

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268

Annual Compliance Report, 2010

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Docket No. ACR2010

**REPLY COMMENTS OF TIME INC.
ON USPS FY 2010 ANNUAL COMPLIANCE REPORT**
(February 17, 2011)

Pursuant to Order No. 636 (issued January 4, 2011), Time Inc. hereby submits its reply comments on the United States Postal Service FY 2010 Annual Compliance Report (filed December 29, 2010) ("ACR").

These comments are in reply to Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") Initial Comments on the United States Postal Service FY 2010 Annual Compliance Report (filed February 2, 2011; corrected February 15 & 16, 2011), in particular to: (1) Valpak's assertion, Comments at 40, that "Periodicals [c]osting [h]as [b]een [f]ound [a]ccurate"; (2) Valpak's implied assertion that the Commission is authorized by § 3662(c) to order the rates of a market-dominant class to be raised above the statutory rate cap; and (3) Valpak's recommendation that "in the pending FY2010 ACD, the Commission . . . [d]irect the Postal Service to immediately increases [sic] prices for Periodicals by 16.0 percent," followed by a similar increase in the subsequent year, and its assertion that the only alternative to such an order is to conclude that "Congress incorporated a fatal flaw into PAEA," Comments at 54-55 (emphasis removed).

SUMMARY

In section 1, we discuss Valpak's assertion that "Periodicals [c]osting [h]as [b]een [f]ound [a]ccurate," which is based entirely on a recent audit report of the USPS Inspector General that did not look into or purport to assess the correctness of the models, the analytical methodologies, the statistical systems, or the empirical assumptions used in Periodicals costing. The OIG's conclusion, which constitutes the whole of Valpak's case--"Postal Service data collection systems and procedures accurately attribute costs to Periodicals *based on existing cost attribution models*"¹-- thus asserts precisely nothing about the empirical accuracy of Periodicals costing or cost attribution, or about any of the aspects of Periodicals costing or cost attribution that have been the subjects of dispute in Commission proceedings since Docket No. R90-1.

In section 2, we demonstrate that Valpak's implicit assertion that the Commission is authorized to raise the rates of a market-dominant class above the statutory rate cap in a § 3653(b) Annual Compliance Determination by § 3662(c)'s grant of remedial power to order "unlawful rates to be adjusted to lawful levels" is without support in the text of the PAEA, and is contrary to the plain meaning of § 3622(d)(1)(A). We conclude that the Commission must therefore reject as beyond its statutory authority Valpak's urging, at 55, that it "[d]irect the Postal Service to immediately increases [*sic*] prices for Periodicals by 16.0 percent" or by any amount that would cause Periodicals Class rates to exceed the statutory cap.

¹ Valpak comments at 40 (*quoting* Postal Service OIG Report No. CRR-AR-11-001 (Dec. 7, 2010), at 2 [emphasis added by Time Inc.]).

In section 3, we note the absence of certain key details from Valpak's recommendations to the Commission. We urge the Commission to reject the Postal Service's arbitrary *diktat* that it is "impossible . . . acting with the powers granted to it and within the constraints imposed by title 39, to present any realistic plan that would result in [Periodicals Class] fully covering [its] attributable costs." And we dispute Valpak's assertion that the failure of Periodicals Class to cover attributable costs can fairly be viewed as a failure of the price cap system rather than as a failure, chiefly, of Postal Service management over a period that began well before passage of the PAEA.

1. The OIG's report did not state that Periodicals costing or cost-attribution is accurate

There are many unanswered questions concerning Periodicals costs and cost attribution. Valpak attempts to dismiss all of them with a quotation from a recent audit report by the Postal Service Office of Inspector General which states that:

we found that Postal Service data collection systems and procedures accurately attribute costs to Periodicals based on existing cost attribution models.

OIG Report No. CRR-AR-11-001 (Dec. 7, 2010), at 2.

But the key to interpreting this OIG statement is the qualifier at the end: "based on existing cost attribution models."

A close reading of the OIG report makes it clear that the OIG spent no time investigating the appropriateness or accuracy of that vast complex of procedures and unproven assumptions which underlies the "existing cost attribution models." Those procedures have undergone only very minor changes since Docket No. R2006-1. Verifying that those procedures were followed in estimating Periodicals

costs is not the same as verifying that those procedures, and the anomalous results they produce, are correct and appropriate. The ultimate purpose of postal costing is to determine the marginal costs of each postal product. The OIG's audit report should not be blamed for claiming that current costing procedures determine marginal costs correctly, since it did not make such a claim. It simply reported that current cost attribution procedures appeared to have been followed.

One example of an unresolved costing issue that is clearly not addressed in the OIG report is the degree to which costs of mail-processing operations vary with volume. This was disputed over a series of rate cases, from Dockets No. R97-1 to R2006-1, in which a series of econometric models, leading to widely different conclusions, were presented by various parties, and the Commission in the end each time elected to stay with its original assumption that mail-processing costs, with a few exceptions, are exactly 100% volume-variable. The matter might have appeared to have been settled. But late last year the Commission issued an order initiating its "first strategic rulemaking," to which it attached a list of "possible candidate[] . . . areas of research in which . . . modifications or improvements to cost estimation methods should . . . be undertaken [because] there is substantial reason to believe that existing systems are obsolete or otherwise inaccurate." In the item pertaining to Periodicals Class, the list includes "successful modeling of mail processing cost variability."²

² Docket No. RM2011-3, Order No. 589, Notice And Order of Proposed Rulemaking on Periodic Reporting (issued November 18, 2010), at 2, 3, and Attachment-2.

The reason, we assume, for the Commission's willingness to suggest reopening a subject on which it has already heard so much evidence and so often pronounced its views is that something of considerable interest has occurred during the last few years. The unprecedented drop in mail volumes, particularly for flats, has provided empirical evidence of what really happens to postal costs under a massive drop in volume. For the major flats categories, e.g., Standard and Periodicals flats, the costs that should have gone away under the theory of 100% volume variability clearly did not go away, resulting each year in much higher unit costs and therefore lower cost coverage. Despite an unprecedented effort to reduce its workforce, the Postal Service has been unable to reduce it fast enough to avoid throwing more or less the same number of workhours at a diminishing volume of flats. As documented in Time Warner's ACR2009 comments, this has led to sharply higher costs of Periodicals and Standard flats, both in the incoming secondary sorting and in the in-house flats sequencing by carriers.³

If the Postal Service were to succeed in eliminating enough of this excess capacity to restore the efficiency with which it processes flats at least to what it was a few years ago (before the steepest part of the volume decline), the unit costs attributed to Periodicals would be much lower than they have been in recent years. But the past inability of the Postal Service to shed excess capacity over a reasonable period has meant that mail-processing costs have not, as an empirical matter, been nearly as volume-variable as has been assumed, and consequently

³ See Docket No. ACR2009, Initial Comments of Time Warner Inc. on ACR2009 Pursuant to Order No. 380 (filed February 1, 2010), at 11-20.

that the costs attributable to Periodicals have been overestimated and the levels of Periodicals cost coverage have been underestimated.

The OIG audit did not look into such issues and so its report cannot be faulted for failing to address them. Valpak's assertion, at 40, based entirely on the OIG's report, that "Periodicals [c]osting [h]as [b]een [f]ound [a]ccurate" and that "[a]ccordingly, there is no justification for delaying Commission action based on supposed flaws in Periodicals costing," is thus nonsense.

The events of the last few years necessarily have complementary implications for pricing, to which Valpak is equally obtuse. For example, compare the attitude toward "underwater" products of Valpak, which believes it must be concluded that the PAEA is fatally flawed if enormous, immediate rate increases cannot be imposed on them, to that of the USPS Chief Financial Officer. In Docket No. R2010-4, witness Corbett, the Chief Financial Officer of the Postal Service, acknowledged that the costs currently attributed to Periodicals are not a reliable guide to the costs that would be avoided if Periodicals volume were reduced, which is another way of saying that they do not represent true marginal costs. See Tr. I (August 10, 2010), at 82 ("We have largely a fixed cost network . . . [I]f you lose a million pieces of that particular product quickly you will not make more money, you'll lose money, even if that product was underwater in most cases"). When asked, "[I]s pricing that results in continued losses on market dominant product consistent or inconsistent with best practices of economical management?" Corbett responded (*id.* at 79-80):

I think it's consistent in the context of what we're doing here, and that's why I was trying to be clear to say that you have to indicate or determine what impact on your overall profitability a drop in volume of a particular type of mail will bring about. For

example periodicals

When asked, "So, well as Chief Financial Officer, CFO, which you are of the Postal Service, do you think that you have an obligation to include in your business model or in your plans the elimination of everything that doesn't make a profit for the Postal Service?" his answer began: "No I don't actually. I think our primary, my primary objective in the organization is to be, obviously to serve the American public and to do it in a profitable way." *Id.* at 81-82.

2. The plain meaning of § 3622(d)(1)(A) deprives the Commission of authority to increase rates of a market-dominant class above the limitation established by that provision under the remedial authority of § 3662(c)

Valpak states (at 29):

The Postal Service raises an issue as to whether the Commission has authority under 39 U.S.C. section 3662(c) to increase rates over the cap, but Valpak believes this issue is completely clear: the Commission has such authority. Indeed, the Commission has express statutory authority to "order[] unlawful rates to be adjusted to lawful levels...." 39 U.S.C. § 3662(c).

We are unaware that anyone has ever questioned the Commission's authority to order the rate for a market-dominant *product* to be raised above the cap under the provision cited by Valpak. But the issue raised by the Postal Service, of course, is whether the rates for a market-dominant *class* may be ordered raised above the cap under that provision.

The issue is whether the authority to "order[] unlawful rates to be adjusted to lawful levels" entails the authority to order the rates for a market-dominant class to be raised above the cap. It follows that if rate levels above the cap are not lawful for a market dominant class, the answer must be no. What is Valpak's position on

whether rate levels above the cap for a market-dominant class are lawful? It can be inferred from the following assertion on page 31 of its Comments:

The Postal Service's general statement that it "seems impossible for the Postal Service" to set rates by which "products" would fully cover "attributable costs" (FY 2010 ACR, pp. 8-9) is only true for classes like Periodicals and does not apply to products like Standard Mail Flats.

Why is the Postal Service's statement "only true for classes"? Why "does [it] not apply to products"? The answer is found in § 3622(d)(1)(A) and (2) of the Act:

§ 3622

(d) Requirements.—

(1) In general.—The system for regulating rates and classes for market-dominant products shall—

(A) include an annual limitation on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index for All Urban Consumers unadjusted for seasonal variation over the most recent available 12-month period preceding the date the Postal Service files notice of its intention to increase rates;

(2) Limitations.—

(A) Classes of mail.—Except as provided under subparagraph (C), the annual limitations under paragraph (1)(A) shall apply to a class of mail, as defined in the Domestic Mail Classification Schedule as in effect on the date of enactment of the Postal Accountability and Enhancement Act.

In other words, it is true for classes because it is unlawful to set rates above the cap for classes.

So, returning to the quotation from Valpak with which we began, we must agree emphatically that it is completely clear, indeed tautologically clear, that the

Commission's "express statutory authority to 'order[] unlawful rates to be adjusted to lawful levels'" constitutes authority "to increase rates over the cap," so long as the rates in question are not rates to which the cap has application under § 3622(d)(1)(A) in the first place, i.e., so long as they are not the rates of a market-dominant class, in which case the above-cap levels would not be "lawful."

Apparently, that is not what Valpak has in mind. Valpak never actually *asserts* that the Commission is authorized by § 3662(c) to order the rates of a market-dominant class to be raised above the statutory cap. However, Valpak does ask the Commission to issue just such an order. If we combine that fact with the fact that no one questions the Commission's authority to order the rates for a market-dominant *product* raised above the cap, we must assume that Valpak's arguments concerning the legality of raising rates above the cap concern the rates for market-dominant classes. In which case we must object that all of its arguments are fallacious or misleading.

Valpak goes on to say, for instance (at 30):

Moreover, if the Commission has the almost draconian authority to eliminate an entire product, which it unambiguously has under section 3662(c), then it certainly has the power to increase rates above the cap.

First, we do not think that the language of § 3662(c) naturally lends itself to interpreting the word "product" in the phrase "loss-making product" as including entire market-dominant classes. That provision provides as follows (emphasis added):

“(c) ACTION REQUIRED IF COMPLAINT FOUND TO BE JUSTIFIED.—

If the Postal Regulatory Commission finds the complaint to be justified, it shall order that the Postal Service take such action as the Commission considers appropriate in order to achieve compliance with the applicable requirements and to remedy the effects of any noncompliance (such as ordering unlawful rates to be adjusted to lawful levels, ordering the cancellation of market tests, *ordering the Postal Service to discontinue providing loss-making products*, or requiring the Postal Service to make up for revenue shortfalls in competitive products).

In Order No. 536 (at 22), the Commission correctly observes that:

The definition of the term “product” in section 102(6) is so general (“a postal service with a distinct cost or market characteristic”) that almost any category of mail nominated would qualify.

However, one category that might not qualify and, even if it did qualify, was not intended to come within the compass of § 3662(c)'s reference to "loss-making products," is one of the four market-dominant classes. A market-dominant class necessarily includes a great many "products," as defined by § 106(2), often of both a profitable and unprofitable character, but it is difficult to define any sense in which a market-dominant class *is* a "postal service with a distinct cost or market characteristic."

Thus, while we do not dispute the general axiom that greater powers include lesser ones, we fail to see how it leads to the conclusion that the power to order a money-losing product to be discontinued includes the power to order that the rate cap be disregarded for a market-dominant class of mail, which includes many products, some money-losing and some not.

Second, even if one makes the improbable assumption that the term "money-losing products" might include market-dominant classes within its potential scope,

the principle that the greater implicitly includes the lesser cannot be applied in the course of statutory construction when the lesser is expressly excluded, as it is in this instance by § 3662(c)'s limitation of the authority to order rates to be adjusted to "lawful levels." If § 3622(c) intended to authorize remedies notwithstanding § 3622(d)(1)(A)'s rate cap, it presumably would have said so, as does, for example, § 3622(d)(1)(E) (the exigency provision). Instead, by stating without qualification that rates may only be raised to "lawful" levels, it expressly says the opposite.

3. The Commission should beware of vague assurances from interested parties

Valpak's specific recommendation to the Commission concerning Periodicals Class, at 54-55, is as follows:

2. Periodicals Class.

- a. Find that the rates for Periodicals Class are not in compliance with PAEA, and
- b. Direct the Postal Service to immediately increase prices for Periodicals by **16.0 percent** — the amount which would move this class half-way to full coverage in this Docket — followed by another similar increase in the next round of pricing adjustments to get Periodicals at least to full coverage. To the extent possible, these price increases should be focused on the least profitable components of Periodicals.

Thereafter, the Commission can consider what further increases will be necessary to have this product and this class make a reasonable contribution to institutional costs.

The only other alternative would appear to be for the Commission to determine that Congress incorporated a fatal flaw into PAEA, and urge that Congress act immediately to correct such a grievous mistake.

Ordinarily, one would expect a party who is asking an agency to take such dramatic steps, of a nature virtually certain to eventuate in litigation, to specify what provisions of the law it believes support the finding of non-compliance and authorize the remedies it recommends be imposed. But Valpak leaves the Commission to shift for itself with respect to what provision or provisions of chapter 36 it is being asked to find that Periodicals Class is out of compliance with and what statutory authority it is being asked to invoke for raising the rates of a market-dominant class approximately 32 points above the applicable rate cap.

The Commission should not fail to note that missing altogether from its carefully crafted comments is the following assertion, which is indispensable to its recommendation:

- that § 3662(c)'s authority to "order[] unlawful rates to be adjusted to lawful levels" includes authority to order the rates for a market-dominant class to be raised above the applicable statutory rate cap.

Valpak's closing remark that "[t]he *only* other alternative [is] for the Commission to determine that Congress incorporated a fatal flaw into PAEA" makes an extraordinary claim. From the perspective of Periodicals Class, it amounts to the proposition that the "grievous mistake" made by Congress in 2006 was not to provide that Periodicals rates might increase on average by 32 percent more than inflation during the first six years the PAEA was in effect and by indeterminate, but unlimited, amounts thereafter. Moreover, the Commission is told that it must reach the conclusion that this particular mistake "incorporated a fatal flaw into PAEA" at a time when the Postal Service is deep in financial crisis because of an entirely

different congressional mistake, and would be in the black if only that mistake had not occurred.⁴

Valpak's suggestion that "[t]he only other alternative"--i.e., in the likely event that the Commission does not believe it is authorized to do what Valpak asks it to do--"would appear to be for the Commission to determine that Congress incorporated a fatal flaw into PAEA, and urge that Congress act immediately to correct such a grievous mistake" merits only a brief response. Valpak has certainly identified *an* alternative that is open to the Commission--if it believes that Congress was grievously mistaken in not retaining a mechanism by which postal rates automatically rise to produce revenues sufficient to cover whatever costs the Postal Service happens to incur. Such a system is generally called "cost-of-service" regulation. It is an *alternative to* price-cap regulation. It is not compatible with price-cap regulation and cannot be designed as some alternative form of price cap regulation.

For reasons explained in our initial comments, we do not think that the failure of Periodicals Class to cover its attributable costs since passage of the PAEA can fairly be viewed as a failure of the price cap system. We regard it as a failure chiefly, although not exclusively, of Postal Service management, a failure that has complex causes and that long antedates the introduction of price-cap regulation.

⁴ The mistake to which we refer, of course, is the imposition by Congress on the Postal Service of an overly optimistic retiree health benefits prefunding schedule, which--as the Postal Service, the Commission, and the USPS OIG agree--"has transformed what would have been considerable profits into significant losses." See Docket No. R2010-4, Order No. 547 (issued September 30, 2010), at 68-72 (the quotation is from p. 72); see also Oral Statement of David C. Williams, Inspector General, United States Postal Service, before the Subcommittee on Financial Services and General Government, Committee on Appropriations, House of Representatives, February 11, 2011, at 1-2.

Respectfully submitted,

s/

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