"). Also, on December 19, 2008, the Commission issued Order No. 152 providing an opportunity for interested persons to submit initial comments on the Report by February 17, 2009, and reply comments by March 19, 2009. Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") submit the following initial comments.

I. THE CURRENT PERIODICALS DEFICIT SHOULD NOT BE CONSIDERED PART OF THE USO

The Report states:

> [U]nder the PAEA **price cap**, the losses in FY 2007 from the two subclasses that make up the **Periodical class could not** have been eliminated. Therefore, the FY 2007 **loss of $448 million** by Periodicals was **made necessary by the current statutory obligations**. Consequently, the negative contribution made by them **should be included with the costs of the USO**. [Report, p. 134 (emphasis added).]

Unfortunately, this statement already is being cited[1] as authority for the Commission to disregard one of the most important provisions in the Postal Accountability and Enhancement Act ("PAEA"):

> 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. [39 U.S.C. § 3622(c)(2) (emphasis added).]

Valpak believes that the above-quoted statement in the Commission's Report was unfortunate — being made in a policy document on an issue only tangentially-related to pricing, without having invited prior public comment on the pricing issues involved, without any express and careful analysis of the applicable statutory language, and reaching a decision that is inconsistent with PAEA. Moreover, inclusion of the above-quoted statement in the Commission's Report creates the significant risk that these three sentences will be used to support a variety of legal arguments by Periodicals' mailers in the pricing arena wholly inconsistent with the text of PAEA, such as:

- The PAEA **price cap** contained in 39 U.S.C. section 3622(d) precludes an increase in Periodicals pricing beyond the CPI cap (3.8 percent, this year) designed to price Periodicals to achieve a coverage of at least 100 percent in a **conventional** (*i.e.*, non-exigent) price adjustment.

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[1] *See* Docket No. ACR2008, Reply Comments of Magazine Publishers of America, Inc. and Alliance of Nonprofit Mailers (Feb. 13, 2009), p. 2 (offering the Commission's statement as "further evidence that Congress, when enacting PAEA, contemplated that Periodicals Mail could make a negative contribution to institutional costs"). *See also* Docket No. ACR2008, Reply Comments of Time Warner Inc. (Feb. 13, 2009), p. 4 (asserting that the Commission's language constitutes "an important legal finding respecting Periodicals class cost coverage").

- The PAEA **price cap on each class** is an absolute bar to establishing **intra-class pricing** which would result in causing Periodicals' prices to track costs more closely, reducing intra-class subsidies, and thereby achieving a coverage of at least 100 percent for the class.

- PAEA does not authorize an **exigent rate case** applicable to **one class** alone of mail (*e.g.,* Periodicals) which could result in price increases for that class in excess of the price cap.

- PAEA does not authorize an **exigent rate case** applicable to **all classes** which could result in price increases for Periodicals in excess of the price cap.

- PAEA requires the Postal Service and other classes of mail **to subsidize** any and all losses incurred on account of deficient Periodical rates that fail to generate revenues sufficient to cover attributable costs.

- Any and all losses on Periodicals should be reckoned as costs of the **Universal Service Obligation** ("USO").

Although the issues stated above relate primarily to pricing-related dockets (*e.g.,* annual compliance reviews, pricing adjustment dockets, complaint dockets, and rulemaking dockets relating to pricing) and probably will need to be resolved in that context, Valpak focuses its attention in these comments on the subject matter of Commission Order No. 152, and for the reasons set out below, believes that no portion of any loss incurred on account of Periodicals should be counted as costs of the USO.

A. Targeted Rate Increases Under PAEA Can and Should Be Used to Achieve 100 Percent Cost Coverage and Eliminate the Deficit from Periodicals.

Even assuming *arguendo* that in a conventional (*i.e.,* non-exigent) pricing adjustment the cap trumps the requirement of 39 U.S.C. section 3622(c)(2), the first sentence of the Commission's above-quoted statement is in error:

> [U]nder the PAEA **price cap**, the losses in FY 2007 from the two subclasses that make up the **Periodical class could not** have been eliminated. [Report, p. 134 (emphasis added).]

The Report notes revenues from Periodicals, as a class, fail to cover their attributable costs by a wide margin. This does not mean, however, that all publications fail to cover their attributable costs. In fact, the existing situation is quite the contrary. Many publications not only cover their attributable costs, but also make a relatively healthy contribution to institutional costs. Within the Periodicals class, these publications are like the proverbial goose that lays golden eggs, and these publications must be viewed as supporting the Postal Service in its effort to survive and become a successful, profitable organization. At the same time, a number of other publications fail to cover their attributable costs, some by a very wide margin indeed. It is these "deficit publications" that are creating the intractable, and, by any standard, extremely large losses for the Periodicals class, as well as the Postal Service itself.[2]

PAEA provides the Postal Service (and the Commission) with the tools to deal with this problem; for example, 39 U.S.C. section 3622(b)(4) supports pricing flexibility, and section 3622(b)(8) expressly provides that price changes need not be uniform within a class of mail. However, the FY 2009 rate changes for Periodicals announced by the Postal Service on

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[2] Imposing higher-than-average rate increases for publications that are profitable to the Postal Service in order to restrain rate increases on money-losing publications makes no economic sense, and those who advance this proposition must find specific provisions of PAEA, not just vague policy generations, to support huge intra-class and inter-class subsidies.

February 10, 2009, appear not to have taken full advantage of the pricing flexibility authorized by PAEA to accomplish various objectives, such as 39 U.S.C. section 3622(b)(5).[3]

Using its new flexibility to have the rate structure reflect costs more fully, as even Magazine Publishers of America, Inc. ("MPA") and Alliance of Nonprofit Mailers ("ANM") have recommended,[4] would result in rate increases that fall more heavily on those deficit publications whose attributable cost far exceeds whatever they now pay in postage. Assuming *arguendo* the constraint imposed by the PAEA price cap trumps 39 U.S.C. section 3622(c)(2), rate increases that impact publications disproportionately, focused especially on those deficit publications that come nowhere close to paying the costs which they impose on the Postal Service, is the most efficacious way to increase class coverage.[5] In fact, if it is determined that the price cap trumps 39 U.S.C. section 3622(c)(2), such focused rate increases may be the only way to eliminate the financial drain imposed by the now-historic subsidy to Periodicals (many of which are themselves **for-profit** entities). If some of those deficit publications that have been perpetually subsidized cannot pay a somewhat larger share of their attributable costs and consequently fail to survive, then they would be in precisely the same position as other

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[3] Even when it does not fully employ its "pricing flexibility," the Postal Service believes that it has it, stating "the PAEA was intended, as the Commission has previously noted, to give the Postal Service considerable flexibility in setting prices." Docket No. ACR2008, Reply Comments of the United States Postal Service (Feb. 13, 2009), p. 28.

[4] Docket No. RM2009-1, Comments of Magazine Publishers of America, Inc., and Alliance of Nonprofit Mailers (Dec. 1, 2008), p. 4.

[5] *See* Docket No. ACR2007, Valpak Reply Comments on the United States Postal Service FY 2007 Annual Compliance Report (Jan. 30, 2008), pp. 12-13, for a discussion of how a rate increase of, say, 10 percent, can, under certain circumstances, reduce the Postal Service's loss by somewhat more than 10 percent.

businesses and entities that rely heavily on the mails and cannot generate revenues to cover their expenses which are not subsidized — and that general result needs to be accepted as the logical outcome dictated by PAEA.[6] It will be essential that future rate increases focus on cost recognition dramatically, and reflect much higher passthroughs as advocated by MPA and ANM. PAEA has given the Postal Service and the Commission the tools to reflect costs in prices. If the Postal Service and the Commission choose not to utilize those statutory tools to protect the financial stability of the Postal Service, as required, *inter alia*, by 39 U.S.C. section 3622(b)(5), those seemingly beneficent policy choices to protect certain businesses and nonprofit organizations from paying their way could exacerbate the current financial crisis that would jeopardize the Postal Service, as well as all mailers — businesses and nonprofit organizations alike.[7]

However, the principal point here is that even if these statutory tools were not utilized, for the foregoing reasons, the Commission's statement that "under the PAEA **price cap**, the

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[6] PAEA has been described as a "sea change," and this outcome should be reckoned as part of that sea change. The Postal Service argues strongly against any pricing that "would almost certainly guarantee that most, if not all, … would **fail to cover their costs**, which **is not consistent with the Postal Service's business interest in having its cost covered.**" Docket No. ACR2008, Reply Comments of the United States Postal Service (Feb. 13, 2009), p. 31 (emphasis added).

[7] The Commission's Report elsewhere recognizes: "At the time of this report, the Postal Service's **declining revenues**, coupled with the Consumer Price Index (CPI) price cap on products that generate approximately 90 percent of its revenues, may put the Postal Service's **financial viability in peril**. The Postal Service may be facing a **crisis**…. In the immediate future, volumes and revenues will likely drop further and the **financial strain** on the Postal Service will continue to increase…. The testimony and comments, while still informative, must be viewed in light of the Postal Service's **precarious financial state**." Report, pp. 166, 170-71 (emphasis added). It should be difficult to rationalize perennial class deficits approaching half a billion dollars during this type of financial crisis.

losses in FY 2007 from the two subclasses that make up the **Periodical class could not** have been eliminated" (Report, p. 134, emphasis added) is demonstrably false.

B. The PAEA Neither Authorizes Nor Mandates Continued Subsidization of the Periodicals Class.

Within the structure of PAEA, none of the eight objectives in section 3622(b), none of the 14 factors in section 3622(c), and no other provision justifies — much less "mandates" — continued subsidization of the Periodicals class. In fact, section 3622(c)(2) expressly **requires** 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. [Emphasis added.]

The obvious purpose of this section is to avoid having any class of mail be subsidized by any other class(es). Note that PAEA requires each class not only to pay its own costs, but also to pay a share of "reasonably assignable" costs. Reducing any money-losing burden is fully consistent with section 3622(b)(5), which calls for the Postal Service to have retained earnings in order to maintain financial stability. Accordingly, there is no support in PAEA for the Commission's following statement:

> Therefore, the FY 2007 **loss of $448 million** by Periodicals was **made necessary by the current statutory obligations**. [Report, p. 134 (emphasis added).]

C. An Exigent Price Increase Obviously Trumps the Cap.

PAEA is absolutely clear that an exigent price adjustment permits price increases for classes that exceed the cap. 39 U.S.C. section 3622(d)(1)(E). There is no requirement in

PAEA that an exigent price adjustment apply equally to all classes of mail. It would appear clear that the Postal Service could have an exigent price adjustment just for Periodicals. In such a situation, it is impossible to say that a large subsidy to Periodicals is required by PAEA, and that it be considered part of the cost of the USO.

D. Losses on Periodicals Are Not Costs of the USO.

As the Report points out, the concept of universal service has grown and evolved over time, and a formal definition for the USO does not exist, in any statute, regulation, or otherwise. A working definition of the USO is provided, however, by the following statement:

> In the Commission's view, the USO has seven principal attributes: geographic scope; product range; access; delivery; pricing; service quality; and an enforcement mechanism. [Report, p. 18.]

It should be clear on its face that "product range" is the principal attribute that might conceivably be used to justify a subsidy to Periodicals under the USO. But the Report's extensive discussion of product range neither mentions nor has anything to do with Periodicals — or, for that matter, with any other single class of mail or individual product. Rather, with respect to product range, as this attribute concerns the USO:

> [t]he Commission has concluded that the range of products covered by the USO includes all mail matter, not just preferential classes or market dominant products. [Report, p. 25.]

The Commission's analysis in reaching its conclusion was predicated upon two assumptions, which Valpak believes have been demonstrated to be incorrect. *See* sections IA, IB, and IC, *supra*. Since the predicates for its view are in error, so is its conclusion that "[c]onsequently, the negative contribution made by them **should be included with the costs of the USO**." Report, p. 134 (emphasis added).

Accordingly, the USO should not be used to justify continued subsidization of the Periodicals class. As a category of USO costs, it should be stricken, and the Commission's estimated annual cost of the USO should be reduced by the $448 million included on account of the revenue shortfall in the Periodicals class.[8]

II. REFORM OF RETAIL POST OFFICES UNDERSTATES POTENTIAL SAVINGS

The Report states:

> A review of international USO costing methodologies leads to the conclusion that USO costs … are likely to take three forms. Absent a USO, postal operators might increase profits by …
> — Reducing the number of postal offices, and substituting contract agencies for traditional postal offices. [Report, p. 105.]

The Report notes here that, in a number of other countries where liberalization has occurred, contract agencies have been substituted for traditional post offices. This statement is quite broad. Nowhere does it indicate that, in other countries studied, the substitution of contract agencies for traditional postal offices has been confined to "small rural post offices."

The Report discusses two studies — one by **George Mason University** ("GMU"), commissioned by the Commission, and one by **IBM**, commissioned by the Postal Service — which estimate the added profits that would accrue from closure of small rural post offices,

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[8] Congress has not provided any indication that it would give serious consideration to an appropriation for deficit publications. Nevertheless, as a hypothetical, suppose that Congress were to appropriate money for a subsidy restricted to and narrowly directed at such publications. Clearly, such a subsidy would not be for continued maintenance of any of the seven USO attributes identified by the Commission.

with almost no explanation as to why either exercise was so restricted.[9] Report, pp. 137-38. With respect to these small post offices, which have "just the postmaster's salary" (*see* below), their functions would be replaced by rural carriers, not contract agencies. The Report quotes GMU's finding that closure of approximately 9,200 Cost Ascertainment Group ("CAG") K and L post offices (one-person staffed) and transfer of their functions to other operations would add $0.586 billion to Postal Service profits. *See id.*

The Report cites three scenarios studied by IBM. Report, p. 138. In **Scenario 3**, closing all CAG H through L offices would add $1.433 billion to the Postal Service's profits. In **Scenario 2**, closing a smaller number of offices with only a minor amount of window service or mail handling hours would add $0.943 billion. In **Scenario 1** closing those "that have no window or mail handling hours, just the postmaster's salary … would add $0.588 billion" of profit. The Report then states:

> GMU's estimate of $0.586 billion of added profit is almost identical to IBM's Scenario 1 estimate ($0.588 billion). That pair of virtually identical estimates appears to be the most reliable. [Report, pp. 138-39.]

Valpak respectfully suggests that: (i) the near-identity of the two above-cited estimates results from the fact that they pertain to closure of almost identical sets of post offices, and (ii) just because these two estimates pertain to essentially the same offices and come up with

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[9] The Report does point out that annual appropriations bills routinely include a prohibition on closure of any post office for economic reasons. These prohibitions tend to protect even the smallest, most redundant post offices from closure. And if the smallest post offices cannot be closed, it may not be unreasonable to assume that larger post offices cannot be closed, either. The Report's discussion about actual experiences of postal administrations in other countries indicates that this assumption may be unduly restrictive within the context of a hypothetical study of profits that might be added if USO-type restrictions were lifted.

essentially the same added profit is not sufficient reason to accept that figure as the best estimate of the USO cost of maintaining the remainder of the existing retail network "as is."

Valpak also would suggest that this alternative does not even consider the possibility of added profits from substitution of contract agencies for urban and suburban post offices that are staffed by more than one person. Had GMU also studied savings from closure of CAG H thru L offices, it is likely that it would have arrived at an estimate quite close to the $1.433 billion estimated by IBM.

There appears to be something of a disconnect between acceptance of this low ($0.586 billion) estimate of added profits from closing only the smallest post offices and the discussion in Chapter 3, which summarizes experience in other countries that have liberalized their postal regimes. To the extent that any pertinent details are presented, the Report indicates that:

- Sweden Post "has transformed the post office network by **replacing more than 80 percent of traditional post offices** with contract agencies." *Id.*, p. 94, emphasis added.

- In the Netherlands, "[t]he post office network has been restructured by introducing contract agencies." *Id.*, p. 96.

- New Zealand "closed one-third of its post offices." *Id.*, p. 99.

The Report also discusses the United Kingdom, Australia, and Canada, but says nothing about whether their respective retail networks have undergone any restructuring. Such additional information would be enlightening and a valuable addition. In particular, it would be informative to know (i) which, if any, of the six countries studied have limited their restructuring of retail counters and replacement with contract agencies to small rural post offices, and (ii) whether replacement of retail counters by contract agencies has extended into urban and suburban areas.

In addition to comments on experiences in the three countries cited above, it also is believed that the United Kingdom and Canada have restructured their retail networks quite extensively by replacing traditional post offices in many urban and suburban areas with contract agencies, and that costs of their formerly company-owned retail post offices have been reduced quite substantially as a result.

At a minimum, it is suggested that the Commission's estimated annual cost of the USO for retail should be increased by at least $0.847 million, the difference between the $1.433 billion estimated by IBM for CAG H through L offices, and the $0.586 estimated by GMU for CAG K through L offices. Were the study extended to closure of urban and suburban retail counters, as has occurred in other countries, even the IBM estimate of $1.433 billion in added profitability in Scenario 3 may be an understatement of potential profits from restructuring of retail counters.[10]

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[10] This finding does not mean that the Report is recommending that any post offices be closed. It is simply an honest recognition of the financial impact that could be realized under certain assumed circumstances. Achieving this higher estimate is no more a recommendation to close post offices than the figure adopted by the Commission.

Respectfully submitted,

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