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

ANNUAL COMPLIANCE REPORT : Docket No. ACR2010

REPLY COMMENTS OF L.L.BEAN, INC.

(February 17, 2011)

L.L.Bean, Inc. hereby submits its reply comments addressing the Postal Service's Annual Compliance Report filed on December 29, 2010. Our comments focus on the issue of below-cost pricing of Standard Flats.

Just yesterday, the Commission issued Order No. 675 in Docket R2011-2, allowing all of the Postal Service's price adjustments to go into effect. However, the Commission again expressed concerns about the continued and increasingly below-cost Standard Flats pricing, noting that price-adjustment proceedings with their compressed timetable "are not well-suited" to explore issues going beyond compliance with the price-cap and workshare discount restrictions. *Id*. at 4.

The Postal Service.

In our initial comments, we noted that the Postal Service has abandoned its earlier plan submitted last July in Docket R2010-4 for bringing Standard Flats up to full cost coverage through "consecutive above average price increases," an objective that it now claims "seems impossible" to achieve.[1] Since the filing of its ACR report, the Postal Service has come up with a new excuse for failing to move Flats prices in the

[1] L.L.Bean Initial Comments at 6, quoting the Postal Service's ACR report at 8-9.

direction of full coverage: that under the price-cap regime, increasing the prices of Standard Flats will be of no consequence to postal finances.

On February 2, 2011 (the date initial comments were filed), the Postal Service was asked in Chairman's Information Request No. 1 in Docket R2011-2 to explain its rationale for a below-average increase for below-cost Standard Flats. In its response filed February 9th, the Postal Service claims that under the price-cap regime, how it prices its Standard Mail products is irrelevant to its financial stability:

> "*Whether one product or mail category within a class receives an above-average increase or a below-average increase is immaterial*. … The Postal Service does not see how adjusting the prices of products receiving below-average increases to the average level, or indeed, above the average could be expected *a priori* to generate more *revenue* than had the prices remained as initially proposed. Any increase in one product's price would have to be offset by a decrease in the prices of one or more other products with no predictable increase in *total revenues* and no predictable impact on the financial stability of the Postal Service." USPS Response to ChIR No. 1, Question 4 at 8-9 (emphasis added).

This seeming indifference about product pricing has apparently led the Postal Service to believe that maintaining a product at below-cost rates indefinitely is of no consequence to its bottom line.

The problem with this reasoning is that it focuses narrowly on revenues, ignoring volume-growth and mix by product, net contribution, and the impact on the Postal Service's bottom line. Particularly in the case of a below-cost product, a below-average increase means that other above-cost products collectively will receive a higher-than-average increase, as is the case with the profitable Carrier Route product. This means that the Postal Service will be encouraging greater-than-otherwise volumes of moneylosing products while stifling growth of money-making products. We fail to see how this indifferent approach to pricing helps the Postal Service financially.

Indeed, in the Docket R2010-4 exigency proceeding, Postal Service witness Corbett, in a colloquy with Chairman Goldway, ultimately acknowledged that there is a difference between promoting profitable versus unprofitable volumes (Tr. 77-78, emphasis added):

> CHAIRMAN GOLDWAY: You are concerned with any loss of volume.
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> THE WITNESS: Any loss of volume.
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> CHAIRMAN GOLDWAY: Regardless of whether it's profitable or unprofitable?
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> THE WITNESS: …I thought the question you asked was, which once [sic] concerns you more? And given the situation we're in today, *from a financial perspective loss of profitable volume concerns us more than loss of nonprofitable volume*.
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> CHAIRMAN GOLDWAY: But the pricing you submitted doesn't really address that.
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> THE WITNESS: Right.

More broadly, we hope that the Postal Service does not really believe what it says – that the price-cap mechanism makes pricing irrelevant as a means of improving its finances. While the price cap does impose constraints on pricing flexibility, we believe that it still offers substantial room for the Postal Service to encourage the growth of profitable mail volumes if exercised wisely. The Commission in its just-issued order in Docket R2011-2, agrees:

> "The Commission finds that the PAEA affords the Postal Service broad pricing flexibility within the rate cap. While not unlimited, that flexibility is sufficient to allow the Postal Service to address the flats' cost coverage issue within the rate cap. In this proceeding, the Postal Service could have designed Standard Mail Flats prices to better align rates with costs and, over time, allow this product to 'be brought to full cost coverage.'" Order No. 675 at 3.

<u>American Catalog Mailers Association</u>

L.L.Bean agrees with ACMA that impact on the catalog industry is a relevant consideration in deciding how quickly to bring Standard Flats up to full cost coverage, but we further believe that there needs to be movement in that direction now. The problem with below-cost Flats rates has existed for several years, yet the Postal Service has responded with a series of below-average increases – and now another proposed below-average increase in Docket R2011-2 that is less than half the inflation index.

ACMA contends that the below-cost problem with Standard Flats is primarily due to Nonprofit Flats. By law, Standard Nonprofit rates are required to be set at approximately 60-percent of the corresponding Commercial rate. ACMA's notion that the losses on Nonprofit Flats should be covered and shared by all Standard Mail products collectively ignores the reason why those rates are below cost: because the benchmark Commercial Flats rates upon which the Nonprofit rates are pegged are too low.

ACMA's proposed solution – splitting Commercial and Nonprofit categories into separate products – would not accomplish anything. The Postal Service still could not independently set and raise the Nonprofit Flat prices to cover costs, because Nonprofit prices, even as a "separate product," would still have to be set at approximately 60 percent of the corresponding Commercial Flat rate benchmark.

ACMA's other "solution" for below-cost Flats – eliminating Carrier Route as a separate product and throwing it into the Standard Flats product – is equally superficial and unsatisfactory. Its principal benefit would be to use the high markup and positive contribution of Carrier Route mail as an offset to the losses on Flats, in essence masking the below-cost problem with existing Standard Flats. Its other claimed benefit of this reclassification – that "doing so allows the Postal Service a degree of freedom to design rates within" – would, we fear, redound to the benefit of lower-density below-cost mail, to the detriment of Carrier Route mailers and others who use Carrier Route as a means for prospecting and growth. Moreover, such a reclassification would likely constrain rather than enhance true pricing flexibility by making Carrier Route merely a presort tier within the larger grouping.

The only solution that would fix rather than mask the problem is the one ACMA opposes: beginning to move prices for Flats toward full cost coverage and a reasonable contribution to institutional costs.

The Public Representative and Bank of America

In their comments in Docket R2011-2, the Public Representative (PR) and Bank of America (BoA) urged not only that prices for below-cost Standard Flats should be increased higher than proposed by the Postal Service, but also that the offsetting price reductions for the rest of the class should be applied to Standard Letters in order to narrow the cost-coverage differential between Letters and Flats. The Public Representative, for example, claimed that "[c]ontinuing discriminatory treatment of letters compared to flats is contrary to a fundamental directive of the PAEA and should be discontinued." PR Comments at 12. While L.L.Bean agrees that prices for Standard Flats need to move in the direction of full cost coverage, we disagree with the PR/BoA position that the Commission should direct that such increases be applied by the Postal Service under the price-cap to reduce the prices for Standard Letters.

The core regulatory problem with Standard Flats is not the cost-coverage differential with Letters, but that Flats are priced below costs – resulting in higher-than-necessary rates for *all* above-cost products collectively, whether other flat or letter products. The BoA/Public Representative position is a throwback to cost-of-service pricing under the old Postal Reorganization Act where cost differentials were the benchmark for pricing of letters and flats. Under the Postal Accountability and Enhancement Act, however, the Commission has recognized that flats and letters are different products, yet it still sometimes harkens back to cost-based notions of "Efficient Component Pricing" that ignore marketplace factors and would greatly limit the pricing flexibility the new act intended for the Postal Service.[2]

Consistent with the intent of the new law, the Postal Service, in adjusting Standard Flats prices upward closer to full coverage, should be given discretion in determining how to adjust the prices for other Standard products, taking into account marketplace and other pricing factors.

ValPak

We agree with much of Valpak's ACR comments concerning the need to move Standard Flat prices toward full cost recovery. However, in its comments in Docket R2011-2, Valpak proposes an immediate increase of "at least 11 percent," about half of the 22-percent increase it claims is needed for full coverage. Valpak Comments at 11, 8. Compared to the Postal Service's proposed below-average increase, Valpak's

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2 See, for example, Chairman's Information Request No. 1, cited above, which focus on whether the proposed increases for Standard Letters and Flats are a "fair and equitable" allocation of costs under 39 U.S.C. §101(d). The "unfairness" of the below-cost rates for Standard Flats is not confined to the relationship to prices for Letters alone, but extends to the prices for all above-cost products collectively.

proposal errors at the opposite extreme. The better approach lies in between, to begin moving in the right direction without causing a train wreck.

As stated in our initial ACR comments, L.L.Bean does not advocate that prices for below-cost products be raised precipitously to cost-covering or full-contribution levels overnight, but rather that 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. The process of transitioning Standard Flats 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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