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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Annual Compliance Report, 2010 **Docket No. ACR2010**

Comments of the
American Catalog Mailers Association (ACMA)
(February 2, 2011)

Pursuant to Commission Order No. 636 (January 4. 2011), inviting comments by today, ACMA is pleased to respond. The matters at issue are important to our members and the nation as a whole.

ACMA members make a wide range of goods and services available to businesses and consumers, largely through catalogs, mostly distributed through the mail, mainly at Commercial Standard rates. Postage represents 40 to 60 percent of their marketing costs, typically. Catalogs account for a high proportion of the volume of Standard Flats. Accordingly, postage rates are critically important to us and the Postal Service.

Catalogs present both graphic and descriptive material, authoritatively prepared, convenient for review and sharing, and suitable for future reference. They are among the most sought-after mailpieces. Although we use several categories of mail, our operations are dependent most heavily on the rates for Standard Flats, on which these comments focus.

I. Introduction.

The Postal Service has chosen to designate Regular[1] Standard Flats, inclusive of Nonprofit, as a product, for which a traditional cost coverage is estimated. The figure reported for FY2010 is 81.59 percent, just slightly below the figure of 82.15 percent for FY2009 (USPS-FY10-2 and USPS-FY09-2, respectively). For the fact that it has not decreased significantly, we are thankful; for the fact that it has not increased significantly, we are disappointed.

Our interest is in presenting the Postal Service with suitably designed, highly processible pieces, with barcodes, bundled and containerized effectively, and entered in such manner that they can be processed at a low cost using automated equipment. The latter does not appear to be happening. The costs are too high and it seems apparent that an efficient, streamlined, well-oiled flats mailstream has not evolved, despite automation and considerable attention to the way the mail is prepared. We want to work with the Postal Service to improve this situation, to find out why so many costs are being picked up, and to bring about improvement.

But there are reasons for believing that the situation in which we find ourselves is not as bad as the above-referenced cost coverage figures suggest. And it is far from clear that the rates we pay are out of compliance with title 39, and specifically with the guidance in its section 3622. In fact, we believe the Postal Service is dealing admirably with a difficult situation and that the law

[1] In the past, the term "Regular" has been used to refer to the non-ECR categories of Standard Mail, both Commercial and Nonprofit. It is so used herein, even though the ECR designation is no longer in use. We know of no other way to refer to the once non-ECR categories.

accords it the flexibility to do just that. We do not see that disruptive rate adjustments need be considered. We lay out these reasons in the following sections.

II. The Products Selected for Cost-Coverage Attention Are Possibilities Among Many, and They Mask What We View as Catalogs that Are Contributing Positively to Postal Finances.

Defining Products. Title 39 does not say how products should be defined. It merely says that when it uses the term *product*, it "means a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied" (section 102(6)). In other words, *if you build it, we will refer to it*. The Commission agrees, essentially, saying that this "definition … is so general … that almost any category of mail nominated would qualify" (Order 536, p 22).

If this definition were taken to be an assignment to exhaust, the number of products would be phenomenally large. The Commission notes in this regard that "[n]othing prevents multiple products that serve the same market from appearing separately on the section 3642 list" (*Ibid.)*. Alternatively, products could be aggregates. And nothing seems to prevent them from being narrow in one direction and broad in another. Carrier Route, for example, is narrow in density and broad in its inclusion of letters, flats, and parcels, both Commercial and Nonprofit.

One approach would be to latch onto categories that make it easy to design rates that are related in fair and reasonable ways to the costs of the mail and the demand in the market. We submit that if this were done, or just taken into consideration, Commercial and Nonprofit would be separated from each other, and Carrier Route would not be separated from 5-digit and its less dense cousins.

Much of the prescription just outlined can be accomplished, in considerable degree at least, by reassembling the revenue and cost information in Library References 2 and 27 (the public CRA (USPS-FY10-2) and the cost estimates for the Nonprofit categories (USPS-FY10-27), respectively). Straightforward arithmetic shows a cost coverage for Commercial Standard Flats, including Carrier Route but excluding High-Density and Saturation, of 109.57 percent.[2] If High-Density flats, a "product" in increasing use by catalogers as co-mail and delivery routes each expand, were included, the cost coverage would increase further. If cataloger originated mail in other classes is included, the contribution to Postal Service overhead by the catalog industry expands even more. The point here is that, as a customer segment, catalog business is good business for the Postal Service. It also drives value in the mailbox, given its high-perceived value by mail recipients. We also suspect that the Commercial Standard Flats category may include flats that are costlier than our members tend to prepare. In any case, to the extent that it represents catalogs, it shows them covering their costs and making a contribution to the Postal Service's net income.

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[2] In its Compliance Report (p. 31, fn. 10), the Postal Service notes that the cost coverage of Regular Flats and Carrier Route combined, including both Commercial and Nonprofit, is "slightly higher than 100 percent."

Carrier Route is 97.77 percent flats and 2.23 percent letters. The proportion of parcels is about one-quarter of 1 percent. *See* USPS-FY10-4. The discussion and calculations in the text proceed as though Carrier Route is all flats. The low proportion of letters is undoubtedly due to the fact that the postage is higher for Carrier Route letters than for 5-digit letters, even though the former has additional preparation requirements (including a line-of-travel requirement).

The Nonprofit Issue. Title 39 provides limited guidance on how Nonprofit mail is to be accommodated. From section 3626(a)(6):

> (A) The estimated average revenue per piece to be received by the Postal Service from each **subclass** of mail under former sections 4452 (b) and (c) of this title shall be equal, as nearly as practicable, to 60 percent of the estimated average revenue per piece to be received from the most closely corresponding regular-rate **subclass** of mail.
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> (b) For purposes of subparagraph (A), the estimated average revenue per piece of each regular-rate **subclass** shall be calculated on the basis of expected volumes and mix of mail for each **subclass** at current rates in the test year of the proceeding.

Emphasis added. As categories to receive attention, however, *subclasses* are no longer taken to exist. What is important is that the subclasses that existed at the time the law was written did not contain non-Nonprofit material. Therefore, it would seem most suitable to replace the term subclass with a term that includes Nonprofit but does not include non-Nonprofit. Neither Regular Flats nor Carrier Route fit the bill.[3]

A principle characteristic of subclasses has been that cost coverages for them are developed. The architecture of the PRA was that cost coverages were selected for subclasses so that breakeven for the Postal Service was expected. We see nothing in the old or the new law to suggest that a low coverage for Nonprofit, including coverages below 100 percent, should be funded tit for tat by elevating the rates for what section 3626 calls "the most closely corresponding regular-rate subclass of mail." Instead, the implication is that preferred rates for Nonprofit should be funded by the overall Postal Service, at least to the extent

[3] The fact that Nonprofit rates are tied to Commercial rates by the 60-percent proportion does not require that Commercial and Nonprofit be part of the same product. At the time applicable law was written, in fact, Nonprofit was in separate subclasses, and subclasses were more pronounced separations than products are now.

allowed by other sections of the law. Accordingly, we feel that Nonprofit should be a separate product (or products). And we see no reason why Congress does not have the authority to sanction below-cost rates for it (or them).

We do not want this to be construed as an attack on the Nonprofit subsidy, but rather an apportionment of the subsidy across the entire mailing industry. Today, the subsidy is paid by the product or grouping that Nonprofit volume falls in, and, as a result, this can be a subsidy that is disproportionately applied to different mailings.

The Carrier Route Issue. Under the PRA, carrier route and denser Standard Mail was separated from 5-digit and less dense Standard Mail, and called ECR (Enhanced Carrier Route). References to ECR were common and understood, without the need for qualification.

We said in our initial comments in Docket No. R2010-4 (p. 13):

> As a practical matter, ACMA is concerned that much of the usage of Standard Regular Flats (one product) is residual to the use of Carrier Route (another product). Also, the relationship between the two is central to co-mailing decisions, and we take co-mailing to be an efficient operation[.]

In comments made at the same time, MOAA referred to the use of Regular Flats, though in lesser degree than Carrier Route. And in its Compliance Report (p. 28), the Postal Service says:

> Although mail pieces in this product [Carrier Route (Letters, Flats and Parcels)] are required to be presorted by carrier routes, delivery point sequencing has reduced the value of carrier route presorting for letters. The deployment of FSS equipment is expected to have similar consequences for flat-shaped mail also.

A related situation would seem to exist in Periodicals, where, as in

Standard, over half of the flats are carrier route. But carrier route pieces in Periodicals are not separated and given product status. If they were, it might turn out that they have a coverage of over 100 percent. We see no reason to treat Standard in a way that is different from the way Periodicals is treated.

In short, it seems more meaningful to estimate a cost coverage for Regular-Flats-plus-Carrier-Route than for Regular-Flats-by-themselves. Doing so allows the Postal Service a degree of freedom to design rates within. Also, especially when combined with treating Nonprofit as a separate product, it allows avoidance of the perverse situation that Commercial Regular has much more Nonprofit to fund that Commercial Carrier Route.[4]

Conclusion. We believe that in a reasonable response to a need to subdivide the revenue of the Postal Service into revenues for non-overlapping products, for cost coverage purposes, Commercial Standard Flats should be separated from Nonprofit Standard Flats and the Regular category should not be separated from Carrier Route. When both of these are done, the cost coverage for Commercial Standard Flats is found to be 109.57 percent.

III. Even If Products Were Suitably Defined, and Section 3622(c)(2) Were Taken to Refer to Them, It Is Far from Clear that This Section of Title 39 Requires Specific Rate-Adjustment Steps to Bring the Indicated Cost Coverages Up to at Least 100 Percent.

If a lengthy future period is the focus, we agree that if a product's suitably-defined incremental cost is higher than its suitably-defined incremental revenue,

[4] Of Regular Flats, 16.70 percent are Nonprofit. Of Carrier Route pieces, 5.82 percent are Nonprofit. The ratio is almost three to one.

the Postal Service's bottom line would be improved by dropping the product.[5] The incremental revenue for this test, and correspondingly the incremental cost, would have to be the total change in revenues (costs) brought about by dropping the product, and thus would have to include all associated reductions (or increases) in the revenues (costs) of products other than the product in question.[6]

For example, the incremental revenue caused by dropping Product 1 would have to include any associated changes in the revenues of Products 2, 3, … ,n. Similarly, the incremental cost would have to include the changes in cost brought about by the 2-n changes. Information of this kind is not available. Certainly the attributable costs referred to in (c)(2) are not designed to allow this kind of test. Therefore, it is clear that (c)(2), however applied, is not aimed at questions of whether a product should be dropped, however interesting such questions might be.

Further, within the framework of a cap for a class of mail with more than one (c)(2) category, (c)(2) is not aimed at any net-income improvements that might result from fixing any shortfall. ACMA noted this phenomenon in its reply comments in Docket No. R2010-4 (pp. 3-5). The workings are reasonably simple. If a shortfall in Category 1 is fixed by raising the rates for Category 1 and lowering them for Categories 2 and 3, staying within a cap, the net effect

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5 This sentence assumes that a decision to drop a product is not accompanied jointly by a step to drop other products or to add new products. These kinds of business decisions are clearly complex. They are often part of formulating a business model.

6 This is a different measure of incremental cost from the narrow one that has been discussed in recent years in postal rate proceedings. In the literature it is sometimes associated with what is called the burden test.

depends on the various elasticities (own-price and cross-price) and would in all cases be no more than a small fraction of the shortfall at issue. It is obvious, then, that (c)(2) does not highlight money that is available to improve the Postal Service's net income position.

This leaves the question of what section (c)(2) *does* refer to, and of its role in the regulatory scheme. Section (c)(2) refers to a price floor for "each class or type of mail service." In a discussion of worksharing (Order No. 536), the Commission referred to this phrase as "broad" (p. 26) and then said "there is nothing in section 3622 … that supports the Postal Service's theory that the PAEA contemplated regulation of market dominant prices primarily at the product level" (p. 27). Further along, the Commission said that "[i]t is not plausible to contend that despite this broad language, the attributable cost floor applies at the product level and no higher because the only compliance tool that section 3652(a) provides is data reported at the product level" (p. 32, footnote omitted).

Consistent with its position that no parts of title 39 "use the term 'product' in defining pricing standards" (*Ibid*., p. 25, footnote omitted), we believe the Commission could with equivalent perspective have said: It is not plausible to contend that despite this broad language, the attributable cost floor applies at the product level and no higher, because title 39 generally does not use the term *product* in defining pricing standards.

If section (c)(2) does not refer to products, however defined, then what is the role of (c)(2)? The Commission answers this question as well, in the same Order (pp. 35-36):

> It is important to recognize that the **quantitative** standards discussed above [the cap, the workshare constraints, and the 60-percent for Nonprofit Standard] are different in kind from the **qualitative** rate and classification standards contained in sections 3622(b) and (c). The PAEA characterizes the **quantitative** standards as "requirements." It frames each in objective terms, in its own self-contained section, where all allowable exceptions are comprehensively itemized. In contrast, the PAEA frames the **qualitative** standards in discretionary terms. (fn. 26: The preamble to section 3622(c) requires that the modern system of ratemaking take all of the list factors "into account.") They are presented as a group and the application of each is conditioned upon the need to recognize and reflect the others. (fn. 27: The preamble to section 3622(b) requires that under the modern system of ratemaking, each qualitative objective "be applied in conjunction with the others.")

Emphasis added. We believe it is clear that the Postal Service has considered section (c)(2) and that it has applied it "in conjunction with the others." No evidence is found here that the current rates are out of compliance with the ratemaking guidance in title 39.

IV. The Costs Available Are Not Robust Enough to Allow Valid Conclusions Concerning the Cost Coverage of Flats.

In our reply comments in Docket No. R2010-4 (pp. 5-13), we explained that resulting costs cannot be viewed as valid when the assumptions underlying them are not met. In particular, we explained that the IOCS cannot be used to estimate volume variable (causal) costs unless the pool of costs being analyzed is 100 percent variable with volume. That is, a 10 percent increase (decrease) in volume must lead to (cause) a 10 percent increase (decrease) in cost. We went on to draw on current Postal Service statements to show that this assumption is not likely met. The most important reason it is not met is excess capacity, often caused, as undoubtedly in part here, by the difficulty of reining in costs when volumes decline.

One approach to dealing with excess capacity is to imagine tightening the operation until it is efficient, and then asking the variability question. If the workload could be handled with 20 percent less labor, then 20 percent of the costs could be removed and the remainder could be allocated with tallies from the IOCS. This would give a cost equivalent to that which would exist in a tight operation, which would be fair to the mailers involved. It would also get away from the fact that the true marginal cost in an operation with excess capacity is zero. One reason zero might not be considered an acceptable answer is that it is temporary, hopefully.

As further evidence that the required assumptions are not met, consider city carrier costs. USPS-FY10-19 shows the direct labor cost of casing Regular Flats by city carriers, *direct* meaning no piggyback costs and no burdening of indirect costs.[7] To go with this cost, the same library reference provides the volume cased by the same carriers.[8] If the cost is divided by the volume, a unit cost of 8.28 cents is obtained. A similar calculation for Carrier Route flats, using information from the same sources, yields a unit cost of 3.97 cents. The difference between these two unit costs is 4.31 cents, implying that it takes a carrier about 3.8 seconds longer to case a Regular Flat than to case a Carrier Route flat.[9]

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7 See USPS-FY10-19, UDCmodel10.xls, tab 11.SummaryBY, cell E83.

8 See USPS-FY10-19, UDCmodel10.xls, tab 9.DeliveryVols, cell H32.

9 The USPS National Payroll Hours Summary Report for Pay Period 9 (April 10-23, 2010) shows a consolidated average wage for city carriers of $40.82/hour. This implies about 0.88 seconds per cent.

The difference between casing Regular Flats and casing Carrier Route flats is that Carrier Route flats are required to be in line-of-travel (LOT); therefore they are cased faster. In Docket No. R2000-1 (LR-I-307), the Postal Service provided an analysis of the speed at which city carriers case mail that is LOT sequenced. It indicated that LOT sequencing saves about 0.74 cents per *RPW* piece, at FY 2001 cost levels. If this is inflated to FY2010 cost levels, the indication is that LOT sequencing saves about 1.09 cents/piece.[10] Expressed per *city carrier* piece, the savings becomes 1.60 cents per piece.[11]

Relative to Carrier Route, then, Regular Flats should cost about 5.67 cents (3.97 + 1.60). Instead, the figure underlying the CRA is 8.28 cents, noted above. The difference is an extra 2.71 cents. We believe this shows that the costs of casing Regular Flats are too high, by a considerable amount. Applying the piggyback factor of 1.316 to this would increase the discrepancy more, as would the burdening of indirect costs.[12]

Based on this analysis, it appears that there is excess capacity in the carrier casing operation, and that considerable tightening is still needed. If the data are accurate, then we believe the Postal Service has made progress in this area but that more is needed. If the costs in the CRA were corrected accordingly, the

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[10] The USPS National Payroll Hours Summary Report for Accounting Period 8 (March 25 – April 21, 2000) shows a consolidated average wage for city carriers of $27.76/hour. The 1.09-cent figure in the text equals 0.74 cents time the ratio of $40.82 to $27.76.

[11] In FY 2010, the ratio of RPW pieces to city carrier pieces was about 1.46, for both Regular Flats and Carrier Route flats. See UDCmodel10.xls, tabs 11.SummaryBY and 9.DeliveryVols.

[12] The piggyback factors are shown in tab BYPBack of UDCInputs10.xls, USPS-FY10-19.

indicated cost coverage for Regular Flats would be significantly higher. Alternatively, it may be that this relation indicates that the current cost system is not sufficiently refined to reflect current postal operations or volume loading. If that is the case, then we believe further attention to improving the accuracy of the costs is warranted. It could be some of both are required.

We do not see a practical way to make adjustments to the CRA. However, the user of costs should bear the burden of showing that the assumptions underlying them are met. If they are not met, the costs are invalid. We do not believe the burden has been borne. In the instant proceeding, the costs are not robust enough to support a finding of noncompliance, no matter how the products are defined. Neither is there a basis for advocating large rate increases for the flats involved.

V. The "Bigger Picture" Issues Must Be Considered Also.

Given the intense focus on data, precedent, measures, and operationally driven regulations, some critics believe the larger picture is missed. Leaving aside the merits of this position, it is clear that policymakers attempt to cover both "the forest and the trees." From this perspective, ACMA offers a few observations that we urge both the Postal Service and the Commission to continue to consider in evaluating the "underwater" status of some catalog mail products.

1. Catalogs enhance the value of mail to the recipient.

2. Catalogs provide significant social and cultural benefits to America.[13]

3. Catalog companies originate considerable mail in a variety of products, many of which are considered clearly profitable in today's understanding of product profitability and cost coverage.[14]

4. The catalog industry remains financially troubled.[15]

When faced with uncertain cost coverage status in a dynamic cost and volume environment that clearly has excess capacity, and a variety of compelling social and industry benefit contributions from catalog volumes, the gentle treatment for catalogs in rate adjustments under the PAEA is prudent and appropriate. The job ahead is to sharpen our understanding of cost behavior in the current environment, drive down the cost of handling flat mail, realize the benefits of automation, and find ways of stimulating additional catalog volumes in both flats and other categories.

VI. Conclusion.

Since the late 1980s, the costs of processing flats have been rising inordinately, despite improved automation and preparation. The Periodicals

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[13] *See* "The American Catalog Experience: *Catalog Marketing's Social Importance to American Consumers & Culture," first published in 2010 and available at http://bit.ly/aCVXpE*

[14] Response to POIR No. 3, Q. 6 and 7, Docket No. R2010-4, August 9, 2010.

[15] A review of the industry's trade publications is replete with articles on downsizings, layoffs, reorganizations, withdrawal from catalog operations and forced sales of entire companies. The number of articles is so large that it is impossible to efficiently cite them here, but many can be found under the "In The News" section of the ACMA website, www.catalogmailers.org. Another large catalog mailer filed for bankruptcy protection this month, a persistent and continuing pattern of economic carnage in the catalog sector that has continued since 2007.

mailers have shown this clearly. And despite reductions in cost coverage, flats rates have reached a point that brings into question the viability of catalogs.

In Docket No. R2010-4, the Postal Service presented a Flats Strategy. That document highlights that flats are receiving attention, from stem to stern. Our interest is in working with the Postal Service to tighten operations around a streamlined processing stream, to the end of controlling rates. The option of business as usual does not exist.

We also believe that while the Commission has expressed concern over this situation, it has also indicated that it does not expect any Draconian changes that imperil an entire industry. One might conclude that the Commission understands the multifaceted issues at play and is content to see the parties resolve these issues, understanding the time required to find effective resolution given the complexity involved.

The matter at issue in the instant docket is whether the results for FY 2010 show noncompliance with title 39. Except that numerous sections of it point to increased efficiency and low costs, we contend that the results do not show noncompliance. The Postal Service should be given continued freedom to make progress on its Flats Strategy and to manage the rates for Standard flats.

Focusing largely on the cost coverage results reported in the CRA for Standard flats products, we have laid out a number of factors supporting our position. In short, they are as follows:

> 1. A compelling case can be made, particularly for cost coverage purposes, that the products as currently defined are stacked against Commercial catalogs and mask their contribution to the Postal Service. At the least, the Nonprofit categories should be separate products, and

Regular and Carrier Route should be combined. If this is done, the cost coverage of Standard flats, exclusive of High-Density and Saturation, is estimated to be 109.57 percent.

2. We do not believe that section 3622(c)(2) of title 39 should be read to constrain the cost coverages of *products*, which have thus far been defined narrowly. This section uses broad terms and does not refer to products. The Commission has explained that it is one among a number of qualitative objectives and factors that should be considered in setting rates. The Postal Service has considered these objectives and factors.

3. The costs available for Standard flats cannot be taken as valid, because the assumptions required to make them valid are not met. This is a systemic problem, made worse by the current conditions of excess capacity. To this point, we provide support for concluding that certain of the city carrier costs are much higher than they should be.

Respectfully submitted,
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