

**BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON DC 20268-0001**

RATE ADJUSTMENT DUE TO)
EXTRAORDINARY OR EXCEPTIONAL) Docket No. R2010-4
CIRCUMSTANCES)

**REPLY COMMENTS OF
USERS OF FLAT-SHAPED MAIL
(September 2, 2010)**

Pursuant to Order No. 485 at 6, the undersigned parties respectfully submit these reply comments concerning the rate increases proposed by the Postal Service for Periodicals Mail and Standard Mail Flats. The undersigned parties are also co-sponsors of the reply comments of the Affordable Mail Alliance, which explain why all of the rate increases proposed by the Postal Service in this docket should be denied in their entirety.

The August 17 initial comments of the Users of Flat-Shaped Mail showed that:

1. The failure of Periodicals and Standard Mail Flats to cover the costs attributed to them by the Postal Service is primarily a function of the Postal Service's inability to gain control of its operating costs, which have outpaced the rate of inflation for years. The Postal Service's losses on flats are due to increases in unit costs caused by the Postal Service's failure to either increase productivity through automation or eliminate excess capacity. Rather than try to price its way out of

negative contribution, the Postal Service should focus on reducing its costs.

2. The Postal Service has grossly overstated the costs properly attributable to these products by ignoring the effect of excess capacity on cost causation during the period until the proposed rates are raised again. Contrary to the Postal Service's assumption, Periodicals and Standard Mail Flats are not the cause of the large amounts of excess capacity in the operations where they are processed, and in fact cover the attributable costs they actually cause.
3. The Postal Service's request ignores the broader contributions that Periodicals and Standard Mail Flats make to the Postal Service's overall revenues. For senders of Periodicals Mail, catalogs and other Standard Mail Flats, these mail products are complementary goods with other, higher-markup classes of market-dominant mail, such as presorted First-Class and Standard Mail letters, and competitive products, such as Express Mail. Rate increases for Periodicals Mail and Standard Mail Flats would further suppress not only the volume of these products (by shrinking these sectors and encouraging the companies that survive to migrate to the Internet and private delivery), but also the Postal Service's contribution from the collateral mail volume that they generate. Moreover, periodicals and catalogs, by increasing the general attractiveness of mail to the public, also increase the attractiveness of mail as an advertising medium for

companies that do not themselves publish periodicals or catalogs. Hence, the proposed rate increases for Periodicals and Standard Mail Flats, by suppressing the volume of these products, would suppress the volume of advertising mail from unrelated senders as well. In short, the proposed increases for Periodicals and Standard Mail Flats, rather than shoring up two “underwater” postal products, would in fact merely exacerbate the Postal Service’s financial problems

Comments of Users of Flat-Shaped Mail; see *also* ACMA Comments; Time-Warner Comments; Affordable Mail Alliance Impact Statements.

Only two parties—Valpak and the Postal Service—attempt to challenge these points. We respond to Valpak in Section I and the Postal Service in Section II.

I. REPLY TO VALPAK COMMENTS

The only initial comments that specifically argue for above-average rate increases for Periodicals Mail and Standard Mail Flats—the comments of Valpak Direct Marketing Systems and Valpak Dealers’ Association (“Valpak”)—almost entirely ignore the three points noted above.¹ Valpak asserts that the Postal Service’s “business model . . . has proven to be robust in dealing with cyclical changes in the economy,” and that the data “simply do not support AMA’s claim

¹ The Public Representative, while asserting in cursory fashion the desirability of big increases on “underwater” mail classes, opposes the Postal Service’s proposed rate changes in their entirety on the ground that the Postal Service has not made a *prima facie* case for an exigent rate request under 39 U.S.C. § 3622(d)(1)(E). See Public Representative Comments at 23.

that the Postal Service is being badly managed or that costs are not being cut.” Valpak at 7. Valpak makes no mention of the detailed evidence that contradicts these glittering generalities. The evidence—including the reports of blue-ribbon commissions, Congress, the GAO and the Postal Service’s own OIG, and the Postal Service’s own reported data—shows that the Postal Service has long maintained an inefficiently large network of undersized and obsolete mail processing facilities; has suffered from an oversized work force, inflexible work rules, and low productivity; and continues to pay its employees above-market rates of compensation. AMA Motion to Dismiss (July 26, 2010) at 17-64 (citing and discussing evidence); Comments of Users of Flat-Shaped Mail at 3-15. The evidence also shows that, while the Postal Service *has* cut costs since the beginning of the recession in late 2007, the cost cuts have trailed far behind the decline in volume and revenue, leading to a collapse in productivity and a surge in unit costs. AMA Comments at 15-16 & n. 5; Comments of Users of Flat-Shaped Mail at 13-15.

Further, despite being fully aware of the summer sales and the short-run variable cost measures the Postal Service used to support them, Valpak ignores the evidence that the Postal Service has grossly overstated the costs properly attributable to Periodicals and Standard Mail Flats by ignoring the effect of excess capacity on cost causation during the relevant time horizon. Valpak’s silence on this key point is understandable, since Dr. John Haldi, a witness for Valpak in many Commission proceedings in recent years, previously testified for other clients that, as a matter of economic principle, the attributable costs of capacity which is fixed during the relevant time horizon, and which exceeds the

level needed to serve demand during that period, are well below the levels indicated by conventional measures of attributable costs, and may be close to zero. See R84-1 Haldi Direct (ANM-T-1) at 30-36 (March 12, 1984); see generally R84-1 Haldi Direct, *passim*; R87-1 Haldi Direct (ANM-T-1), *passim* (Sept. 14, 1987).²

Finally, Valpak offers little challenge to the broader contributions that Periodicals and Standard Mail Flats make to the Postal Service's institutional costs by stimulating demand for complementary, higher-markup products such as presorted First-Class and Standard Mail letters and Express Mail. Valpak cites Dr. Kiefer's response to POIR No. 3, Question 6, indicating that catalog mailings generate a response rate of 1.9 percent, but neglects to mention Dr. Kiefer's response to POIR No. 3, Question 7, which calculates a cost coverage of approximately 132 percent for the catalog industry as a whole (even with the Postal Service's inflated measures of the attributable costs of Periodicals Mail and Standard Mail Flats). See Comments of Users of Flat-Shaped Mail at 26-28 (discussing data).

² In Docket No. R84-1, the Commission declined to adopt the full "peak load cost" adjustment proposed by Dr. Haldi on the ground that the record evidence on the extent to which the Postal Service could vary its mail processing capacity in response to daily and hourly changes in workload was conflicting and uncertain. PRC Op. R84-1 at ¶¶ 3180-82; PRC Op. R87-1 ¶ 3042. In Docket No. R87-1, based on further evidence, the Commission found that only a small adjustment was warranted because staffing levels during hourly, daily and weekly peak and off-peak periods were affected by expected changes in both peak and off-peak demand. In the present case, by contrast, the very premise of the Postal Service's exigent rate request is that the Postal Service suffers from excess capacity and does not expect to be able to shed it throughout the expected life of the proposed rates. See Comments of Users of Flat-Shaped Mail at 19-21; USPS Response to AMA Motion to Dismiss (Aug. 2, 2010) at 6-7, 27-35, 41-44 (arguing that USPS is constrained from shedding excess capacity).

II. REPLY TO THE POSTAL SERVICE

In this section, we discuss the Postal Service's responses to questions from the bench and to Presiding Officer's Information Request ("POIR") No. 5 regarding the trends in Periodicals and Standard Mail Flats unit costs.³ The responses underscore that (1) the Postal Service's failure to react effectively to recent volume declines has been borne disproportionately by flat-shaped mail, and (2) there is no legitimate causal or operational reason for the explosion in the Postal Service's reported costs for handling flats.

The Postal Service downplays the magnitude of the huge cost increases by adjusting the analyses and changing the bases of comparison. But these manipulations are unavailing. Trends in Postal Service costs for handling flat-shaped mail are abysmal even if one accepts the Postal Service's proposed benchmarks and methodological adjustments. The Postal Service's responses leave the following conclusions undisputed:

- Deployment of the AFSM 100 and increases in the average level of worksharing should have caused the unit costs of handling Periodicals and Standard Mail Flats to increase much more slowly than inflation; in fact, those costs have increased much faster than inflation over a period of many years.

³ Docket No. R2010-4, Responses of the United States Postal Service to Questions from the Bench at the Hearing for Mr. Masse (August 18, 2010) ("August 18 Response"); Docket No. R2010-4, Responses of the United States Postal Service to Questions from the Bench at the Hearing for Dr. Kiefer (August 19, 2010) ("August 19 Response"); Docket No. R2010-4, Responses of the United States Postal Service to Questions 1-32 of Presiding Officer's Information Request No. 5 (August 25, 2010).

- The increases in unit costs of flat-shaped mail have been due to a combination of declines in productivity⁴ and substantial increases in already-excessive rates of compensation.
- The Postal Service's failure to respond effectively to recent volume declines has significantly worsened the already-present problems. Comments of Users of Flat-Shaped Mail at 13.

The Commission should not reward the Postal Service's "poor performance" by allowing it to continue to increase rates for flat-shaped mail by above-average amounts. *Id.* at 4. Rather, it should require the Postal Service to finally get its costs for handling flat-shaped mail under control.

A. USPS-Proposed Adjustments To Reflect Intervening Changes in Costing Methodology

In its responses to the Commission's questions, the Postal Service proposes adjustments to the reported trends in Periodicals unit costs to reflect changes in costing methods over time. Even with these adjustments, however, the trends in Postal Service unit costs for handling flat-shaped mail still show a lack of effective cost control.

First, in the August 19 Response to question posed at Tr. 3/416-17, the Postal Service suggests that the increase in Periodicals unit costs from FY 1996

⁴ A major contributor to the Postal Service's poor flat-handling productivity is excessive manual processing. As the Postal Service admitted in response to POIR No. 5, Question 26, the Postal Service still processes 30 percent of flat-shaped mail manually—to a large extent needlessly—despite the deployment of AFSM 100s.

to FY 2009 was 64 percent, not 82 percent. Even the lower value, however, indicates that Periodicals unit costs increased by 70 percent more than the 37 percent rate of inflation during this period.

Second, the largest USPS-proposed adjustment to account for changes in costing methodology during this period is clearly erroneous. To account for the potential effect of the In-Office Cost System (IOCS) Redesign, the Postal Service proposes to use the average cost increase (across all products) from FY 2003 to FY 2005 as a proxy for the much-higher Periodicals cost increases during the same period. August 19 Response to question posed at Tr. 3/416-17, footnote 9. This adjustment is both unsupported and counterintuitive. There is absolutely no basis for assuming that Periodicals costs would increase at only the system-wide average rate from FY 2003 to FY 2005, when we know that attributed Periodicals costs increased at a much higher rate for the FY 1996 to FY 2009 period as a whole.

Third, the Postal Service's August 18 responses to the question posed at Tr. 2/229 and POIR No. 5, Questions 8 & 9, suggest that an unspecified portion of the increase in Standard Mail Flats unit costs was due to an increase in the variability of City Carrier–Street Time costs. The effect of such an adjustment, however, is unlikely to affect the Standard Mail Flat unit cost trend very much. City Carrier–Street costs comprise only a small percentage of attributable delivery costs. The vast majority—82 percent—of attributable delivery costs are City Carrier–Office (C/S 6) and Rural Carrier (C/S 10) costs. FY 2009 Public Cost Segments and Components Report.

B. Cost Trends

The Postal Service also downplays the huge cost increases in the unit costs of flat-shaped mail by comparing those increases not to inflation in the private sector, but to measures of inflation in postal input prices and by performing separate comparisons of pre-recession (through FY 2007) and recession (FY 2007 through FY 2009) performance. Comparisons of the unit costs of flat-shaped mail with inflation in postal input prices are circular, however, because *both* measures have suffered from the failure of the Postal Service to limit its average hourly compensation costs to levels comparable with the compensation paid by private firms for comparable work. This lack of cost control alone is responsible for a large share of the huge increases in the Postal Service's input prices during this period. Moreover, while private sector productivity grew substantially during the period, USPS productivity in handling flat-shaped mail declined. Separate comparisons for the pre-recession and recessionary period simply confirm that the Postal Service's performance was poor before the onset of the recession and has become even worse since then.

A variety of data produced by the Postal Service on long-term cost trends underscore these facts:

1. Long-term cost trends

- From FY 1996 to FY 2009, USPS hourly compensation increased (by 63 percent) much more rapidly than in the private sector (48 percent).⁵

⁵ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Lab-14"; BLS Series ID ECU10002I (FY 1996 – FY 2001); BLS Series ID CIU2010000000000I (FY 2002 – FY 2009).

Similarly, from FY 1999 to FY 2009, the growth in USPS hourly compensation (53 percent) was much higher than in the private sector (34 percent).⁶

- From FY 1996 to FY 2009, the 82 percent increase in attributed Periodicals unit costs was much higher than the increase in postal input prices (52 percent), indicating that USPS productivity for handling Periodicals *declined* substantially during this period.⁷ From 1996 to 2008,⁸ private nonfarm business sector multifactor productivity increased by 17 percent.⁹
- Similarly, from FY 1999 to FY 2009, the 106 percent increase in Standard Mail Flats unit mail processing and delivery costs was more than double the 44 percent increase in postal input prices, also indicating a substantial *decline* in USPS productivity for handling Standard Mail Flats.¹⁰ From 1999 to 2008, private nonfarm business sector multifactor productivity increased by 12 percent.¹¹

⁶ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Lab-14"; BLS Series ID ECU10002I (FY 1999 – FY 2001); BLS Series ID CIU201000000000I (FY 2002 – FY 2009).

⁷ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Tfp-49".

⁸ 2008 is the last year for which private sector multifactor productivity data are available.

⁹ BLS Series ID MPU491007 (using Calendar Year).

¹⁰ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Tfp-49"; BLS Series ID CUUR00000SA0.

¹¹ BLS Series ID MPU491007 (using Calendar Year).

2. Pre-recession cost trends

- From FY 1996 to FY 2007, USPS hourly compensation increased (by 48 percent) more rapidly than in the private sector (41 percent).¹² Similarly, from FY 1999 to FY 2007, the growth in USPS hourly compensation (38 percent) was higher than in the private sector (28 percent).¹³
- From FY 1996 to FY 2007, the 62 percent increase in Periodicals unit costs was much higher than the increase in postal input prices (40 percent), indicating that USPS productivity for handling Periodicals *declined* substantially even before the onset of the recession.¹⁴ From 1996 to 2007, private nonfarm business sector multifactor productivity increased by 17 percent.¹⁵
- Similarly, from FY 1999 to FY 2007, the 49 percent increase in Standard Mail Flats unit mail processing and delivery costs was much higher than the increase in postal input prices (32 percent), indicating that USPS productivity for handling Standard Mail Flats also *declined*

¹² Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, “Lab-14”; BLS Series ID ECU10002I (FY 1996 – FY 2001); BLS Series ID CIU201000000000I (FY 2002 – FY 2009).

¹³ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, “Lab-14”; BLS Series ID ECU10002I (FY 1999 – FY 2001); BLS Series ID CIU201000000000I (FY 2002 – FY 2009).

¹⁴ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, “Tfp-49”.

¹⁵ BLS Series ID MPU491007 (using Calendar Year).

substantially before the onset of the recession.¹⁶ From 1999 to 2007, private nonfarm business sector multifactor productivity increased by 12 percent.^{17,18}

3. Cost trends since beginning of recession

The Postal Service's responses affirmed that the Postal Service failed to adjust its workforce sufficiently in response to volume declines from FY 2007 to FY 2009, resulting in astronomical—24 percent and 36 percent, respectively—increases in Periodicals Flats and Standard Mail Flats unit delivery costs as well as substantial increases in flats processing costs.

- The volume declines “led for a time to excess capacity in delivery costs and in plant and equipment costs.” August 19 Response to question posed at Tr. 3/416-17.
- “By 2007, deployments of the AFSM 100 and related equipment had been completed, so much of [the recent] increase in unit indirect costs

¹⁶ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, “Tfp-49”.

¹⁷ BLS Series ID MPU491007 (using Calendar Year).

¹⁸ In defending its pre-recession performance, USPS highlights that unit mail processing labor costs for Standard Mail Flats increased less than increases in USPS hourly compensation, suggesting a slight increase in labor productivity, which was more than offset by higher increases in indirect costs during this period. August 19 Response to question posed at Tr. 2/229; Response to POIR No. 5, Question 9. A slight increase in labor productivity over nearly a decade is poor performance. Private sector nonfarm business labor productivity increased dramatically – by 24 percent – during the same period. Furthermore, equipment should be deployed only if savings from increased labor productivity (or other savings) more than offset the increased depreciation and indirect costs.

is a reflection of reduced volume and excess capacity for plant and equipment for flats.” Response to POIR No. 5 Response, Question 9.

- The “volume declines have also lead [sic] to excess capacity in plant and equipment.” Response to POIR No. 5, Question 10.
- “[C]ased volume is falling faster than workhours....Workhours declined fifteen percent but cased volume dropped by twenty-one percent over that time period. This implies a fall in casing productivity.” Response to POIR No. 5, Question 8.
- “Labor costs rose during the 2007 to 2009 period, faster than wages – workhours could not be reduced as fast as volume declined.” Response to POIR No. 5, Question 9.
- The “rapid decline in volume caused an associated decline in carrier productivity....” Response to POIR No. 5, Question 9.
- “It is clear, however, that the volume declines have played a substantial role as they have caused declines in carrier productivities in FY2008 and FY2009....” Response to POIR No. 5, Question 10.

While the Postal Service’s failure to react to the volume declines affected postal costs for all products, the trends for flat-shaped mail were even worse.¹⁹

¹⁹ In response to a question from the bench, USPS witness Neri suggests that flats processing productivity has increased since FY 2006. His analysis is contrary to the overwhelming trends in flats costs—and incorrect. According to his calculations, flats volumes remained essentially unchanged from FY 2006 to FY 2009. In reality, flats volumes declined sharply. Mr. Neri appears to have

- From FY 2007 to FY 2009, increases in Periodicals unit costs (12 percent) and Standard Mail Flats unit mail processing and delivery costs (38 percent) were higher than postal inflation (11 percent) and the increase in the CPI (4 percent).²⁰
- From FY 2007 to FY 2009, increases in Periodicals unit costs (12 percent) and Standard Mail Flats unit mail processing and delivery costs (38 percent) were also higher than the increase in USPS hourly compensation (11 percent) and the increase in private sector hourly compensation (5 percent).²¹

That Periodicals and Standard Mail Flats unit mail processing and delivery costs increased much more than the increase in USPS hourly compensation

overlooked that over time a larger percentage of flats are handled in the preparation operation in addition to the distribution operation. From FY 2006 to FY 2009, volumes in the preparation operation increased substantially while total flats volumes dropped. Ignoring these trends overstates productivity estimates in two ways: (1) it artificially inflates the measure of flats volumes (because a piece will be counted in the preparation operation only if handled there); and (2) it decreases the workload for each piece in the distribution operation because some of the work previously performed in the distribution operation is now performed in the preparation operation. The peculiar metric used by the Postal Service to measure productivity may have contributed to its poor performance in handling flats: a manager can increase reported distribution productivity simply by having part of the work performed in the preparation operation. Docket No. R2010-4, Supplemental Response of the United States Postal Service to Question from the Bench at the Hearing from the Bench at the Hearing for Mr. Neri (August 27, 2010).

²⁰ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Tfp-51"; BLS Series ID CUUR00000SA0.

²¹ Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Lab-14"; Annual_2009_(2009_CRA).xls, "Lab-14"; BLS Series ID CIU2010000000000I.

from FY 2007 to FY 2009 indicates that Postal Service productivity for handling flats *declined*. Private sector labor productivity increased by four percent during this period.²²

Conclusion

The reported failure of Periodicals Mail and Standard Mail Flats to cover attributable costs is an artifact of the Postal Service's inability to gain control of its operating costs, and the Postal Service's disregard of the effect of its excess capacity on cost causation and cost attribution during the likely life of the proposed rates. Moreover, the notion that Periodicals Mail and Standard Mail Flats are a burden on users of other mail classes ignores the large volume of presorted First-Class Mail and other high-markup mail products that periodical and catalog mailers generate, and the value to other mailers that periodicals provide by increasing the attractiveness of mail generally to consumers.

For these reasons, and the separate reasons provided by the Affordable Mail Alliance, the proposed rate changes should be rejected.

²² BLS Series ID PRS85006093; Total Factor Productivity, USPS Annual Tables, FY 2009 (filed March 2, 2010), Table_Annual_2009_(2009_CRA).xls, "Tfp-53". This bullet reference private sector labor productivity, rather than multifactor productivity because 2009 multifactor productivity data are not yet available.

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