Postal Regulatory Commission
Submitted 2/11/2011 3:37:13 PM
Filing ID: 71921
Accepted 2/11/2011

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Estimating Volume Changes from Pricing Incentive Programs	))	Docket No. RM2010-9

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
REPLY COMMENTS**
(February 11, 2011)

The Commission instituted this docket on June 8, 2010, to consider the methodologies used to estimate volume changes as the result of the various Postal Service pricing incentives. Initial comments were filed on August 16, 2010, but the deadline for reply comments was suspended by Order No. 516 pending Postal Service responses to a Chairman's Information Request and a Commission Information Request. Order No. 646 set February 11, 2011, as the deadline for reply comments. Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereafter "Valpak"), hereby submit these joint Reply Comments.

BACKGROUND

Under certain circumstances, the Postal Service has selectively reduced rates in an effort to spur additional volume, principally through special sales.[1] Evaluation of such incentives requires agreement on how to analyze any resulting change in volume. The challenge is to develop a methodology that distinguishes between volume entered in response

[1] Docket No. R2009-3, Standard Mail Incentive Program, the so-called "summer sale," was the first broad-based, short-term incentive program. It resulted in rebates of $67.2 million on an eligible volume of 988 million pieces. Docket No. R2009-5, First-Class Mail Incentive Program, a "fall sale," was the second broad-based, short-term incentive program. Docket No. R2010-3, Standard Mail Incentive Program, was the third broad-based, short-term incentive program, and the second "summer sale."

to the price reduction and "anyhow volume" that would have been sent at the full rate in the absence of the special rate reduction.

Various parties have proposed different ways to isolate anyhow volume arising from a price incentive, and most initial comments in this docket have focused on that threshold issue. But once a method for making that determination is adopted, **a second issue, equally important,** arises: namely, evaluating the net contribution achieved from the pricing incentive. Did the increase volume (and revenue) attributed to the rate incentive **add to profits** — and if so, by how much? The underlying purpose of price incentives should never be just volume, but profitable volume — that is, an increase in profitability and contribution to overhead expense over what they otherwise would have been. Therefore, additional **revenue** induced by the price change must be offset by the **additional cost** incurred in processing and delivering the extra mail attracted by the incentive.[2]

COMMENTS

1. SMC/VDM and PR Initial Comments.

The initial comments of (i) the Saturation Mailers Coalition and Valassis Direct Mail, Inc., ("SMC/VDM") and (ii) the Public Representative ("PR") mention the issue of estimating incremental cost when determining incremental profit from price incentive programs.

[2] *See*, *e.g.*, Public Representative Initial Comments, p. 4 ("In the case of excess capacity, due to either secular or seasonal causes, it is important to develop the marginal cost of the incentivized pieces through econometric models similar to those used in the ACR process.").

SMC/VDM touch on the issue of incremental cost in the context of the Postal Service's various sales programs. The portion of SMC/VDM's Initial Comments most relevant to cost issues states that:

> As the Commission has noted previously, a discount will always generate more volume than otherwise, all else equal, and if the revenue from the additional volume is greater than the **additional cost**, such discount **can lead** to greater contribution to institutional costs. Any time the **additional revenue** exceeds the additional cost, there is an economic efficiency gain. That gain is even greater **if the additional volume takes advantage of "excess capacity"** in the system **that would go unused without the discounts.** [SMC/VDM Initial Comments, p. 2 (emphasis added).]

SMC/VDM thus broach the topic of additional cost as it relates to excess capacity, but do not expound on its implications.

The PR raises the issue of "excess capacity" in somewhat more detail:

> In most of the Pricing Incentive Programs offered by the Postal Service … the Postal Service has claimed **reduced marginal cost** on incentivized pieces. Accurately capturing this reduced cost is **essential to estimating the value of the incentive.** In the case of **excess capacity**, due to either secular or seasonal causes, it is important to develop the marginal cost of the incentivized pieces through econometric models similar to those used in the ACR process. In response to R2009-3 CHIR No.1, the Postal Service stated that, "there is and will continue to be material excess capacity in city carrier street activities and operational experts are confident the additional volume caused by the Standard Mail Volume Incentive Program can be handled without incurring additional city carrier street time costs." This **qualitative analysis** forces an **inaccurate** estimation of the cost function and will lead to a **less accurate estimation of incremental profits.** The information provided during the ACR process contains the best current estimates of the Postal Service's incremental costs. The Rulemaking process allows the Postal Service to propose adjustments to costing methods. If the ACR methods are **unsuitable for the purpose of estimating incremental costs for**

> **incentivized volume,** proposals should have to follow the Rulemaking process to ensure that they meet the necessary economic rigor (the 90 day Rate Case process does not allow for substantial review of new costing proposals).... If there is an economically valid reason to believe that costs vary by mailer (or by season), the Postal Service can (and should) produce **a study that proposes more appropriate costs.** Without such a study, an appropriate proxy for the supplier cost function is the unit cost developed for the worksharing models, and provided for "special classifications" in ACR2009-USPS-LR27. [Initial Comments of the Public Representative, pp. 4-5 (emphasis added).]

The PR notes that, to date, all analysis, or "evidence," concerning excess capacity has been of a **qualitative** nature, recommending that adjustments to costs for analytic purposes (*e.g.*, for determining profitability of incentive programs) should be the subject of a separate study and rulemaking. Valpak agrees that the Commission should address the subject of excess capacity and related cost issues at its earliest opportunity — hopefully before the Postal Service files a request for yet another price incentive program.

2. Issues Related to Excess Capacity.

It would seem that true excess capacity rarely exists. When it does exist, the **marginal cost** of additional volume is said to be less than **attributable cost**. Excess capacity thus gives rise to the concept of **short-run marginal cost** that differ significantly from **longer-run attributable cost**. In evaluating incentive programs, the Postal Service proposes to estimate profitability, or value of the pricing incentive program, by subtracting only the short-run marginal cost of additional volume from the revenue of that incremental volume obtained through the price incentives.

Excess capacity clearly is a changing, highly variable phenomenon, depending on a variety of circumstances. In the first summer sale docket (Docket No. R2009-3), the Postal

Service believed it had excess capacity in the delivery force, while in the second summer sale docket (Docket No. R2010-3), it stated that excess capacity in delivery no longer existed. The bulk of the excess capacity claimed by the Postal Service has been related primarily to the labor force, and much less to capacity of its fixed investment in plant and automation equipment. Since labor accounts for about 80 percent of total cost, it is appropriate that excess labor capacity be the focus of concern. At the same time, excess labor capacity is not wanted and, when found, is mitigated through attrition, layoffs, and re-assignment.

This important issue has received little attention. For example, in none of the incentive dockets to date have questions such as those shown below been addressed by the Postal Service or the Commission.

a. The Postal Service never estimated **how much excess capacity** existed at the time the incentive proposal was submitted, hence no estimate was made concerning **how much additional volume** would exhaust such excess capacity.

b. The Postal Service did not state **how long** the excess capacity was expected to exist. Nor was the **termination date** of any incentive program tied to an estimate of when excess capacity no longer would be available to process additional volume submitted under the incentive program.

c. It is not known **how** the Postal Service **determines** that some labor "is excess." There have been press reports of clerks and mailhandlers being assigned to special "resource rooms" to sit and do nothing, sometimes for the entire day.[3]

---

[3] *See, e.g.,* "Paid to do nothing: 11,000-plus postal workers idle at any given time," Gregg Carlstrom, *Federal Times* (Sept. 7, 2009) http://www.federaltimes.com/article/

Any such workers clearly represent “excess capacity” during those hours each day when they are idle. Does the Postal Service data system record the number of hours during which workers are assigned to do nothing each day? And how does the Postal Service estimate the number of workers likely to stay in such a “semi-employed” capacity? Does the Postal Service know the length of time that each one is expected to be in such less-than-fully-utilized capacity? Are any workers not assigned to a “resource room” also considered excess?[4] If so, how does the Postal Service determine the number who are excess among those not in the “resource room”? Does not the Postal Service aggressively respond to the problem of excess labor capacity with re-assignment, retirement incentives, etc., making it the object of management efforts to reduce it as quickly as it is identified?

d. Are piggybacking concepts applicable to excess labor capacity? For instance, if it is estimated that 5 percent of clerks and mailhandlers (cost segment 3) are excess, does it follow that 5 percent of superintendents (cost segment 2) also are excess, regardless of whether such supervisors are assigned to sit in the “resource room”?

20090907/DEPARTMENTS02/909070306/.

[4] Periodicals mailers have claimed for years that the Postal Service often has mail clerks sort publications manually in order to keep them busy, and out of the “resource room.” Halstein Stralberg uses the term “automation refugees” to describe such workers. *See*, *e.g.*, Docket No. R2010-4, Time Warner Reply Comments, p. 8.

3. Issues Related to Short-run Attributable Costs.

We do not know how short-run costs are defined and quantified by the Postal Service. Over what period would short-run costs be applicable? Should the Postal Service use short-tun attributable costs over longer periods, such as a year? To what mail volume would short-run costs be applicable? CRA costs are calculated to reflect longer-run attributable costs. The existence of excess capacity (or even the claim by the Postal Service that excess capacity exists) gives rise to the assertion that short-run marginal costs are less than CRA costs. Use of short-run marginal costs for any purpose — such as ad hoc evaluation restricted to estimation of profitability — raises a host of questions not previously studied. For example, if excess capacity exists over some definable, predictable short-run period of time (*e.g.*, the summer, which typically has been a slack season for mail volume), should attribution to all products, or to the entire volume of selected products, during that period be based on an estimate of short-run marginal costs, rather than CRA costs? Before the door to this Pandora's box is opened, should we not know where it will lead?

The reliability of estimates of short-run attributable costs is open to serious question. The Postal Service, on an ex post basis, and using its own ad hoc "qualitative" methodology, has computed short-run marginal costs for Standard Mail following the 2009 and 2010 summer sales.[5] Those results are set forth in Table 1, showing that short-run marginal costs varied quite substantially from one year to the next (Table 1, columns 3 and 4). The short-run marginal cost of Saturation Letters varied by over 100 percent, and the short-run marginal cost

---

[5] The Postal Service did not submit a computation showing short-run marginal costs for the other classes of mail or other products during those periods.

of Saturation Flats and Parcels varied by almost 200 percent. Of course, these estimates are not based on any accepted methodology, because none exists. The extent to which such wide variations could reflect some change in methodology versus a change in "facts" (*e.g.*, a diminution in excess capacity) has not been explained by the Postal Service.

Table 1

Standard Mail Products
Short-Run Marginal Costs

	(1) Docket R2009-3	(2) Docket R2010-3	(3) Increase	(4) Percent Change
High Density and Saturation Letters	0.026	0.055	0.029	112.6%
High Density and Saturation Flats & Parcels	0.022	0.064	0.042	192.6%
Carrier Route	0.082	0.145	0.063	77.3%
Standard Regular Letters	0.061	0.087	0.027	44.4%
Standard Regular Flats	0.297	0.369	0.072	24.4%

Sources: (1) Docket R2009-3, FY 2009 Summer Sale Data Collection Report, spreadsheet Calc.SR Att Cost for Summer Sale.xls (filed 2/26/2010).
(2) Docket R2010-3, Summer Sale Data Collection Report, spreadsheet Cal.SR.AC.SS.FY10.CRA.xls (filed 12/29/2010).

Mailers of products significantly underwater seek to use short-run attributable costs to justify the fact their rates are subsidized by other mailers. *See*, *e.g.*, Docket No. ACR2010, Comments of Magazine Publishers of America, *et al.*, pp. 3, 15-18 ("In FY 2010, Periodicals mail covered its short-run attributable costs, which, during periods of excess capacity, are much lower than the attributable costs reported in the Cost and Revenue Analysis ('CRA')."). It seems they would prefer nothing more than to see only short-run marginal costs attributed all year, every year, even though this was not what the Postal Service had in mind in offering these costs to support the summer sale. Acceding to such desires would reduce the already low level of attribution even further, thereby increasing the amount of costs classified as institutional. As Valpak noted previously, long-run mischief seems to be the most likely result of using short-run costs for summer sales.[6]

CONCLUSION

A shift to the use of short-run marginal costs for attribution purposes would undermine 40 years of analysis of attributable costs and would eviscerate the concept that each class or type of mail service at least pay, as a minimum, the costs which it causes the Postal Service to incur. Rate setting then would become even more arbitrary, further undermining any business model that aims for a financially self-sustaining Postal Service. These costing concepts need to be explored fully by the Commission before they do damage to long established principles underlying postal pricing, and to the Postal Service itself.

Respectfully submitted,

William J. Olson
John S. Miles
Jeremiah L. Morgan
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc.,
and Valpak Dealers' Association, Inc.

6 *See* Docket No. R2010-4, Valpak Reply Comments (Sept. 2, 2010), pp. 16-19.