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

ANNUAL COMPLIANCE REPORT : Docket No. ACR2010

INITIAL COMMENTS OF L.L.BEAN, INC.

(February 2, 2011)

L.L.Bean, Inc. hereby submits its initial comments addressing the Postal Service's Annual Compliance Report filed on December 29, 2010. Founded in 1912, L.L.Bean is one of the oldest catalog distribution companies in America, for nearly a century using the mails to reach customers with its catalogs as a cornerstone of its growth. L.L.Bean is a substantial user of Standard Mail, mailing its catalogs predominantly at Carrier Route postal rates and also at Standard Mail Flat and higher-density rates.

Our comments focus on rates for Standard Mail Flats, which the Postal Service's ACR filing indicates fell short of covering attributable costs by $616 million in FY 2010. This issue is of timely significance in light of the Postal Service's recent filing in Docket R2011-2, proposing a below-average rate increase at less than half the CPI inflation index for this below-cost product.

OVERVIEW

The catalog marketplace, as with most mail products and even major business sectors of the economy, has changed significantly over recent years. Since the turn of the century, the internet has played a major role in transforming the market. In some cases it competes with or has replaced catalogs as the primary means for reaching customers, displaying products, taking orders, and driving sales; while in other cases it has created an enhanced role for printed catalogs as the vehicle to drive existing and prospective customers to online catalog web sites, adding to the range of choices and ease of transactions for buyers and enhancing overall sales and profitability for sellers. L.L.Bean firmly believes that catalogs will continue to serve a useful and valuable function for consumers by providing a hardcopy presence, immediacy, and shelf-life that can never be duplicated by the internet. The challenge for individual catalogers and the industry as a whole is to develop strategies that adapt and meld these complementary media to maximize profitability.

The catalog industry has also been adversely affected by the recession, particularly due to cutbacks in consumer spending. How long that effect may last, the nature of the recovery, and the longer-term impact on individual catalogers and the catalog industry as a whole are, of course, unknown. Current economic signs suggest that the worst may be behind us, but the recovery will not likely be quick or even.

L.L.Bean believes, however, that the biggest risk to catalogers – and to all other businesses that depend on the mail – is the long-term viability of the postal system to provide reasonable service at affordable rates. Much of what ails the Postal Service – such as its oppressive employee-benefit funding obligations – is indeed beyond its control and will require Congressional action to fix. Others – such as restructuring of its network and operations – will require time and capital, both in short supply.

These challenges make it that much more important that the Postal Service rationalize its pricing (1) to mitigate losses on below-cost products with the goal of eventually generating a reasonable contribution to institutional costs; and, (2) equally important, to encourage the growth of profitable products. Contrary to its claims, the

Postal Service is not powerless in this regard; the Postal Accountability and Enhancement Act (PAEA) does, indeed, afford it the rate-cap pricing flexibility within Standard Mail to bring prices for below-cost products more in line with costs.

L.L.Bean recognizes the need for gradualism. We do not advocate that prices for below-cost products be raised precipitously to cost-covering or full-contribution levels overnight. Nevertheless, the Postal Service must begin moving in that direction now, or risk creating self-perpetuating and increasing losses that cannot be sustained, and that will require at some not-too-distant point substantial rate corrections that may generate an even more disruptive "rate shock" for catalogers than that which it professes to want to avoid now.

I. <u>THE *DÉJÀ VU* HISTORY OF BELOW-COST RATES FOR STANDARD FLATS</u>.

This is the Commission's fourth annual compliance review under the PAEA. In the first proceeding, Docket ACR2007, the Commission did not address rates for Standard Flats due to lack of separate cost data. Since then, the issue of below-cost rates for Standard Flats has been raised in each of the last three ACR proceedings and in four rate proceedings, most recently the new rate-cap filing in Docket R2011-2. A review of the history of this issue is enlightening because it has a direct bearing on the need to start taking corrective action now.

<u>Docket ACR2008</u>. In its second compliance review, Docket ACR2008, the Commission found that Standard Mail Flats had generated an FY 2008 loss of $218 million, coincident with a below-average price increase:

> "Below average price increases were adopted for the Standard Flats product [in 2008]. The Flats product subsequently ended the year with a $218 million loss whereas in previous years it had been profitable." PRC ACR2008 at 5.

The Commission noted that: "For the planned May 2009 rate increases, the Postal Service *continues the policy of below average increases for Standard Flats mail*." *Id*. It therefore cautioned the Postal Service that:

> "In the future, the Postal Service should either reduce the costs of handling flats *or develop a pricing strategy which increases prices sufficiently to recover costs within a reasonable timeframe*. The justification for the lower-than-average pricing increases provided by the Postal Service may be applicable for a limited period of time. The Postal Service should provide a long term strategy to address *continued pricing preferences* for a product line that lost $218 million." *Id*. (emphasis added).

The Commission found that, to cover costs, rates for Standard Flats would have to be increased by 6.2%. *Id*. at 61.

Docket ACR2009. In its last annual compliance determination, the Commission found that the losses from Standard Mail Flats had almost tripled to $616 million, for a product "which, for the second year in a row, had a below average price increase in May 2009." PRC ACR2009 at 6. Referring to "the chronic under pricing of Standard Mail Flats" (*id*. at 31), the Commission underscored the Postal Service's failure to take action to close the gap, stating that:

> "When the Postal Service adjusted prices for market dominant products in May 2009, it increased prices for Standard Mail Flats by 2.294 percent, less than the class average of 3.759 percent. This below average increase did not keep pace with the increase in unit attributable cost for flats, which grew by 15 percent from FY 2008 to FY 2009." *Id*. at 86

The Commission calculated that "[f]or flats to have covered FY 2009 costs, the rates of flats would have needed to be 21 percent higher, ignoring elasticity effects." *Id*.

With respect to the question of compliance generally, the Commission noted that its takes into account actions that the Postal Service may be undertaking to correct identified deficiencies:

> "In prior ACDs, the Commission noted that several products failed to satisfy one or more factor, objective, or policy of the PAEA. In those instances, the Commission found it unnecessary to formally declare that rates for certain products were noncompliant because, almost universally, the Postal Service had already taken steps to address the situation, *usually in the form of prospective rate increases*." *Id*. at 16 (emphasis added).

However, in light of the Postal Service's apparent failure to move in that direction, the Commission expressed its concerns by directing the Postal Service to present a plan to rectify the below-cost rates:

> "The Commission is requiring the Postal Service to develop and present a plan explaining how the Postal Service expects to increase cost coverage on these products to a level where each *makes a reasonable contribution* to institutional cost." *Id*. at 64 (emphasis added).

Docket R2010-4 Exigency Case. In its July 2010 exigency rate filing, the Postal Service proposed rate increases averaging 5.6% both systemwide and for Standard Mail. However, it yet again proposed a below-average 5.1% increase for Standard Flats. The Postal Service rationalized this below-average increase on the ground that "for Standard Mail Flats, a cautious approach is warranted because the catalog industry, which depends heavily on Standard Mail Flats, is in a delicate financial position."

> "Clearly, we cannot continue to price Standard Mail Flats below costs for an extended period of time; however, it is prudent to take a judicious step in this price increase and to move gradually towards the goal of full cost coverage. Consequently, the Postal Service is proposing that the Flats product be given a 5.1 percent increase in this price adjustment. The Postal Service may have to adjust Standard Mail Flats prices at above average rates at some point, but now is not the time."

See Statement of James Kiefer, Docket R2010-4 at 28-30. The Commission, because it denied the Postal Service's exigency proposal on other grounds, did not need to address the Postal Service's justifications for individual rates.

II. <u>THE POSTAL SERVICE'S MOST RECENT EXCUSE FOR NOT RECTIFYING BELOW-COST FLATS RATES IS MISDIRECTED</u>.

In its current annual compliance report in this docket, the Postal Service referred to its "plan" presented in the exigency case for bringing Standard Flats up to a full cost coverage, stating that:

> "[T]he Postal Service presented a detailed plan for capturing efficiencies for Standard Mail Flats that, *when combined with consecutive above average price increases*, would result in full attributable cost coverage." USPS ACR2010 at 8 (emphasis added).

Now, however, the Postal Service claims that, because the Commission denied its exigency rate increase, its plan for bringing Standard Mail Flats up to full coverage "is no longer workable." *Id*. Elaborating, it contends that "even if the Postal Service achieves the most optimistic efficiency enhancements possible, it does not foresee that such enhancements, combined with annual rate increases within the statutory price cap, will result in … Standard Mail Flats … reaching full cost coverage." *Id*.

Then, tossing its hands in the air, the Postal Service makes the bold assertion that it is powerless to correct this cost coverage shortfall:

> "In other words, *it seems impossible* for the Postal Service, acting with the powers granted to it and within the constraints imposed by title 39, to present any realistic plan that would result in these products fully covering their attributable costs, much less making any contributions to institutional costs. *Id*. at 8-9 (emphasis added).

This whole tactic of, first, blaming the Commission for the problem, then blaming the PAEA, and finally abdicating responsibility, is not only mystifying but (at least with respect to Standard Mail Flats) wrong. Far from being "impossible," under the rate-cap scheme of the PAEA, the Postal Service has substantial pricing flexibility within Standard Mail to adjust prices for below-cost products in a manner that would close the cost-gap, so long as the average increase for the class as a whole is within the cap. The problem lies not with the Commission nor the statute, but with the Postal Service.

III. THE POSTAL SERVICE'S DOCKET R2011-2 RATE CAP INCREASE PROPOSAL UNDERSCORES THE NEED FOR CORRECTIVE ACTION.

The Postal Service's claim of powerlessness in its annual compliance report was a harbinger of what was to come just fifteen days later. On January 13, 2011, the Postal Service filed a "Notice of Price Adjustment" in Docket R2011-2. Although filed in a separate docket from this ACR proceeding, that proposed price-cap rate adjustment is highly relevant to the Commission's review here, and should be taken into account in the Commission's assessment of compliance.[1]

For Standard Mail, the Postal Service proposes an average rate increase of 1.739%, in line with the increases for other classes and just within the 1.741% allowable rate cap. However, for the Standard Flats product that is currently priced well below costs, the Postal Service once again proposes a *well-below-average* increase of only 0.835%, which is *less than half of the CPI Inflation index.* The Postal Service's proposal goes in the wrong direction. A below-inflation price increase for a below-cost product

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[1] Although compliance reviews focus on the current rates for the year under review, the Commission, in assessing noncompliance, can and has taken into account steps the Postal Service is taking "to address the situation," including "prospective rate increases." *See* PRC Compliance Determination, Docket ACR2009, at 16, quoted above. Here, the Postal Service's prospective increases will only make matters worse, widening the cost-coverage gap.

will assuredly widen the gap, making it that much more difficult to ever bring prices up to costs, much less to make a reasonable contribution to institutional costs.

This surprising proposal was foreshadowed by the Postal Service's claim in its ACR filing just two weeks earlier that its plan for bringing Flats rates up to full cost was "no longer workable" (blaming the Commission's exigency denial), and that achieving such a goal was therefore "impossible" (blaming, in addition, the constraints imposed by the PAEA). Those excuses are undermined by the Postal Service's own statements and actions, as described below:

First, in its exigency filing last July, the Postal Service presented a plan for capturing efficiencies for Standard Flat "that, *when combined with consecutive above average price increases*, would result in full attributable cost coverage." *See* USPS ACR2010 at 8 (emphasis added). Yet six months later, it is proposing in Docket 2011-2 to go in the opposite direction – with a *below-average* increase less than half of the CPI inflation index. This abandonment of its plan for consecutive above-average price increases is neither explained nor justified in either its ACR2010 filing or its R2011-2 filing, and it certainly cannot be blamed on the Commission or the PAEA.

Second, its justification for this latest below-average increase for Flats is likewise inconsistent with its exigency justification. Here, it merely repeats almost verbatim the justification it presented in its exigency rate filing last July, centered around the identical theme that "for Standard Mail Flats, a cautious approach is warranted because the catalog industry, which depends heavily on Standard Mail Flats, is in a delicate financial position." *Compare* Statement of James Kiefer, Docket R2010-4 at 28-30 *with* Notice of Rate Adjustment, Docket R2011-2 at 16-17. The only fundamental difference is that in the exigency case, it was defending a proposed below-average *5.1% increase* for Flats, whereas here it is proposing a *mere 0.8% increase*. If the Postal Service believed last July that the industry could have managed a 5.1% increase, then why – just six months later and with a stronger economy – does the Postal Service now believe a mere 0.835% increase is the most that Standard Flats can afford?

Third, far from undermining the Postal Service's "plan" for "consecutive above average price increases" as a means of narrowing the cost gap, the Commission's denial of its exigency request – by any measure of common sense – *intensifies* the necessity for such above-average increases.

Fourth, unlike the situation with Periodicals, there is no statutory rate-cap constraint that bars the Postal Service from narrowing the Standard Flats cost-gap through an above-average increase, much less a constraint that warrants a below-average increase.[2]

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[2] Surprisingly, the Postal Service suggests that it can get around this below-cost problem by regrouping the mail – throwing profitable Carrier Route mail into a pot with unprofitable Standard Flats so that, in the aggregate, the new grouping will appear profitable. USPS ACR2010 at 31, n. 10. Yet that ploy would not change any costs or make the current mail in Standard Flats suddenly profitable. It would merely disguise the problem so as to perpetuate the cross subsidy, at the expense of profitable Standard Mail products.

Moreover, such a re-grouping would substantially *lessen* the Postal Service's pricing flexibility by constraining these rates to worksharing cost differentials. It would, even more directly, cause Carrier Route to shoulder the burden of cross-subsidizing below-cost Flats – leading to higher than necessary rates for the Carrier Route product that has been successful and consistently profitable for the Postal Service. As it stands, rates for Carrier Route mail have increased 7.4% over the last two rate-cap adjustments, an above-average increase more than double the 3.2% increase for below-cost Flats. The pending proposal would continue that trend, with a cumulative 8.9% Carrier Route increase compared to only 4.0% for Flats.

In sum, the Postal Service's "impossibility" argument is entirely misdirected. It is the Postal Service's *own* actions in refusing to move in the direction of closing the gap that will make attainment of that goal impossible.

IV. <u>THE COMMISSION MUST TAKE ACTION TO RECTIFY THE POSTAL SERVICE'S ABDICATION</u>.

After declaring itself powerless to close the below-cost gap, the Postal Service in its ACR filing invited the Commission to consider taking remedial action *sua sponte*, stating that:

> "Therefore, it seems most appropriate for the Commission to determine whether it can exercise any of its powers to remedy the cost coverage shortfall of the products in question." USPS ACR2010 at 9.

The Postal Service, of course, is the one that should and could have taken remedial action with respect to Standard Flats. In light of its failure to do so – indeed, moving in the opposite direction – we concur that the Commission must now exercise its authority to remedy the shortfall and direct that rates be moved in the direction of full cost coverage.

The Postal Service, referring to Commission Order 536 in Docket RM2009-3 (Workshare Order) questions whether the Commission's statement that the product level is not the appropriate level for applying pricing standards means that a cost-coverage shortfall is "acceptable at the product level" so long as the class as a whole covers attributable costs. USPS ACR2010 at 9-10. Under this interpretation, the Postal Service would supposedly be free to price any market-dominant product well below cost indefinitely, unfettered of any review or remedial action, so long as it is within a class that covers costs. But under the PAEA rate cap mechanism where the Postal Service chooses to exercise its full cap rate-adjustment authority (as is it's intent, stated in its

January 13th Schedule of Regular and Predictable Price Changes), the maintenance of one product at below-cost rates necessarily means higher-than-otherwise-necessary rate increases for other above-cost products collectively in the class. This would certainly seem an unfair or inequitable apportionment of costs among Standard mail users under 39 U.S.C. section 101(d), favoring the below-cost product to the detriment of others in the class. Order 536 clearly contemplates that such issues be considered by the Commission in compliance determinations. *See* Order 536 at 17.

The pattern could not be clearer or more puzzling. In seven straight proceedings, the Postal Service has acknowledged that Standard Flats are priced below costs, with the gap widening. Yet in four straight rate proceedings, the Postal Service has nevertheless proposed and/or implemented less-than-average rate increases for Flats – due to the "delicate financial condition" of the catalog industry.[3] But, it has proposed and implemented greater-than-average increases for Carrier Route, another product that is used extensively by that same catalog industry – this despite the fact that Carrier Route currently has a healthy 142% cost coverage compared to an anemic 82% coverage for Flats.[4] If the Commission does not act now, it will find itself next year at this time looking at a grimmer picture with a widening cost gap, and likely with a continuing plea to again withhold "catch-up" rate increases.

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[3] *See* Dockets ACR2008; ACR2009; ACR2010; R2008-1 (USPS Notice of Price Adjustment at 15); R2009-2 (USPS Notice of Price Adjustment at 14-15); R2010-4, and R2011-2 (USPS Notice of Price Adjustment at 16-17).

[4] USPS ACR2010 at 23. The Postal Service's concern about the large increase for Flats in Docket R2006-1 overlooks that Carrier Route flats also took a hit in that case. Since FY 2005, Carrier Route flat rates will have increased more than 25%, greater than the increase for 5-Digit Flats, while Carrier Route flat volumes have fallen nearly 30 percent. Source: Billing Determinants, Dockets R2006-1 and ACR2010.

CONCLUSION

On its current course, the Postal Service seems intent on ensuring a perpetuation of below-cost rates for Standard Flats, evidenced by its feigned powerlessness to close the gap and by its own pricing actions that will only widen it. No mailer wants to see its rates increased, even if below costs. But at some point in the future, this will become unsustainable. Then, mailers will face an even greater rate shock. Instead of postponing the day of reckoning, the process of transitioning those rates to full cost coverage and a reasonable contribution should begin now, allowing a graduated and predictable phasing toward that objective.

Respectfully submitted,

/s/

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