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POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268

Annual Compliance Report, 2009	:	Docket No. ACR2009

INITIAL COMMENTS OF TIME WARNER INC.
ON ACR2009 PURSUANT TO ORDER NO. 380
(February 1, 2010)

Pursuant to Order No. 380, Notice of Filing of Annual Reports to the Commission by the Postal Service and Solicitation of Public Comment (issued January 5, 2010), Time Warner Inc. (Time Warner) hereby submits its initial comments on the United States Postal Service FY 2009 Annual Compliance Report (filed December 29, 2010) (hereinafter "FY 2009 ACR").

These comments address the following interrelated topics: (1) the legal standard applicable to a determination of noncompliance with respect to Periodicals class cost coverage; (2) the meaning and proper application of the attributable-cost recovery requirement; and (3) the operational causes of continuingly high Periodicals class mail-processing costs, and opportunities for making progress toward higher Periodicals class cost coverage by reducing these costs.

1. The Proper Standard for a Determination of Noncompliance Under § 3653

Subsections 3653(b) and (c) of the Act provide:

> (b) Determination of Compliance or Noncompliance.—Not later than 90 days after receiving the submissions required under section 3652 with respect to a year, the Postal Regulatory

> Commission shall make a written determination as to—
>
> > (1) whether any rates or fees in effect during such year (for products individually or collectively) were not in compliance with applicable provisions of this chapter (or regulations promulgated thereunder); or
> >
> > (2) whether any service standards in effect during such year were not met.
>
> If, with respect to a year, no instance of noncompliance is found under this subsection to have occurred in such year, the written determination shall be to that effect.
>
> (c) Noncompliance With Regard to Rates or Services.— If, for a year, a timely written determination of noncompliance is made under subsection (b), the Postal Regulatory Commission shall take appropriate action in accordance with subsections (c) and (e) of section 3662 (as if a complaint averring such noncompliance had been duly filed and found under such section to be justified).

The Commission has not as yet had occasion to make a determination of noncompliance. The proper interpretation and application of § 3653(b) and (c) is therefore a matter of first impression. In a close and careful reading of the statutory language, James I. Campbell Jr. reached the following conclusions about these provisions:[1]

> Notwithstanding its heading, this subsection calls only for a *determination of noncompliance*. That is, the Commission is obliged only to find noncompliance; it [is] not obliged to find compliance by the Postal Service. There may be cases in which the Commission cannot determine whether the Postal Service has complied with statutory or regulatory standards, for example in cases in which the Commission lacks sufficient data to decide. In such situations, it seems the Commission must withhold a determination of noncompliance.

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[1] Docket No. RM 2007-1, An Analysis of Provisions of the Postal Accountability and Enhancement Act Relating to the Regulation of Postal Rates and Services, by James I. Campbell Jr. (filed August 3, 2007), at 89-90, 90-91.

. . .

> At the outset, it should be noted that, with respect to regulation of rates, the key statutory commands of chapter 36, those in § 3622 and § 3633, are directed to the Commission, not to the lawfulness of rates and fees per [se] nor to the duties of the Postal Service. . . .
>
> The Postal Service cannot logically be found out of compliance with *statutory* commands addressed to the Commission. Noncompliance can be found only if the Postal Service's rates or fees are held to be inconsistent *with Commission regulations*.

Time Warner has consistently advocated this interpretation of the *determination of noncompliance* provision of § 3653. In Docket No. RM2007-1, we urged the Commission to make clear that

> in performing its annual compliance review under § 3653, the Commission will, absent extraordinary justification, make a determination of "noncompliance" only with respect to matters that involve a clear and determinate obligation imposed on the Postal Service by either the statute or the Commission's regulations at the time the rates were in effect.[2]

We have also argued at length that § 3653 "does not, and could not without leaving coherence behind, authorize the Commission to make determinations of 'compliance' with statutory 'goals' or 'objectives' or 'factors,'[3] and we have pointed out, as Campbell has, that "the 'factors' and 'objectives' set out in § 3622 . . . are addressed not to the Postal Service but to the Commission."[4]

Given the potentially far-reaching consequences of a determination of noncompliance, which automatically triggers authority for the Commission to impose

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[2] Initial Comments of Time Warner Inc. in Response to Commission Order No. 2 (April 6, 2007), at 18.

[3] Docket No. RM2008-4, Reply Comments of Time Warner Inc. in Response to Order No. 104 (November 14, 2008), at 9.

[4] Initial Comments of Time Warner Inc. in Response to Order No. 104 (filed October 16, 2007), at 4-11.

a remedy under the remedial subsections of the complaint provision (§ 3662), Campbell's reading is persuasive not only as construction of the specific statutory text but also in terms of the overall statutory scheme. Under the PAEA, as the Commission has stated, its "comprehensive provisions unequivocally establish subsection 3622(d)," which includes the price cap mechanism and the exigency clause, "as the administrative cornerstone of the new rate setting system for market dominant products."[5]

2. The Meaning and Proper Application of the Attributable-Cost Recovery Requirement

Subsection (a) of § 3622 provides that "the Postal Regulatory Commission shall . . . establish . . . a modern system for regulating rates and classes for market-dominant products." Subsection (b) provides that "[s]uch system shall be designed to achieve" nine stated "objectives." Subsection (c) provides that "[i]n establishing or revising such system, the Postal Regulatory Commission shall take into account" fourteen stated factors (the last of which includes "such other factors as the Commission determines appropriate"). The second of the fourteen "factors" is:

> (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.

For convenience, we refer to this factor as the "attributable-cost recovery requirement."

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[5] Docket No. RM2007-1, Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking (issued August 15, 2010), at 9.

The meaning and proper application of the attributable-cost recovery requirement under the PAEA has been a subject of much discussion in various dockets at the Commission. There is widespread, if not universal, agreement that "the attributable cost 'requirement' . . . cannot trump the price cap."[6] James I. Campbell Jr. has stated the central argument for this view concisely:

> It is possible that setting rates to cover attributable costs could one day result in rates which would exceed the statutory price cap specified in § 3622(d)(2)(A). If the minimum cost coverage requirement and the statutory price cap were expressed in statutory language of equal force (so to speak), it would be difficult to resolve this conflict. However, demotion of the minimum cost coverage requirement to factor status seems to imply that the statutory price cap must be given primacy.[7]

The Postal Service has stated that "reading this factor as 'requiring' that every class of mail cover its costs, regardless of the ceiling imposed by the cap, would eviscerate the framework set forth by Congress."[8] Time Warner has argued that

> the exigent circumstances and banking provisions of § 3622(d) provide the *exclusive* authority for increasing rates for any market-dominant class in excess of the caps [and that] the use of the word "requirement" in § 3622(c)(2) does not elevate the failure of a market-dominant class to recover its attributable costs to the status of "exigent circumstances."[9]

A small minority of commenters in Commission proceedings have taken a different view, however, and have asserted or strongly implied that a failure of any

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[6] *See, e.g.,* Docket No. RM2007-1, initial comments of ANM/MPA (at 3-4, 7-8), NNA (at 6), PostCom (at 7) (all filed April 6, 2007); the quoted words are from NNA's initial comments at 6.

[7] An Analysis of Provisions of the Postal Accountability and Enhancement Act Relating to the Regulation of Postal Rates and Services, at 45.

[8] Docket No. RM2007-1, Initial Comments of the United States Postal Service (filed April 6, 2007), at 22-23.

[9] Docket No. RM2007-1, Reply Comments of Time Warner Inc. to Initial Comments in Response to Commission Order No. 2 (filed May 7, 2007), at _.

class's revenues at any time to equal or exceed its attributable costs necessarily constitutes a case of noncompliance within the meaning of § 3653.[10] The arguments in support of this view have neglected the profound change in approach represented by the PAEA's adoption of a price-cap regime of regulation in place of the PRA's cost-of-service regime, and have misread both Postal Rate Commission and judicial precedents concerning the predecessor of the PAEA's attributable-cost recovery requirement--§ 3622(b)(3) of the PRA.[11]

As Time Warner has previously argued, the first step in determining the meaning of the PAEA's attributable-cost recovery requirement must be to recognize that it tracks the almost identical language of PRA 3622(b)(3) and

> to concede the existence of conventions of statutory interpretation that are plainly applicable to the retention of the word "requirement" in § 3622(c)(2). As the Supreme Court has stated, "where . . . Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute."

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[10] *See* Docket No. ACR2008, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Initial Comments on the United States Postal Service FY 2008 Annual Compliance Report (filed January 30, 2009), at 14:

> PAEA (current 39 U.S.C. section 3622(c)(2)) maintains the same requirement [as PRA § 3622(b)(3)], with the addition that costs be attributed "through reliably identified causal relationships" . . . . A class of mail is impermissibly "subsidized" under PAEA when revenues from the class fail to cover its attributable costs.

See also Docket No. ACR2008, Public Representative Comments (filed February 2, 2009), at 10:

> As in FY 2007, 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 atttributable costs.

[11] Former title 39 § 3622(b)(3):

> the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type.

Lorillard v. Pons, 434 U.S. 575, 580-581 (1978).[12]

In *National Ass'n. of Greeting Card Publishers v. USPS*, 462 U.S. 810, 820 (1983) (*NAGCP IV*), the Supreme Court stated that "[o]f the factors set forth in § 3622(b), only subsection (b)(3) is styled a 'requirement.'" The Court's statement does not self-evidently mean, as some commenters have assumed,[13] that a violation of law exists if at any time a class of mail should fail to generate revenues at least equal to its attributable costs. It is equally consistent with the proposition that, whereas the other § 3622(b) factors must merely be taken into account by the Commission when it recommends rates--and may, in the Commission's sound judgment, be entirely discounted--subsection (b)(3) states a mandatory objective of the ratemaking process.

The way to resolve the question is to look at how the PRA's attributable-cost recovery requirement was interpreted and applied subsequent to the decision in *NAGCP IV.* As Valpak has pointed out:

> Despite the long-standing existence of this statutory, "mandatory" requirement, for the last 10 consecutive years — *i.e.*, **every year** from FY 1997 through FY 2006 — and over the span of four successive omnibus rate cases, revenues from the Periodicals class have been less than their attributable costs.[14]

The conclusion that Time Warner draws from this history is that the Postal Rate Commission interpreted former § 3622(b)(3) as establishing a mandatory *objective*

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[12] Docket No. RM2007-1, Reply Comments of Time Warner Inc. to Initial Comments in Response to Commission Order No. 2 (filed May 7, 2007), at 28-29.

[13] *See, e.g.,* Docket No. RM2007-1, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Regulations Establishing a System of Ratemaking in Response to Commission Order No. 26 (September 24, 2007), at 17.

[14] *Id.*

of the ratemaking process--i.e., as requiring the Commission to recommend rates designed to achieve estimated revenues from each class at least equal to its estimated costs in a prospective test year. But the Commission never espoused the view that a failure to achieve that objective consistently and at all times rendered the associated rates *illegal*. Had the Commission held that view, one would have expected it to single out attributable-cost recovery for application of a year-by-year (rather than test-year) analysis. One would have expected it to adopt a policy of "truing up" rates retrospectively in order to make up for failures of a class to recover attributable costs in previous years (similar to the allowance for recovery of prior years' losses in the Postal Service's revenue requirement). The Commission did not do these things, but it did, in Time Warner's view, faithfully recommend rates that were designed to bring Periodicals class revenues into alignment with Periodicals class costs. It apparently did not interpret § 3622(b)(3) as requiring more, and it is not clear that it could have done more without producing a devastating effect on the periodicals publishing industry and making a travesty of other important statutory policies.[15] That situation has not changed in the years since the PAEA was adopted.

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[15] The same view is implicit in the Commission's discussion of the negative cost contribution of the Periodicals class in FY 2007 in its *Report on Universal Postal Service and the Postal Monopoly* (issued December 19, 2008), at 134:

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

The same logic applies to losses in FY 2008 and FY 2009, which also could not have been eliminated without exceeding the statutory price cap.

In a similar vein, the OCA (now the Public Representative) complained of the rule originally proposed by the Commission in instances in which the Postal Service proposed to raise rates for "a class of mail that is not expected to cover its attributable costs" by less than the full amount permissible under the applicable rate cap plus any banked rate authority:

> The rule's provision for an explanation from the Postal Service of the reason for the inadequate rate adjustment, rather than an outright prohibition of such shortfall in rates, appears to negate long-standing Commission practice. That practice has been based on interpretation of the same statutory language just re-enacted in the PAEA to ensure that the rates for each class or type of mail recover its direct and indirect attributable costs. The proposed rule diminishes the "requirement" by assuming the Postal Service's failure to propose rates to meet the requirement may be explained away, thus essentially weakening the requirement that has been the bedrock of Commission ratemaking. . . .[16]

Plainly, the history of Commission practice under the PRA does not support the OCA's contention that § 3622(b)(3) was regarded as "an outright prohibition" of any shortfall in a class's recovery of attributable costs. Just as plainly, under the PAEA the attributable-cost recovery requirement is no longer "the bedrock of Commission ratemaking." That position is now occupied by the "comprehensive provisions [of] subsection 3622(d)," which "unequivocally establish" that subsection, which includes the price cap mechanism, the exigency clause, and the banking provision, "as the administrative cornerstone of the new rate setting system for market dominant products."[17] Under the PAEA, which makes the attributable cost

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[16] Docket No. RM2007-1, Office of the Consumer Advocate Comments in Response to Order No. 26 Proposing Regulations to Establish a System of Ratemaking (filed September 24, 2007), at 19-20.

[17] *See* n. 5, *supra; see also* Commission Order No. 26 (72 FED. REG. 50744, 50748 [¶ 2029]

recovery requirement merely one among a number of subordinate policy provisions, the importance of the provision in the hierarchy of statutory policies is necessarily diminished, and the flexibility possessed by the Commission in interpreting and applying the provision is necessarily enhanced.

The Commission has evidently reached similar conclusions. In its FY 2008 Annual Compliance Determination (issued March 30, 2009), at 54, the Commission observed that "[t]he attributable costs of Periodicals, as a class, exceeded revenue by a little more than $400 million in Fiscal Year 2008, equating to cost coverage of 84 percent." It recognized (at 58) that "Periodicals remain, in the Postal Service's words, 'a challenged class' in terms of cost coverage," but it declined even to consider a determination of noncompliance. Rather, in agreement with the Postal Service, the Commission concluded that "*efforts to improve cost coverage . . . should be directed mainly at cost control and improved pricing signals so that meaningful progress toward compliance with section 3622(c)(2) can be made*." *Id*. at 54. More specifically, the FY 2008 ACD stated that

> *the Commission anticipates exploring the feasibility and impact of including allied piece costs in worksharing cost. It supports and encourages the Joint Task Force effort to improve the data used in the Periodicals cost model, to search for practices that will improve operational efficiency handling and transporting Periodicals, and to consider whether the discount or rate structure can help the Postal Service and its customers to become more efficient users of the mail. It also strongly encourages the Postal Service and Periodicals mailers to consider administrative solutions to processing decisions that currently elevate service decisions over cost considerations.*

[September 4, 2007]), ("[t[he Commission agrees that the PAEA ushers in a fundamentally different approach to rate regulation for market dominant products, and that its implementing regulations should honor the spirit and letter of the new law").

Id. at 58-59.

The following section discusses the status of those efforts, the reasons for their apparently disappointing results, and the actions needed going forward to improve the situation.

3. Actions Needed to Improve the Low Periodicals Cost Coverage Reported in ACR2009

Between FY 2008 and FY 2009, Periodicals class cost coverage fell from 84% to only 76%. There are several reasons why the class finds itself with such a low cost coverage. They include:

- a precipitous drop in flats volumes in FY 2008, followed by an equally large drop in FY 2009;[18]
- a failure to adjust the number of employees assigned to flats processing to the much lower volume; and
- continuing diversion of large volumes of machinable Periodicals flats to manual incoming secondary sorting, despite excess capacity for automated sorting due to reduced flats volumes.

In comments filed in Docket No. ACR2008, Time Warner described the diversion of machinable Periodicals to manual sorting and urged that it be addressed by the Postal Service.[19] But as we demonstrate below, the practice continued unabated in FY 2009, with the unfortunate twist that in FY2009 the Postal Service appears to have devoted approximately the same number of workhours to the sorting of far fewer flats.

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[18] The largest drop occurred in Standard class flats. The volume of non-carrier route Standard flats dropped from 12.86 billion in FY 2007, to 10.01 billion in FY 2008, to only 7.79 billion in FY 2009. Standard class has always been the largest contributor of flats volumes. Periodicals and First Class flats volumes have also been falling, though to a less extreme degree.

[19] Reply Comments of Time Warner Inc. on ACR2008 in Response to Order No. 161 (filed February 13, 2009), at 7-12.

In addition to the reasons listed above, the following also adversely affected Periodicals class cost coverage:

- average Postal Service wage rates, particularly in mail processing, increased considerably more in FY 2009 than the small increase in the CPI might lead one to expect;[20] and
- periodical publications experienced a considerable reduction in advertising content, which pays a higher rate of postage than editorial content, thus lowering the Postal Service revenues that would have been generated in a normal advertising year.

The return of advertising content to more normal levels as the economic climate improves in 2010 and beyond would, by itself, raise the Periodicals class cost coverage by several percentage points.

In the following two sections, we discuss the impact of the factors listed above on: (1) mail processing costs (cost segment 3, particularly flats piece-sorting costs) attributed to Periodicals; and (2) in-office carrier costs (cost segment 6) attributed to Periodicals.

a. Cost Segment 3: Mail Processing Costs

On several past occasions, Time Warner has discussed the alarming extent to which the Postal Service continues to divert Periodicals flats to manual processing, particularly in the incoming secondary sorting that is performed on all non-carrier route flats. Studies prepared by our postal consultant, Halstein

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[20] Based on the national payroll summary data for FY 2009 we estimate that the average wage rate for all USPS employees increased by 5.72%, and the rate for clerks and mailhandlers increased by 7.43%. Comparison of the Periodicals models in ACR2008 and ACR2009 indicates a 7.56% increase in the mail processing wage rate. It appears that a major reason why this rate increased so much more than the CPI is that workforce downsizing has focused more on casual employees than on the much more highly paid fulltime and part-time employees. An unfortunate side effect of eliminating so much casual labor is that it reduces Postal Service staffing flexibility, since casual employees can be brought in for a few hours at a time to handle peak workloads, while fulltime employees must be paid for eight hours five days a week, regardless of the workload.

Stralberg, have indicated that the extra costs imposed on Periodicals by diversion to manual processing when machine capacity is available for automated sorting are very large.[21] Postal Service management has acknowledged this problem.[22] Addressing it is an essential step in putting the Periodicals class on the road to full cost coverage.

In its reply comments in Docket No. ACR2008, Time Warner demonstrated, based on FY 2008 cost and volume data, that even though Periodicals and Standard flats are similar in many respects and are often sorted together, Periodicals flats are far more likely to receive manual sorting, while Standard flats are more likely to receive fast, automated sorting on AFSM 100 machines.[23]

Table 1 in those comments compared FY 2008 costs at three mail-processing cost pools devoted to piece-sorting of flats, including the AFSM-100 automated pool, the pool representing manual flats sorting in MODS processing plants (MODS MANF), and the pool representing manual flats sorting in NonMODS facilities (NonMODS MANF). In each pool, "unit costs" of Outside County Periodicals and

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[21] *See* Docket No. RM2010-6, Initial Comments of Time Warner Inc. in Response to Order No. 363 (filed January 11, 2010), Appendix: Comments On Costing Proposal No. 29; Docket No. RM2010-4, Initial Comments of Time Warner Inc. in Response to Order No. 327 (filed November 16, 2009); Docket No. RM2009-10, Initial Comments of Time Warner Inc. in Response to Order No.269 (filed August 20, 2009), Appendix: The High Costs of Manual Flats Sorting; Reply Comments of Time Warner Inc. on ACR2008 in Response to Order No. 161 (filed February 13, 2009); Docket No. ARC2008, Initial Comments of Time Warner Inc. in Response to Order No. 161 (filed January 30, 2009); Reply Comments of Time Warner Inc. in Response to Order No. 130 (filed December 10, 2008); Docket No. RM2009-1, Initial Comments of Time Warner Inc. in Response to Order No. 130 (filed December 1, 2008); Docket No. RM2008-2, Initial Comments of Time Warner Inc. in Response to Order No. 99 (filed September 8, 2008), Addendum: Recommendations for Improving the Periodicals Class.

[22] *See* Slide 10 in the "webinar" presented by Ashley Lyons, Manager, Regulatory Reporting and Cost Analysis, USPS, on October 28, 2009

[23] Reply Comments of Time Warner Inc. on ACR2008 in Response to Order No. 161 (filed February 13, 2009), at 7-12.

Standard Regular flats respectively were defined as the mail processing costs attributed by IOCS, divided by the non-carrier route volume of each product.

We reproduce that table as Table 1 below, in order to demonstrate, based on corresponding FY2009 data in Table 2, that:

(1) in FY 2009, as in FY 2008, Periodicals flats were often--far more often than Standard flats--diverted to slow manual sorting; and

(2) in FY 2009, both manual and automated sorting, on both Periodicals and Standard flats, were much slower, and had much higher unit costs, than in FY 2008.[24]

Table 3 below shows how much each of the unit costs measured in Tables 1 and 2 increased in just one year. For example, taking the combined costs at the two manual flats operations, Outside County Periodicals incurred manual costs of 4.7 cents per non-carrier route flat in FY 2008, more than twice as much as Standard flats. But in FY 2009 those costs had grown by 28.23% to 6.03 cents per piece, still more than twice as much as for Standard flats, whose costs had also increased, though not by quite as much. During the same period, the costs incurred by Periodicals in the automated AFSM pool had also grown, by 28.81%.

Given the much lower flats volumes and the much higher unit costs in FY 2009, there can be little doubt that those higher unit costs are due to the Postal Service's inability to adjust the workforce in accordance with the lower volumes. The number of employees staffing the three cost pools in FY 2008 appears to have remained the same in FY 2009 when there were much smaller flats volumes. The result was much higher per-piece costs.

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[24] Note that the unit costs in Tables 1 and 2 represent only mail-processing labor costs attributed by the IOCS (*see* USPS-F09-7 and USPS-F08-7 part 3). They do not include the piggyback costs that routinely are attributed on top of the direct labor costs.

Table 1: FY 2008 Sorting Costs (cents/piece) For Outside County and Standard Regular Flats in Major Cost Pools, as Attributed By IOCS				
	AFSM 100	MANF Cost Pools		
		MODS	NonMODS	Total MANF
Std Flats	3.16	0.47	1.77	2.24
Outside County	2.39	1.27	3.43	4.70

Table 2: FY 2009 Sorting Costs (cents/piece) For Outside County and Standard Regular Flats in Major Cost Pools, as Attributed By IOCS				
	AFSM 100	MANF Cost Pools		
		MODS	NonMODS	Total MANF
Std Flats	3.79	0.64	2.09	2.73
Outside County	3.08	1.80	4.23	6.03

Table 3: FY 2008-9 Increases In Piece Sorting Costs For Outside County and Standard Regular Flats in Major Cost Pools				
	AFSM 100	MANF Cost Pools		
		MODS	NonMODS	Total MANF
Std Flats	19.71%	37.41%	17.88%	21.96%
Outside County	28.81%	41.06%	23.46%	28.23%

The Postal Service needs to stop diverting Periodicals flats to manual processing when there are machines available that could sort them much faster. This may not be easy, because it involves changing longstanding, ingrained local management practices. But it is a change that must be made. It will, of course, mean that there will be even less work available for the crews that today sort Periodicals flats manually (most of whom are located in the many thousands of NonMODS offices where most manual sorting occurs). The task of downsizing the workforce to the appropriate size is a formidable one. It will not be enough to reduce crew sizes in mail processing plants, since a huge excess manual sorting capacity in NonMODS offices (delivery units) clearly exists. The task is also necessary

because, as the FSS systems are installed, it will not be possible to realize the large cost savings they are expected to produce, especially in the work being done in local delivery units, without still further workforce reductions.

The Postal Service has made impressive progress in achieving necessary workforce reductions in recent years. We are confident that it will eventually achieve the right balance between workforce and workload in its flats processing operations. But to do so, it may need help from the Commission, the mailing community, and Congress for example in not placing undue obstacles in the way of the consolidation or closing of postal facilities that are no longer needed.

As to the reasons why Postal Service managers continue to divert Periodicals to manual sorting, a report written recently by Halstein Stralberg, based on a tour of Postal Service facilities as representative of the Periodicals publishing industry to the joint Periodicals Task Force, provides several relevant observations.[25]

One must hope that as the economy recovers, some of the lost flats volumes will return, reducing somewhat the need for large workforce reductions. But raising

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[25] Stralberg notes, for example, that mailers and Postal Service managers have in the past often had sharply contrasting views of why these diversions occur, and that there may be considerable truth in both points of view. One major factor that does not appear to have been much addressed is what appears to be a conflict between the use of APPS machines to sort flats bundles and their use to sort Priority mail. In many facilities, APPS machines have become the only option for flats bundle sorting, but they are also needed to sort Priority packages and are apparently often reserved for Priority mail during the times when they would be most useful for processing Periodicals mail. The result, in some cases, appears to be that Periodicals mail that arrives at its destinating facility prior to the published critical entry time (CET) nevertheless ends up being delayed at the bundle-sorting stage and then has to be either sorted manually or delivered one day late. This is a problem to which Postal Service management needs to give top priority. It will become even more urgent as FSS machines are deployed.

Stralberg's report was previously shared with Postal Service and Commission staff. In order that it be available to all interested parties, a copy of the report is appended to these comments for reference purposes.

rates on Periodicals or Standard flats because of abnormally high unit costs in FY 2009 would only diminish the prospects of ever retrieving the lost volumes.

b. Cost Segment 6: In-Office Carrier Costs

The main in-office activity performed by postal carriers is to sequence mail pieces prior to delivery. In the case of letter mail, sequencing is today mostly automated and performed by mail-processing employees rather than carriers. Consequently, carrier in-house activity today consists mostly of flats sequencing.[26] When flats volume drops as much as it did in both FY 2008 and again in FY 2009, one would expect carriers to find themselves with much less in-office work, resulting in higher unit costs.

As Table 4 shows, that is exactly what occurred between FY 2008 and FY 2009. For example, the volume of Standard regular flats fell from over 10 billion to less than 7.8 billion. Yet there was only a small change in the attributed carrier in-office costs, causing a unit cost increase of 21.87%. Outside County Periodicals also had lower volume but higher attributed carrier in-office costs, amounting to a unit cost increase of 19.55%.[27]

To adjust to the effects of reduced volume, Postal Service management will need to restructure carrier routes so that carriers spend less time in-office. All else being equal, that will obviously result in a reduction of the total number of carriers.

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[26] Carriers also sequence letter mail pieces that for various reasons have fallen outside the automated letter mail stream. These are typically sequenced together with the flats.

[27] In both years, Table 4 shows sharply lower Segment 6 unit costs for Periodicals than for Standard regular flats, e.g., in FY 2009, 5.2 cents versus 7.22 cents, a two cents per piece difference. That is because Periodicals mail includes over 50% carrier route presort, whereas the Standard regular flats include only non-carrier route flats. IOCS data have consistently shown, over many years, that it takes much less time to sequence flats that come to carriers in carrier-route bundles.

Such a restructuring is not an easy task, especially since under its no-layoff policy the Postal Service must rely mainly on attrition to achieve reductions in its carrier force. Additionally, restructuring carrier routes can be expected to result in temporary cost increases while the carriers familiarize themselves with their new routes.

Table 4: FY 2008-09 Changes In Segment 6 (Carrier In-office) Costs For Standard & Periodicals Flats

FY	Mail Product	Volume (1,000's)	Segment 6 Costs ($1.000's)	Segment 6 Unit Costs	Unit Cost Increases
FY2008	Standard Regular Flats	10,010,857	592,706	$0.0592	
	Outside County Periodicals	7,774,339	338,009	$0.0435	
FY2009	Standard Regular Flats	7,793,511	562,349	$0.0722	21.87%
	Outside County Periodicals	7,094,447	368,748	$0.0520	19.55%

On the other hand, with the deployment of FSS systems, in-office carrier costs are expected almost to disappear, as carriers are projected to spend as few as 15 to 30 minutes before leaving on their delivery routes. The Postal Service must therefore be confident that it can accomplish a much more severe restructuring of carrier routes than would be required merely by a temporary loss of flats volume. When such a restructuring is accomplished, it will result in a sharply reduced cost attribution to the flats that today are being sequenced manually.

Because most of the costs reflected in Table 4 eventually will disappear under FSS, the FY 2009 drop in flats cost coverage is likely to be a temporary phenomenon.

c. Steps that the Postal Service Can and Must Take to Improve Cost Coverages for its Flats Products

(1) The longstanding practice of diverting Periodicals flats to manual sorting, even when they can be sorted much more efficiently on machines, must stop. The Postal Service and the mailing community must work together closely to achieve this goal with a minimum impact on service.

(2) The Postal Service must bring its workforce into alignment with the reality of lower volumes and increasing ability to automate many tasks that used to be performed manually (e.g., FSS). This is a difficult undertaking that will take time. It will need to include network restructuring and closing of some facilities that are no longer needed.

(3) While the economy remains stagnant, the Postal Service must seek to retain as much of its existing flats volumes as possible. As the economy improves, the Postal Service must seek to recapture as much as possible of the flats volume that has been lost in recent years. A rate increase motivated by the abnormally high FY 2009 unit costs of Standard and Periodicals flats would be self-defeating, causing further loss of volumes, and thus resulting in even higher unit costs for the remaining flats.

(4) When rate levels are next adjusted, there remain improvements that need to be made in the Periodicals rate structure to encourage more efficient mail preparation. For example, the current rates pass through only 71% of the cost savings from carrier route presortation, while passing through less than one third of the added costs of some sack and bundle types. Correcting

these weaknesses will lead to a more efficient Periodicals mail stream and improved cost coverage.

Conclusion

There can be no doubt that Postal Service efforts to improve the situation of Periodicals are ongoing, but nor can there be doubt that the results as of this date have been disappointing. There are a number of reasons why this is so, some of which are plainly beyond the Postal Service's control or the possibility of being ameliorated by any possible alternative set of rates. Among these are the severe economic downturn that began in 2008 and the longer-standing continuing losses of volumes to electronic alternatives, both of which have contributed to the Postal Service's enormous losses in the past two years and resulted in severe constraints on the Postal Service's current freedom of action (for example, limitations in its ability to make capital investments in needed sorting machines). Others, such as excessive funding requirements for retiree health care benefits, political obstacles to needed network restructuring, and the high initial costs and lagging realization of benefits associated with reducing the size of the workforce, have thus far proved to be effectively beyond the Postal Service's control. None of these factors can fairly be said to have a discernible causal relation to the Periodicals class. Some factors are related to the Periodicals class but are tenuously, if at all, related to postal rates and classifications and do not appear to be within reach of the Postal Service's influence. As the Postal Service points out in its Annual Compliance Report (at 39-40), "the [magazine publishing] industry itself is facing challenges such as electronic alternatives, the high costs of paper and other non-postal costs, and a substantial

decline in advertising during the current economic downturn." There is very little the Postal Service could have done to change any of these factors.

There remain some important causes of low Periodicals class cost coverage that are features of how Periodicals mail is processed, how its costs are analyzed, and how elements of the Periodicals mailstream are classified and priced. We have attempted to understand and to explain some of these causes of the problem, why they tend to be inherently intractable, and how the unusually challenging economic conditions currently facing the Postal Service have temporarily exacerbated both the problem itself and its intractability.

If there is one clear lesson to be drawn from the facts as they exist today, it is that simply raising Periodicals rates at this time could not under any circumstances solve the cost coverage problem, and would in fact make any chance of solving it more remote.

Respectfully submitted,

s/ _____
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ADDENDUM

A TOUR OF POST OFFICES HANDLING PERIODICALS MAIL IN NORTHERN VIRGINIA

by

Halstein Stralberg

A TOUR OF POST OFFICES HANDLING PERIODICALS MAIL IN NORTHERN VIRGINIA

On December 2-3 the Postal Service arranged a tour of post offices, processing plants and one short run printer in the Northern Virginia area. The purpose was to observe the processing of Periodicals mail, both in an FSS and non-FSS environment. Tour participants, besides various USPS employees, were a number of PRC staff members and myself. I was introduced at various places as the Periodicals industry representative.

The facilities visited were:

- The Northern Virginia ADC at Merrifield, Tuesday 1130 pm ;
- The Mclean DDU, an FSS site, starting Wed morning;
- The West Mclean DDU, a non-FSS site;
- United Litho, Inc., a shorter run printer located near Dulles airport;
- The Sterling processing plant, with two APPS machines, a few blocks from the Dulles FSS facility; and
- The Dulles FSS facility, which also has several AFSM 100 machines and eventually is planned to assume all flats distribution responsibility in Northern Virginia, leaving Merrifield as a letters only facility.

The following is a short description of what I learned, focusing on the things I believe

are most important.

SOME GENERAL CONCLUSIONS

Before discussing each facility, here are some general conclusions I came away with from this whirlwind tour.

One tour objective was to illustrate the transition flats processing is in at this time during the deployment of FSS machines. And the difference was clearly demonstrated by starting the tour in an FSS and then a non-FSS delivery unit. In the FSS site, when we arrived a little after 8 am, the carriers were finishing up the sortation into a “third bundle” of the relatively small letter/flats volumes that had fallen outside the automated mail

stream – then they would be ready to start their street rounds. At the non-FSS site, although we arrived later and carriers there had started their day earlier, they were still working on massive flats volumes needing to be sequenced manually.

However, it became very clear that substantial volumes of Periodicals flats still are being sorted manually to carrier route and therefore also require manual sequencing by the carriers. Postal Service employees argue that this is a result of its commitment to meeting service standards. They deny that it results from excessively heroic efforts to deliver mail that arrived after the published critical entry time (CET). Industry representatives, on the other hand, have tended to think it is the latter, i.e., that out of misplaced emphasis on service at any cost, postal employees take late arriving "hot" Periodicals and sort them manually for next day delivery even if they arrived later than the CET.

The existence in some of these facilities of "Hot lists" of publications (which did not necessarily request to be on such lists) might appear to support the industry viewpoint. However, it became clear to me that it also is true, as USPS employees argued, that the combination of existing service "commitments", mailer entry practices and other constraints on facility management and existing practices will cause many Periodicals flats, and not only those considered "hot," to end up in the manual mainstream.[28] Needless to say, this has very negative consequences, both for the aspirations of the Periodicals class to reduce costs and improve cost coverage, and for the Postal Service's hopes of showing a high return on investment (ROI) from the FSS deployment.

Some of the reasons appear to be that:

a. Before incoming flats can be sorted on the FSS (or AFSM 100) the flats

[28] The argument, as it was presented by Rosa Fulton, is that if a monthly magazine arrives at a processing facility before the CET, then current service obligations apply regardless of whether or not it is considered "hot." And if, in spite of it having arrived before the CET the facility is unable to fit it on the automated equipment, it may be processed manually. For similar reasons, certain color-coded Standard flats may also end up being sorted manually.

bundles must be sorted. Most of this bundle sorting today is performed on APPS machines. Those machines have long setup times and are used not only for flats bundles but also to sort Priority mail parcels. At the Sterling facility, for example, both APPS machines are used for Priority mail starting around 4 pm. That means Periodicals bundles must either be sorted before that time (allowing also for Setup to change to the Priority scheme) or much later.

In other words, there appears to be a conflict between the use of the APPS for Priority mail and for flats bundles. Priority is a competitive product that the Postal Service is making money on and sees a chance to grow further. Perhaps it is unrealistic to expect the Postal Service to hold up Priority mail just in order to sort some Periodicals bundles?

b. The CET generally means the latest time that mail can arrive at a facility and expect to be delivered next morning. But what if all the volume arrives exactly at the CET? For example, the CET for Periodicals at Sterling/Dulles is 3 pm. If all the Periodicals arrive exactly at 3 pm there will be time for some of them, but perhaps not all, before the APPS machine switches over to Priority processing.

In other words, the limitation is not only capacity of the FSS, or AFSM 100, for flats sorting, but also the availability of the APPS machines for flat bundle sorting.

One thing that might help a great deal, in the FSS environment, would be if the Postal Service were to acquire the flats bundle preparation modules for the FSS that they were considering ordering but currently have decided they cannot afford. With such units in place, mailers would be able to prepare a substantial portion of the total Periodicals volume on pallets that could go directly to an FSS, bypassing the APPS bundle sorting completely, while avoiding both the bundle breakage problem presented by the APPS and scheduling conflicts with the use of APPS for Priority processing.

Without these modules, the only pallets that could be made up directly to the FSS would be pallets containing flats for a single FSS sort scheme, which typically may include two or more 5-digit zones. While this may become practical for portions of very large

magazines, most Periodicals, as well as Standard, flats will continue to depend on the APPS or other bundle sorting operations (e.g., SPBS machines).[29]

THE MERRIFIELD PROCESSING PLANT.

Our tour started 1130 pm at the Merrifield plant. While it still has some AFSM 100 machines, the plan is for those to eventually be transferred to other sites with the Sterling/Dulles facilities performing almost all flats operations. Time Inc.'s magazines are no longer entered at Merrifield, they go instead to the Sterling facility.

A stated purpose of the Merrifield visit was to observe the handling of "Hot 2C" publications, which meant mostly daily newspapers. Wall Street Journal, Investor's Business Daily and a list of other newspapers come in here nightly. As it turned out, we were not actually able to see any of them arrive at the platform, but we were told that they are handled the way Wall Street Journal has always been handled, i.e. with high priority and strictly manual handling. We observed the bullpen where the bundles are sorted and the incoming flats cases (MODS 074) where they sort anything with less than 5-digit presort. Everyone agrees that this mail is non-machinable.

We also saw the rather extensive Merrifield list of "hot" publications. Dailies were listed on top – I did not count them but I would say there must have been as many as 20. Then there was a long list of weeklies. I noticed People and Entertainment Weekly, even though those publications are no longer entered at Merrifield. Time and SI were not on the list, but I found the next day that SI is considered "hot" in the Sterling plant.

THE MCLEAN AND WEST MCLEAN DDUs

Both these post offices serve high income areas where people receive lots of flats of all classes. Flats to McLean DDU are sorted and sequenced on the Dulles FSS. Flats to West McLean are sorted to carrier route on the AFSM 100 at Dulles, then manually sequenced by the carriers.

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[29] At this time, mailers cannot prepare any flats in a way that would be optimal for FSS processing, since the Postal Service has issued no regulation for FSS preparation. That is expected to change in 2010.

Carriers at the FSS site come to work later than their counterparts at the non-FSS site, but still are able to start their street delivery earlier. They do, however, have some sequencing to do. There were both letters and flats that had bypassed automated sorting. Both are sequenced into carrier's case, then combined with any saturation mailing that might be scheduled for delivery that day to make up the "third bundle."

It appeared that non-automated letters and non-automated flats might represent roughly an equal amount of work in sequencing the third delivery bundle. There was no attempt in this office to sequence the left over flats in with the FSS flats, but as I understand it that is another option available to the carriers.

In an earlier FSS presentation I had heard estimates that carriers might need only 15 minutes in-office before starting their tour. Also that the carrier cases might be eliminated completely. In this DDU the carriers still had vertical cases to sequence the non-automated mail into, and it looked like the volume of mail to be sequenced (though small in comparison with the non-FSS site) was still large enough that doing it without vertical cases might have been difficult. It seemed that a half hour to an hour and a half might be more realistic for total in-office time. That may of course vary from site to site.

UNITED LITHO INC.

We received a warm welcome at this shorter run printer and were given an extensive tour of their printing, binding and shipping operations. Litho produces a number of Periodicals and Standard catalogs. Their product is mostly shipped on pallets, but at least a portion is actually sacks on pallets.

I was watching, together with some USPS employees, as Litho employees packed a series of sacks that then were neatly placed on a mixed ADC pallet. The sacks typically contained two or three bundles each. I believe they all met the 24-piece minimum. They used large white plastic sacks, which I was told is the only type of sack still in use. The address labels are much larger than sack labels used to be, but as the sacks with bundles in them were folded several times to be placed neatly on the pallet, the labels became hidden, so one would have to pick up each sack and unfold it to be able to read

the label.

It seemed a lot of time was being spent by Litho employees that could have been avoided if they had just placed the bundles directly on the pallet. Additionally, they have to pay postage on each sack, at least for Periodicals. Furthermore, the Postal Service is later going to spend a lot of time picking up these sacks, finding and reading the sack labels, sorting the sacks and then in some subsequent operation opening and shaking out these sacks, disposing of the sacks for recycling, before finally sorting the bundles themselves. The USPS employees who were watching seemed to agree that it would be much better for the Postal Service also to simply sort the bundles right off the pallet and not have to deal with the sacks at all.

All it would take for this to happen, and for sacks thereby to almost disappear from the Periodicals mailstream, would be for the Postal Service to officially recognize bundles on mixed ADC pallets as a legitimate method of mail entry, and to set the appropriate additional bundle and pallet rates. Sorting the bundles off a mixed ADC pallet would most likely be done manually, since there is unlikely to be enough volume to justify use of an APPS or SPBS machine. But the Postal Service already has the type of bullpen operations where such sorting is done, and they could save space and time by not having to deal with the sacks.

APPS MACHINES AT STERLING

The Sterling facility has two APPS machines. Both are used for (1) Priority mail parcels; and (2) flats bundles. I was told that the highest number of APPS anywhere in the country is three. With two machines, one might have thought that one would be dedicated to Priority and one to flats bundles, but in fact both are dedicated to Priority starting at 4 pm so that Periodicals bundle sorting has to occur either before that or much later.

An APPS can make about 180 separations. The number of separations needed to be made in the Sterling/Dulles service area is substantially larger, leading to the need to use two machines for the same product.

The “setup” time for changing from one APPS scheme to another is of necessity large. However, a supervisor we talked to said he had gotten it down to as little as 15 minutes. We did not get to see that occur.

They were sorting SI bundles at the machine I observed, and some bundles were breaking. It appears that some of the highly publicized efforts from some years ago to minimize breakage by restoring partially broken bundles whenever possible, communicating back to mailers when poorly prepared bundles are found, etc., have more or less fallen by the wayside. As I understand it, restoration was easier on the SPBS machines, where bundles are keyed manually, than it is on the APPS. The bundle dumper on the APPS subjects the bundles to a pretty rough treatment.[30]

In a hamper next to the APPS they were accumulating pieces from broken bundles, which would be sent to an AFSM for incoming primary sorting. The hamper included several bundles that were still partly in the plastic they had been wrapped in, and which clearly would have been possible to restore fully. Whether or not it would have been cost effective to aim at doing so in the APPS environment is a question I cannot answer. Apparently this facility at least had concluded it would not be worth the extra effort.

The SI bundles had one sideway strap in addition to being wrapped in thin plastic. Remarks were made that this was a poor preparation, the plastic was too thin, etc., and general remarks that the efforts of mailers to reduce costs through use of thinner paper, thinner plastic wrap, etc. is causing more damage and other problems in postal facilities.

The APPS is in my opinion an ideal machine for small parcel sorting, but less ideal for bundle sorting. To insure that bundles survive the APPS, mailers must make their bundles very sturdy, which not only adds to mailer costs but makes the bundles harder

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[30] By comparison, breakage on the “sweep” side of the machine, where the sorted bundles fall into the containers they will be dispatched in, was minimal, though it did occur. Additionally, even if bundles do break at that point the damage is limited because flats have already achieved a sort level higher than if they were to break on the front end. If, for example, a bundle is sorted to a given FSS scheme, it is going to be broken anyway as part of the preparation for that sort scheme, so the breakage is inconsequential.

to break for the postal employees who eventually must do so.

One could perhaps also argue that the current method of distributing the costs of the use of the APPS machines does not reflect the fact that it really is Priority mail, a competitive product, that has the “priority” on the use of these machines, and that Periodicals and other flats get to use them only when the Priority mail processing does not need them.

When the Postal Service eventually issues new regulations for the FSS flats environment (presumably in the first half of 2010), I believe a high priority for mailers should be to look for ways to bypass the APPS (or SPBS where those still are used) whenever possible. That will require pallets that can be loaded directly into an FSS operation. Initially that may be possible only for the densest portions of large publications – perhaps extended by comailing/co-palletization to some smaller publications as well. If/when the Postal Service acquires the mail prep machines that can serve up to six FSS schemes at a time, it may be possible for a large portion of the Periodicals volume to avoid the APPS altogether.

THE DULLES FLATS SORTING PLANT

This was the last stop on our tour. As in other places, there was only so much time and I probably would have asked many more questions had there been more time. We observed an FSS machine, working on pass one of some scheme. We also observed an AFSM machine and ended up in the acceptance office with explanations of the process they go through to verify mailings. There was a Merlin machine there but we did not get to see it in use.

The FSS appeared to be working fine from what I could see. Compared with my earlier visit to observe the FSS (in October 2008), gone were the many Northrop employees with their laptops trying to figure out what was going on. I also did not observe any stalled feeders needing manual intervention, employees removing flats they thought should be sent to manual processing, or severely damaged magazines being extracted from the machine. On the other hand, we did not really have enough time to observe

any of those things, so I cannot say that they never occur.

I observed a staging area where they place the flats that have been prepped for each FSS scheme. Most schemes seemed to include two 5-digit zones. I would assume that in other areas of the country several more zones would fit within each FSS scheme.

FSS processing today is clearly less efficient than it will be eventually. One reason is that the Postal Service still has not issued regulations for FSS preparation. Consequently, mailers are still preparing mail for the non-FSS environment. Carrier route bundles are still being prepared for zones now served by FSS machines. Those bundles must be opened and "prepped" by combining the flats with all other flats to the given FSS scheme. I did not get to see the operation where this is done, but it is a step that should disappear eventually, as mailers begin to prepare FSS scheme bundles.

I believe they said that there are eleven functioning FSS machines today, serving about 180 5-digit zones in 59 DDUs. Those numbers should be increasing rapidly in the months ahead.

The Dulles plant uses AFSM 100 machines for incoming flats secondary sorting to non-FSS zones, as well as incoming primary sorting.

The AFSM's at Dulles (and those still at Merrifield) were all equipped with the AI (automated input) attachment as well as the automated tray take away feature (ATHS). All input to the machines were through the AI unit, where flats are placed in special green trays from which they are automatically fed into the machines.

It had been my understanding that the AI units would replace the separate bundle preparation performed under MODS No. 035. That is, rather than opening bundles and staging the flats in "ergo carts" which then would be transported from the 035 operation to the AFSM where flats are fed into the machines, bundles would be opened at the AI unit and the flats placed directly into the green trays which automatically feed the AFSM. That presumably would allow for one less handling of each flat and thereby save costs.

But at most of the AI operations I observed flats were being taken from regular white flats tubs and placed into the green AI trays. That could be First class flats that had been entered or prepped directly into flats tubs, or it could be flats from a preceding AFSM sorting scheme. Then as we were leaving we passed by an AFSM AI unit where they were loading flats from ergo carts into the green AI trays. The ergo carts must have been prepared in some previous 035 type manual operation, and that would seem to mean that the 035 type work, which the AI were supposed to replace, still continues.

In the van going towards DC afterwards I posed this riddle to several USPS employees, but no one seemed to know the answer. One suggested that perhaps prepping bundles right at the AI would make it impossible to keep feeding the hungry machine fast enough and that the separate prepping still therefore is needed. And that may be the reality, confirming once again how difficult it is to get rid of the flats bundle preparation costs.