Postal Regulatory Commission
Submitted 2/17/2011 3:00:41 PM
Filing ID: 72006
Accepted 2/17/2011

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

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

# Reply Comments of the American Catalog Mailers Association (ACMA)

(February 17, 2011)

ACMA files these reply comments pursuant to Commission Order No. 636.

In initial comments in this docket, several parties, led in strength and length by Valpak, argue that the rates for what is now the Regular Standard Flats[1] product should be raised in significant degree soon.[2] Doing so would harm substantially and irreparably all catalog merchants and nonprofit organizations that need to send flats mail in this country. We believe that doing so is neither required by title 39 nor supported by good ratesetting practice. In particular, we believe that title 39 does not require a myopic focus on the cost coverages of the products as currently defined, nor does it state that the costs as reported must be viewed as sufficient.

---

[1] The term "Regular" is added herein to clarify that the Standard Flats product does not include flats in Standard Mail that are entered as Carry Route, High-Density, or Saturation. Each of these categories includes a Commercial and a Nonprofit component.

[2] Valpak argues that "large steps are now necessary" and suggests an 11 percent increase (pp. 70-71). L.L.Bean speaks of "gradualism" (p. 3). The Public Representative devotes about one page to Regular Flats and suggests an increase of 5 percent (p. 6).

## I. What Valpak Sees and What Valpak Does Not See.

A. In our initial comments, we acknowledge the low cost coverage reported for Regular Standard Flats. This appears to be the only measure Valpak sees. We also discuss how to think about this measure. Valpak does not.

B. In our initial comments, we explain that section 3622(c)(2) does not constrain rates to be above costs for every product *du jour*. Valpak (pp. 30-31) deals with this issue in two bullets. In the first, (c)(2) applies to the class and the class is underwater. In the second, (c)(2) applies to the product and the class is *not* underwater. Valpak seems to have missed the case where (c)(2) applies to the *class* and the class is not underwater. In a lexicon of possibilities, this omission is puzzling..

C. In our initial comments, we explain that for meaningful review, the Regular Standard Flats product should be split into Commercial and Nonprofit, and that it should be considered jointly with the Carrier Route product (and maybe with the High-Density category). Valpak does not mention either of these matters.[3]

---

[3] L.L.Bean, however, discusses the Carrier Route matter and says, among other things, that including Carrier Route would "*lessen* the Postal Service's pricing flexibility" (p. 9, fn. 2, italics in original). At the proposed rates, the rate difference between 5-digit automation and Carrier Route is only 39.8 percent of the cost difference. It is difficult to see that pricing flexibility is at issue. Otherwise, Bean shows concern, and we share that concern, for the levels of Carrier Route costs and rates. But we also note that, given the mighty increases Regular flats received in 2007, a multi-year view already shows the "gradualism" that Bean calls for.

Moreover, as ACMA has written in Commission filings and elsewhere, the large-scale change to catalog rates resulting from Docket No. R2006-1 fundamentally altered the economics of the catalog business. The reduction of catalog volumes by a third since that time pays tribute to this. Until a way of restoring favorable economics can be found, the catalog industry will remain, by and large, financially imperiled, and will fail to generate the volume growth potential it has and the USPS so clearly needs. How this may be done is beyond the scope of this reply, but

D. In our initial comments, we present evidence that the costs in Valpak's crosshairs are so seriously deficient that they do not provide a basis for adjustments in rates, certainly not for strident ones. Except for highlighting a unit cost for Carrier Route letters (a virtually defunct category) that increased 133 percent from last year, and that was once linked to a product Valpak uses, Valpak does not discuss cost deficiencies.[4] We say more about costs infra.

E. In our initial comments, we note that fixing a product's shortfall by increasing its rate and decreasing other rates, within a class, under a cap, would have a net financial effect that is a small fraction of that shortfall, if that. In fact, faced with a volume decline (which we believe would be significant), if the Postal Service could not rein in the costs of producing the product, which is likely in the short to medium term, there would likely be no financial gain at all. Valpak fails to acknowledge this phenomenon and instead speaks repeatedly of "massive financial hemorrhaging" (p. 82), "[d]rown[ing] the Postal Service in [r]ed [i]nk" (p. 44), and "[s]eriously [j]eopardizing" (p. 26) the Postal Service's financial health[5].

---

we appreciate that this bit of history has not been lost on policymakers intent on stimulating future volumes from otherwise healthy customer segments. The importance of taking a variety of market realities into account in changing rates for elastic products, given the new competitive reality of multiple communications alternatives for marketers, must be considered as postal policy moves from a cost driven ratesetting regime to a market based one.

[4] In the case of Periodicals (which are flats too), Valpak advises that the reported costs are "accurate" (p. 40) because a study by the Office of the Inspector General (OIG) found them to be so. But the OIG, in a role similar to that of an auditor, did nothing more than say that the costing algorithms have been followed, as job descriptions would have it. Whether the algorithms yield meaningful costs is different from whether the algorithm grinder ground his algorithms dutifully. Valpak's conclusion of accuracy is unfounded and misleading.

[5] Some of this dire language is the result of the general circumstances the Postal Service finds itself in. The magnitude of red ink from the legacy cost situation has the risk of clouding every judgment. Things are so dire because of it. The circumstances provide an opportunity to advance shrill arguments to correct an alleged injustice that may find a more willing ear given this

F. In our initial comments, we express a belief that a low-cost processing stream for flats is possible and a hope that, by studying its operations and working together with mailers, the Postal Service can achieve such a system. Valpak's argument contains no such vision. Many commentators have wondered at how long it took, apparently, for the automation of letters to result in lower costs. The period is measured in years. While we acknowledge the significant difficulties of automating anything on this scale, we are hopeful that the same thing can happen for flats, but more rapidly.

## II. Building a House on Sand Is Not Likely to Avail Much.

In our initial and reply comments in Docket No. R2010-4 (the exigency request), our comments in Docket No. R2011-2 (the on-going omnibus adjustment), and these comments, we raise troubling questions about the validity of the costs being reported for flats. And it is not only us raising questions. Over a period of years, including in the instant docket, enough questions have been raised about the meaningfulness of the costs of flats that a burden of proof should now rest on the user.

In other words, there is an elephant in the room and his name is Bad Costs. To build on this elephant is to build on sand. The perils of building on sand have been clear for some time.[6] We believe such perils exist here. Valpak

---

and given the comparative impact of flat costs and legacy costs, making the argument that flats are the primary source of red ink simply is exaggerating.

6 *See*: Matthew 7:24-27.

prefers not to see the elephant, but to build on it. We believe a better foundation is needed.

Outside County Periodicals is composed almost entirely of flats and has been either a subclass or a product for many years. For this reason, costs have been available for it. These costs have increased inordinately for over two decades, despite enhancements to mail processing technology, significant capital investments, increases in presorting, increases in dropshipping, and increases in palletization. The Periodicals mailers have documented all this in considerable detail.

The increases in the costs of processing and delivering Standard flats have undoubtedly been similar to those for Periodicals. Indeed one could be used as a first-cut proxy for the other. But the increases for Standard flats have been more difficult to document and display. This is because they have not been treated as a subclass or a product, save in the last two or three years, and costs for them have not been available.

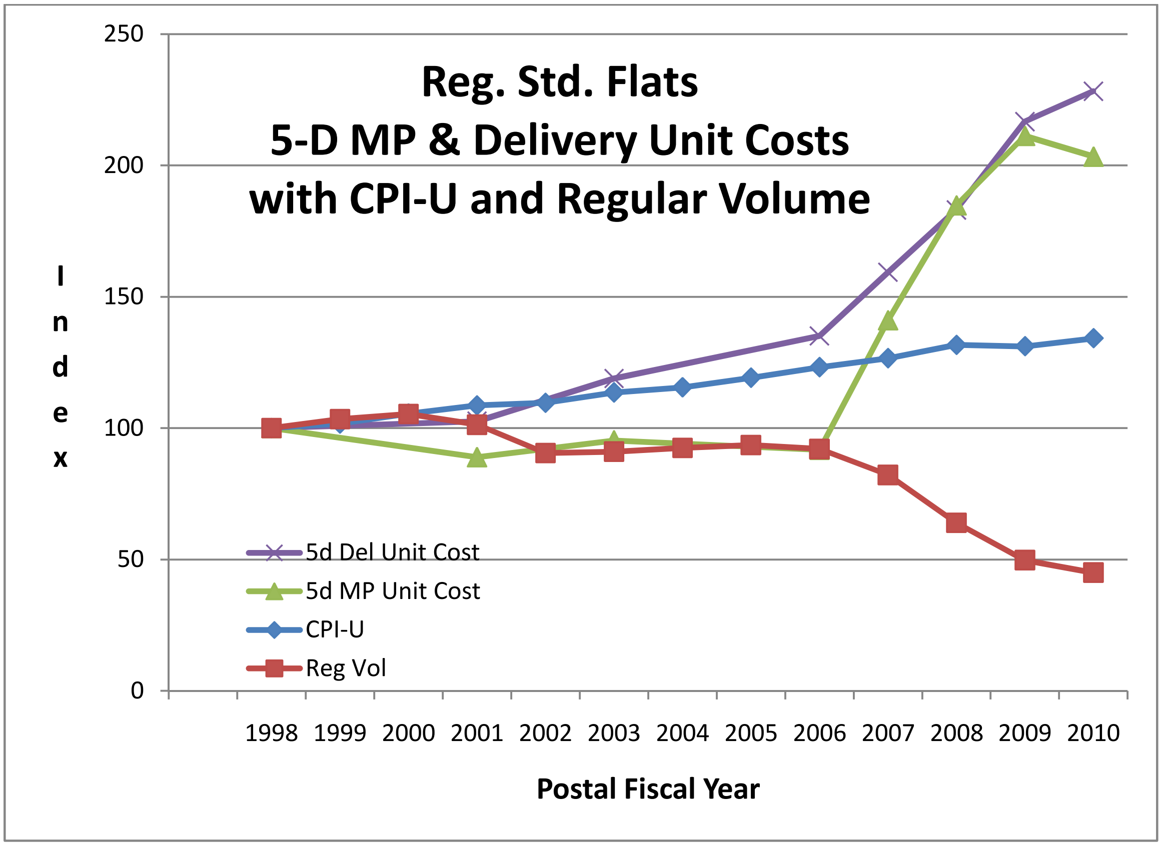
However, mail processing and delivery costs have been developed for a number of years for the flats *presort categories*. These two costs account for about 90 percent of the total attributable costs of flats.[7] We have assembled these costs for 5-digit automation flats, the largest category by far in the current Regular Standard Flats product.[8]

---

[7] *See* USPS-LR-L-125, LR-L-135.xls, tab Unit Costs, Docket No. R2006-1.

[8] Five-digit automation flats were 67.45 percent of all Commercial and Nonprofit flats in FY 2010. Billing Determinants, USPS-FY10-4.

The following graph shows separately the unit costs of mail processing (MP) and delivery for automation 5-digit Regular Standard Flats, indexed to FY 1998.[9] Also shown is an index of volume and the CPI-U. An attachment to these comments discusses certain details and identifies the sources.




On its face, this display is startling. Several notes are in order. First, these costs are immune from any effects of increases in dropshipping. Second, these costs, by definition, should not be influenced by increases in presorting or in the proportion of automation compatible pieces. Third, these costs include Nonprofit in the recent years but not in the early years. Since the Nonprofit costs

[9] In absolute terms: In FY 2010, the unit cost of all Regular Standard Flats was 40.92 cents. Within this, the unit costs of 5-digit automation flats were 20.52 cents mail processing and 15.95 cents delivery.

generally tended to come in lower than the Commercial costs, correcting this would generally lower the costs in the early years and make the cost increases somewhat larger.[10] Fourth, these costs are for 5-digit recently and 3/5-digit in several earlier years. Also, parcels are not separable from other non-letters in some early years, but their volume is small. Correcting either or both of these also would lower the costs in the early years and make the cost increases larger. In short, this display does not suffer from some of the weaknesses of more aggregate displays, and there are reasons for believing that it understates the cost increases.

Two other notes should be made. The costs shown in the display occurred during a period of increasing automation, which should have led to cost decreases.[11] For this reason, probably, a decrease in mail processing cost is shown from FY 1998 to FY 2006. But the reduced figure for FY 2006 (91.8 percent of the FY 1998 level) makes the increases since then even more pronounced. Second, we understand that costing-method changes could have affected these costs.

---

[10] For example, for the 3/5-digit automation category, the Commission's workpapers in Docket No. R97-1 show unit mail processing costs of Commercial to be 10.093 cents and of Nonprofit to be 6.991 cents. For delivery, the two costs, in the same order, are 7.650 cents and 5.887 cents. PRC-LR-13.

[11] The Postal Service's FY 1998 Annual Report (p. 52) says: "We committed $1.2 billion for such labor-saving mail processing equipment as Advanced Facer Canceller Systems and Flat Sorting Machine 1000 Bar Code Readers." The FY 2000 Comprehensive Statement (p. 46) says: "An important addition to our automation processing capability has been the Automated Flat Sorting Machine (AFSM) 100. Deployment of 175 AFSM 100s began in April 2000 and is scheduled for completion in January 2001." The FY 2006 Comprehensive Statement (p. 27), the year the rapid increase in the graph started, says: "A firm fixed-price contract for 148 Automated Flat Sorting Machine Automatic Induction (AFSM-ai) systems was awarded for $125.2 million. The AFSM-ai system improves flat mail preparation and operation on the AFSM 100 platform with a state-of-the-art preparation, transport, and feeding system." A review of such documents over the years shows a continual stream of improvements.

L.L.Bean begins its “DÉJÀ VU HISTORY” (p. 3) by noting that the first coverage available for Regular Flats was in the Compliance Report for FY 2008. It is clear from the above display that the unit costs had increased rather precipitously by that point. Valpak goes back to Docket No. R2006-1, which had a base year of FY 2005, and, though presenting no data for any year, suggests that Regular Flats “then were deeply underwater” (p. 43). The above display shows the costs in FYs 2005 and 2006 to be at moderate levels, before the most troublesome increases.

To the extent, then, that the costs in the above display are indicative, and we believe they are, they show that the volume decline that was beginning at the end of FY 2006 was accompanied by well-nigh explosive increases in the unit costs of both mail processing and delivery. This should not have occurred. It is suggestive of excess capacity in substantial amounts. And it stands in sharp contrast to Valpak’s statement that “the Postal Service has demonstrated exemplary abilities to cut costs to adjust to new volume realities” (p. 81).[12] One message is that unit cost *decreases* will probably accompany any increases in volume. Another is that these costs are not caused in any meaningful way by the flats associated with them. Hence, the resulting cost coverages should not be taken as valid.

## <u>III. Conclusion.</u>

The question is whether the rates for Regular Standard Flats, both

[12] We agree with Valpak that the Postal Service has reduced costs significantly. But we do not believe it has reduced them nearly enough.

Commercial and Nonprofit, as currently defined, were out of compliance with title 39 during FY 2010, a year of decreased volumes due primarily to conditions in the national economy. Valpak (and to a limited degree L.L.Bean and the Public Representative), looking narrowly at the reported cost coverage, without questioning the costs or the way the product is defined, argues that the answer is yes, whether or not section 3622(c)(2) applies in a direct way.

Valpak addresses none of the matters we discussed in our initial and reply comments in Docket No. R2010-4, filed last August and September, including issues relating to the validity of the costs. We address the same matters and more in our initial comments in the instant docket. Further, we present a graph above that displays subject costs in improved historical perspective.

Briefly, as explained above and in our initial comments: 1) Valpak does not see that the most logical grouping for cost coverage attention is Commercial Flats including Carrier Route (and maybe High-Density) or that the coverage for this grouping is 109.57 percent. 2) Valpak does not see that the costs underlying the coverage in its aim are insufficiently meaningful to serve as a basis for ratemaking. To say that the costs leave much to be desired would be an understatement. Accordingly, the record does not support a finding of non-compliance.

Nevertheless, we are not comfortable with the situation that exists currently. We believe that an efficient, low-cost mailstream for flats is possible and that the Postal Service should move heaven and earth to get there, supported by all relevant constituencies. In fact, such is basically the assignment given to it by

Congress. All operations should be examined. Smooth flows should be the goal, and ancillary operations should be eliminated. The graph shown above suggests that an increase in volume will probably reduce unit costs, but cost reductions beyond that are needed. We must also continue to work to find ways to incent volume growth in general and of flats in particular. In the scaled volume business model that surely characterizes the Postal Service, finding ways to creatively increase volumes is paramount, while parallel work to lower costs and improve efficiencies continues apace.

Respectfully submitted,
**American Catalog Mailers Assn., Inc.**

By: Hamilton Davison

Hamilton Davison
President & Executive Director
PO Box 11173 Hauppauge, NY 11788-0941
800-509-9514

Attachment to Reply Comments, ACMA, February 17, 2011.
Docket No. ACR2010. Two pages.

Source information for graph in text. The graph shows the information in indexed to 1998-100. All years are Fiscal Years.

Volumes. Volumes for each year from 1998 through 2010 were obtained from the Billing Determinants for the respective years. When available, the volume of flats is used. When not available, the volume of non-letters is used, which includes parcels. The number of parcels is not large enough to have a material effect on the graph. In all years, the volume is the sum of Regular automation flats and Regular non-automation flats, Commercial and Nonprofit. No categories of the former ECR grouping are included.

CPI-U. These figures for each year from 1998 through 2010 are the March CPI-U value from the Bureau of Labor Statistics, not seasonally adjusted. March is approximately the center of the Fiscal Year.

Costs. For 1998, the test year of Docket No. R97-1 is used. It is thus a systematic reflection of base year 1996. For 2001, the test year of Docket No. R2000-1 is used. It is thus a systematic reflection of base year 1998. For 2002, the test year of Docket No. R2001-1 is used. It is thus a systematic reflection of base year 2000. For 2006, the test year of Docket No. R2005-1 is used. It is thus a systematic reflection of base year 2004. For years 2007 through 2009, costs as reported in Commission library references for the Annual Compliance Reviews are used. For 2010 costs from the Postal Service's ACR filing are used (PRC version not yet available). All costs are for 5d automation flats. In years when separate Nonprofit costs are available, Commercial costs are used. Mail processing (MP) and carrier costs (city and rural combined) are shown separately.

1998: MP and carrier costs from PRC-LR-13, Docket No. R97-1.

2001: MP and carrier costs from PRC-LR-15, Docket No. R2000-1.

2003: MP and carrier costs from PRC-LR-10, Docket No. R2001-1.

2006: MP costs from PRC-LR-13. Carrier costs from USPS-LR-K-67_2nd.revised – PRC Version.xls. Docket No. R2005-1.

2007: MP costs from PRC-LR-5, PRC_Std Reg Flats07ACR.xls. Carrier cost from PRC-LR-7, UDCmodelACR07.PRC.xls. Docket No. ACR2007.

2008: MP costs from PRC-LR-4, STD passthrough ACD.xls, tab FY 2008 unit costs. Carrier cost from PRC-LR-7, UDCmodel2008.xls. Docket No. ACR2008.

2009: PRC-LR-4, STD passthrough ACDFY2009.xls, MP costs on tab F CRA Adj Unit Costs, carrier costs on tab Delivery Costs. Docket No. ACR2009.

2010: MP costs from USPS-FY10-11, STD_Reg_flts 2010.xls, tab CRA ADJ UNIT COSTS. Carrier costs from USPS-FY10-19, UDCmodel10.xls, tab 1.Table 1. Docket No. ACR2010.