

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

Consideration of Technical Methods to Be )  
Applied in Workshare Discount Design )

Docket No. RM2010-13

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND  
VALPAK DEALERS' ASSOCIATION, INC.  
REPLY COMMENTS  
(April 4, 2011)**

**INTRODUCTION**

On October 25, 2010, the Commission issued Order No. 568 setting February 18, 2011 as the due date for Initial Comments, and April 4, 2011 as the due date for Reply Comments. Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. ("Valpak") did not submit initial comments, but submit the following reply comments.

**REPLY COMMENTS**

A total of 14 parties submitted initial comments. Initial Comments from 13 parties were confined to First-Class Mail. Standard Mail was discussed by only one party, Association for Postal Commerce ("PostCom"), which stated that its "comments address Standard Mail **only**; PostCom takes no position with respect to other classes." Initial Comments of PostCom, p. 1 (emphasis added). These comments address the Initial Comments of PostCom.

PostCom suggests the following three modifications with respect to the approach used by the Postal Service and Commission to develop Standard Mail product costs, as well as measuring differences in costs between the various Standard Mail products (*see* Postcom Initial Comments, pp. 4-11):

- Recognize that most Standard Mail products with different degrees of worksharing serve **different markets**, as changes in price alone do not dictate mailers' decisions to choose one product over another.
- Develop product costs through a "**bottom-up**" process, and set prices based on those costs.
- Use **IMb data** for costing, while phasing out reliance on MODS and IOCS data.

Valpak believes PostCom's comments are beneficial, but differs on important matters, as explained below.<sup>1</sup>

**1. PostCom Fails to Acknowledge the Linkage That Exists Between Costs Incurred and Costs Avoided.**

In its discussion of bottom-up costing, PostCom mentions "costs incurred" and "costs avoided" as constituting distinctly different concepts, but does not define either term. For example:

By determining costs from the bottom up, the Postal Service will ensure that each product it offers reflects the **costs incurred** by the Postal Service in providing that product while excluding the costs incurred by mailers engaging in workshare activities.... Thus, the requirement of 39 U.S.C. § 3622(e)(2) that workshare "discounts do not exceed the cost that the Postal Service avoids as a result of workshare activity" will be upheld even without a formal analysis of **avoided costs**. [*Id.*, pp. 7-8 (emphasis added).]

Perhaps no definition or explication is required for "**costs incurred**," since such costs are widely understood to be for expenses paid by the Postal Service and recorded appropriately in

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<sup>1</sup> Counsel for Valpak has suggested changing the way the Postal Service has looked at workshare discounts prior to PAEA. See J. Haldi and W. Olson, "Postal Costing and Pricing: Top Down Discounts versus Bottom Up Surcharges," (Draft) Apr. 1, 2004, <http://www.lawandfreedom.com/site/postal/postalpricing.pdf>.

its accounting records. “**Costs avoided**” is another matter, though. PAEA requires that “discounts do not exceed the **cost** that the Postal Service **avoids** as a result of workshare activity” (39 U.S.C. § 3622(e)(2) (emphasis added)), but provides no operational definition of the term “costs avoided.”

“Costs avoided” represent **hypothetical expenses** for services (*e.g.*, sorting, transportation) that the Postal Service does not provide — *i.e.*, work that the Postal Service does not perform because of mailer worksharing.<sup>2</sup> Developing an operational definition of costs avoided is problematic, because no accounting system ever has been designed to record expenses that are **not incurred** for services (or products) that are **not provided**. This means that no measurement of costs avoided can be obtained directly from records or databases maintained by the Postal Service. Instead, costs avoided must be estimated via some proxy method, which is what the Postal Service now is forced to do.

How does the Postal Service estimate costs avoided for **not sorting** mail of different types, such as letters, flats or parcels? It does so by (i) measuring, to the best of its ability, the unit cost that it incurs for sorting each type (*e.g.*, letters) and category of mail (*e.g.*, bundles or trays of letters presorted to three digits), and (ii) then assuming that the portion of mail which it does not have to process because of mailer worksharing would have the same characteristics and unit cost as similar mail which it does process.

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<sup>2</sup> PAEA includes barcoding as a “worksharing activity,” meaning that if the mailer does not supply a barcode, the Postal Service will print one on the envelope. That description was applicable to the postnet barcode, but not to the Intelligent Mail barcode (“IMb”), which contains information that only the mailer can supply. For more discussion, *see* Section 5, *infra*.

In other words, within Standard Mail, “costs incurred” is used as a proxy, or estimate, for “costs avoided.” This has two immediate implications not mentioned by PostCom. First, measurements, or at least estimates, of cost incurred exist. Second, the estimate of costs avoided is, at best, only as accurate as the measurement of costs incurred.<sup>3</sup>

Any difference between costs incurred and costs avoided, regardless of whether such differences are real or only perceived, predictably will give rise to vexations by one party or another. For example, “APWU argues that ... even workshare discounts that are set at 100 percent of avoided costs exceed the **true cost** the Postal Service is able **to avoid**.” Docket No. ACR2010, ACD, pp. 86-88 (emphasis added).

Bottom-up costing, which relies solely on costs incurred, would eliminate all problems arising from differences between costs incurred and costs avoided.

## **2. Bottom-Up Costing is Feasible Now.**

PostCom’s Initial Comments state that in order “[t]o effectively implement bottom-up costing ... the Postal Service will need to improve its ability to measure costs.” (*Id.*, p. 8.)

This statement appears to be based on PostCom’s failure to recognize that when estimating costs avoided the Postal Service is actually measuring the cost which it incurs for each activity subject

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<sup>3</sup> A potential problem arises whenever less workshared mail requires the Postal Service to incur other costs that are not included within the narrow scope of costs measured for workshared activities. Under those circumstances, a deduction purportedly representing 100 percent of costs avoided would not reflect all costs actually incurred by the Postal Service. When that occurs, costs avoided will be less than, but not equal to, costs incurred. In such instances, estimated cost differences will fail to reflect the full amount that the Postal Service avoids when handling less workshared mail. This situation frequently has been asserted to be a serious problem in First-Class Mail. The various categories of Standard Mail are more homogeneous than single-piece First-Class Mail, and within each category of Standard Mail, this particular costing issue appears to be less serious.

to worksharing. In fact, as pointed out above, the Postal Service already has available sufficient cost information to implement bottom-up costing for Standard Mail. That is not to say, though, that the Postal Service could not or should not improve the accuracy of its cost measurement. (*See* Section 5, *infra*). In fact, one might assume that within Standard Mail, bottom-up costing using available data for costs incurred certainly would be no worse, and probably better than, top-down costs avoided.

### 3. **Bottom-Up Costing Eliminates “Discounts.”**

PostCom notes that bottom-up costing would eliminate discounts altogether (as well as all discussion of costs avoided), while resolving benchmark problems.

Under this [bottom-up] approach, workshare “discounts” would no longer be relevant as the actual cost of the end-to-end operation would be used instead of work avoided for costing purposes. This approach also moots the difficult and often contentious question of defining the proper benchmark. [*Id.*, p. 7.]

As PostCom explains, bottom-up costing starts with the unit cost of Standard letters, flats, or parcels that require the **least amount of handling** by the Postal Service (*e.g.*, Saturation letters and flats), rather than starting with the unit cost of letter, flat, or parcel categories that require the **maximum amount of handling** by the Postal Service. When worksharing discounts for Standard Mail were first implemented, mail with minimal presort was the dominant portion of all Standard Mail. As PostCom notes, a veritable sea change has occurred in the entry profile of Standard Mail in response to worksharing discounts. Those categories that require comparatively little handling by the Postal Service — *i.e.*, the most heavily workshared mail — now represent a major and growing portion of Standard Mail. The large volume of saturation and highly presorted mail provides a far more stable base, or

reference point, for statistical cost measurement than does the relatively small amount of origin-entered mail with only minimum presort (the mail that requires the maximum amount of handling by the Postal Service). In light of the change in entry profile, use of bottom-up costing would better align reference points and costing methodology for Standard Mail with current reality, which should help reduce costing controversy.

With bottom-up costing, the fact that the cost for less workshared categories of letters (or flats) are built upon the cost of more workshared categories of course would continue the cost linkage between various categories. The linkage is simply via **addition**, rather than **subtraction**. Adding differentials for costs incurred, instead of subtracting costs avoided, does not negate the possibility of worksharing relationships. The decision as to whether one category is a workshared variant of another category would still need to be determined by demand considerations.

**4. Bottom-Up Costing Provides a More Business-like and Transparent Perspective on Price Differentials for Activities Subject to Worksharing.**

PostCom's Initial Comments state:

the Postal Service and the Commission should develop product costs through a "bottom-up," rather than "top-down," process, beginning with the costs incurred for pieces of mail that require the last [sic] work input from the USPS [because] doing so will result in more accurate estimates of the costs incurred in processing different types of mail and **allow for the development of more rational price relationships between different types of mail.** [*Id.*, p. 2 (emphasis added).]

As PostCom explains, starting with the least costly categories, each progressively more costly category would reflect the additional costs that the Postal Service incurs to provide additional services required by mail that is less workshared. When translating such additional unit costs

into price differentials, any organization (including the Postal Service) must decide whether price differentials for additional services should reflect:

- (i) less than the additional cost,
- (ii) the additional cost,<sup>4</sup> or
- (iii) more than the additional cost (*i.e.*, cost plus some markup on the additional costs).

PostCom is correct that bottom-up costing would focus attention on the total cost incurred to provide each product.

Bottom-up costing, based on costs incurred, makes the financial implications of pricing decisions, including price differentials, far more transparent. Under most circumstances, standard business practice would be to adopt **option (iii)**, reflect extra costs in a price differential that includes a markup, and occasionally **option (ii)**, depending on demand considerations. Rarely, if ever, would a profit-oriented business select **option (i)**, and price additional services **below** the additional cost which they cause the firm to incur. However, 39 U.S.C. § 3622(e)(2) requires that most price differentials not exceed the costs incurred. In other words, except for those price differentials that qualify as meeting one of the exceptions specified in PAEA, the Postal Service is restricted to **option (i)**, pricing additional services below their cost, or **option (ii)**, just recovering additional cost in the price differential.<sup>5</sup>

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<sup>4</sup> This option, setting the price differential just equal to the cost difference, conforms with the Efficient Component Pricing (ECP) principle.

<sup>5</sup> In view of the Postal Service's strained financial condition, pricing any service below attributable cost does not appear advisable.

Any price differential that reflects **less** than the additional costs incurred, **option (i)** above, or that **just** reflects the additional costs incurred, **option (ii)** above, is seen to be in full compliance with 3622(e)(2) — *i.e.*, the PAEA automatically sanctions any price differential that fails to cover the cost of the associated services.<sup>6</sup> Any price differential that reflects **more** than the costs incurred, **option (iii)** above, must qualify under one of the exceptions allowed by the law. When postal pricing is viewed from the perspective of bottom-up costing, the PAEA is seen to impose, perhaps inadvertently, a pricing paradigm that favors loss leaders and is counter to standard business practice.

**5. Mailflow Data Provided by Intelligent Mail Could Help Improve the Postal Service’s Cost Models, But Not By Phasing Out MODS or the IOCS.**

PostCom observes:

Currently, the IMb is falling short of the expectations first envisioned by the industry and Postal Service, becoming a burdensome task that has caused more costs than benefits for both the Postal Service an [sic] its customers. [*Id.*, p. 10.]

Valpak agrees that any discussion about use of data from intelligent mail depends on widespread mailer adoption of IMb, especially the full-service option, and concurs wholeheartedly with PostCom that within Standard Mail the Postal Service has not done nearly enough to encourage adoption of the full-service IMb option. The results speak for themselves. The rate of adoption of IMb in Standard Mail lags far below First-Class Mail or Periodicals.<sup>7</sup> Within Standard Mail,

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<sup>6</sup> Since worksharing activities have independent prices, or price differentials, they can be viewed as optional, or “severable” services. Severable services priced below cost are sometimes referred to as “loss leaders.”

<sup>7</sup> See Docket No. ACR2010, FY2010 Annual Compliance Determination, p. 47, Table V-3.

the meager price differential for adoption of Full-Service IMb offers virtually no incentive to make the requisite investment for participation; it even can be viewed as encouraging “freeloading” by many mailers who stand to reap benefits from service improvement while doing nothing.

It seems likely that even by the end of FY 2011 Standard Mail usage of IMb will be far short of 90 percent, the level previously hoped to be achieved. Valpak has previously commented how and why the Postal Service should increase the pecuniary incentive within Standard Mail for mailer participation.<sup>8</sup> Failure of the Postal Service to provide incentives adequate to promote more mailer enthusiasm for IMb could cause the whole system to be jettisoned.<sup>9</sup> And alternate performance measurement systems do exist, *e.g.*, UNEX, which uses Radio Frequency Identification (RFID) technology.<sup>10</sup>

In stressing the desirability of more accurate estimates of costs incurred when processing different categories of Standard Mail, PostCom also states:

to ensure that the Postal Service has accurate cost data on which to rely, the Postal Service should make greater use of Intelligent Mail

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<sup>8</sup> See Docket No. RM2011-7, Valpak Direct Marketing Systems, Inc. and Valpak Dealers’ Association, Inc. Comments Regarding Request for Temporary Waiver from Periodic Reporting of Service Performance Measurement (February 15, 2011).

<sup>9</sup> The Commission implicitly notes these alternatives: “Should growth [of IMb adoption] not continue during this fiscal year, the Commission may review its previous decision to allow the Postal Service to proceed with development of an internal IMb based hybrid measurement system.” Docket No. ACR2010, FY2010 Annual Compliance Determination, p. 67.

<sup>10</sup> *Id.*, p. 63. The ACD reports that more than 40 postal administrations currently participate in the UNEX system.

barcode (“IMb”) data **while phasing out its reliance on MODS and IOCS data.** [*Id.*, p. 3 (emphasis added).]

Valpak agrees that more accurate cost estimates, including elimination of various anomalies, is highly desirable, but the MODS and IOCS systems need to be refined and improved, not jettisoned as PostCom proposes.

### CONCLUSION

Contrary to what PostCom asserts, bottom-up costing for Standard Mail is entirely feasible now. Among the advantages of using costs incurred for each category within each product, the foundation for pricing decisions would be more business-like, and the cost basis for price differentials within each category would become more transparent. Valpak recommends that the Postal Service and the Commission move toward the early adoption of bottom-up costing for Standard Mail.

A larger pecuniary incentive (price differential) to encourage wider and faster adoption of the Full-Service Intelligent Mail barcode in Standard Mail is highly desirable for a number of reasons. Among them, the IMb has the potential to improve substantially the data used in Postal Service cost models. However, adoption within Standard Mail is lagging badly. The Postal Service should implement a larger (but still revenue-neutral) pecuniary incentive designed to jump-start the adoption rate by mailers.

Respectfully submitted,

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